



Considering Buying an Investment Property?

Vacation Rental Versus Long Term Rental

Now would be a good time to purchase property held for investment and due to market conditions, a rental home in the San Juans would be the best investment. We are not like the metropolitan areas nearby with multiple offers on most every property and robust appreciation; we remain in a buyer's market in most categories of property.

Once you have made the decision of the type of investment property to purchase, then how you intend to use that property is the next process; vacation rental or long-term rental. To assist you with this process, I have compared the different aspects of each below.

Vacation Rental General Description

The most successful and thereby most desirable properties include waterfront or view homes, homes with docks, hot tubs, pools and those that offer gaming tables such as a ping pong or a pool table. Flat usable land and having good internet connectivity is a must; your tenants must stay connected while on holiday. Allowing at least small dogs will increase your occupancy numbers.

Buying a home with an existing permit, customer list, website and income history is the most efficient avenue. The permit for a vacation rental runs with the land. It is annually renewed automatically but can be voided by the County should the home not be used as a vacation rental within the last 12 months.

The cost to obtain a vacation rental permit can be up to \$2300 plus the consultant that will process the application. The consultant will charge around \$600-\$1000 subject to complexity.

It is possible to process a vacation rental permit directly with the County but in the long run, it is more beneficial to work with a professional who does them on a regular basis.

The process requires the corners of the lot be well marked, which may require a survey if you are not able to locate them. The application requires a current water test, if on a private well and recent septic

inspection. The owner must evidence adequate parking and access roads to allow for fire protection and emergency vehicles. Floor plans are required so a designer may be needed to create those.

The owner or manager must publish rules of conduct for the individual home as well as a telephone list of emergency and contact numbers. The owners must have an on-island person for the tenants to contact at all times. Providing details of operation is advisable, especially for appliances and systems.

Further, many homeowners have developed their own set of rules, such as being respectful of the neighbors, garbage, recycling and water use conservation suggestions. The County does restrict head count based on a maximum of three people per bedroom for occupancy and a total allowed for gatherings. Some homeowners have a pet restriction as well.

Most any property is eligible for a vacation rental permit however there are some exceptions.

- If you are in town and on town water, vacation permits are not allowed unless you are commercially zoned.
- If you are in the County and hooked up to town water, vacation permits are not allowed.
- Many plats contain a provision in their Covenants, Conditions and Restrictions which prohibit vacation rentals.
- If you have a home and guest house on one parcel, one of the structures must be owner occupied or be a long-term rental, you may not have individual vacation rentals in both structures.

You do not want to operate a vacation rental without the proper permit. The County has regulations that must be complied with and notable fines and penalties for failure to operate your business properly.

Long Term Rental General Description

A non-transient rental property is described as a rental occupied by a tenant on at least a month-to-month agreement or a term lease. The typical lease is for 12 months and will terminate with notice at the end of the term or convert to a month-to-month until terminated. Notice of termination is normally given in the range of 20-60 days.

Many of these homes are rented direct by the owners without the use of professional management firms. However, if one decides to go that direction, they must be knowledgeable about the Washington State Tenant Landlord ACT plus the owner must have a separate trust bank account.

Some plats have Covenants, Conditions and Restrictions that restrict against occupancy by a long-term tenant, but very few. The Oaks manufactured home park on San Juan is an example, but they also have an exception for homes on the market.

Income and Expense Review

Most property owners will consider the net income calculation for each type of rental as their decision maker. For the example shown below, I used a three-bedroom, two-bath waterfront home with approximately 1800 sf. The home is valued near \$850,000 and has a well and septic. Per the vacation rental calendar on a similar home, the rent range is from \$225 to \$475 per night subject to the time of year. I used the calendar schedule of varying nightly rates and 100 days of occupancy which was generally the end of May through September. I have noted that the majority of the homes produce at least \$25,000 per year and some produce as high as \$90,000. Of course, the homes at the high-end of the range offers more amenities than the low end.

Proforma for Vacation Rental Versus Long Term Rental for the **FIRST** 12 months

	Vacation Rental	Long Term Rental
Income	\$35,000	\$2,100/mo - \$25,200/ yr
Expenses:		
Water & Sewer Fees	?	Paid by Tenant
Power	\$1550	Paid by Tenant
Propane	\$1300	Paid by Tenant
Rental Home Insurance	\$2520 - Commercial	\$1560- Standard Rental
Umbrella Policy	\$250	\$250
Garbage	Included in Mgt Fee	Paid by Tenant
Taxes	\$4300	\$4300
Management Fee	30%-35% or \$10,500-\$12,250	First month's rent plus 10% monthly or \$4620.
Phone & DSL or Fiber	\$1400	Paid by Tenant
Website/ VRBO	\$400	0
TV Dish or Direct	\$800	Paid by Tenant
Yard Maintenance	\$1300	Done by Tenant?
Cleaning	Billed to Tenant	Done or Paid by tenant
Repairs	???	???
B&O Tax	Applicable	Not Applicable
NET INCOME	\$10,680-\$8,930	\$14,470
Debt Service	?	?

Expenses Comments

Of course, if the home you intend to purchase has HOA dues, water and sewage usage fees, those fees need to be added into this proforma. Similar, if the home didn't have propane, it would need to be excluded. Typically, the long-term tenants pay for their utilities but it all depends on the negotiations at the time of the lease. This chart can't take everything into consideration and is not intended to be relied upon.

Maintenance and Repairs

The overall property maintenance will be more for a vacation rental as the property grounds must be mowed and tidied up regularly. Repairs will also be higher for a vacation rental as the tenant is less likely to be familiar with the various systems and operation of the home versus a long-term tenant so damage may occur, requiring regular maintenance. The property management firms arrange for repairs at \$50 plus per hour and cleaning at \$35, which is close to market rates.

The general types of repairs would be similar, although a long-term tenant may be more accepting of a broken microwave versus a vacation tenant. It is not possible to include the analysis for maintenance and repairs in this article unless I had the data on a home that was a vacation rental for one year then a long-term rental for the next.

Proforma

In the proforma above for this type of home, it is more favorable to rent under a long-term rental situation. Again, as I mentioned, there is no way for me to analyze the comparison in generalities. You need to process a comparison spreadsheet based on the home you own or the home you intend to purchase based on the actual income and expense.

Other differences include the following:

Property Management

Vacation

The management for a vacation rental is very complex. They are running the home similar to a hotel and are on call 24-7. The management fees vary subject to the level of service, but the range is 30-35%. Roche Harbor charges 49% however they originate most of the clients directly due to their wedding and events business and they offer more services and amenities.

The management firms operate a website that showcases the property, most feature it on Air B&B and/or Vacation Rental by Owner (VRBO), make reservations, collect rent, deposits, and prepare the home for each tenant. They must make immediate repairs as needed and have repair persons and cleaning people on staff or 1099 contractors at their beckon-call. The firm is not required to have a Washington State Brokers license or Trust account for the deposits.

Long-Term

The long-term rental management can be a phased management. You can hire them to run ads, screen and credit check the tenant, write the lease and collect the first month's rent, damage deposit and last month's rent, and then end their services. This first phase of the service charge is typically equal to the first month's rent. If you want full service, then they would also collect the monthly rent and provide any notices and administer final departure services required with the tenant. They monitor the condition of the property during the tenant's occupancy. Typical fee is equal to the first month's rent plus 10% monthly thereafter. The firm must hold a broker's license and have a trust account for funds.

Self-Manage

As a property owner you may self-manage a property and avoid the management fees. However, you must be willing to complete all of the necessary functions. The lure of a lucrative investment is strong but the romance of it ends quickly once you must go out and unplug a toilet in the middle of your own dinner party. I have interviewed many property owners who started off as self-managed and soon changed their approach to hiring the professionals that have regular connections with service providers and the knowledge of the industry. VRBO and Air B&B are common websites that owners join to self-manage.

Whether you self-manage or hire management, a business license is required for the operation, which requires payment of B&O taxes. Proof of filing of B&O tax is what the County may require as evidence of an active rental which is required for the permit renewal.

Options for property management firms are very low on San Juan Island. We have more options for vacation rental management firms as the regulations are less; no brokerage license required or state regulated trust accounts. It is easier to manage vacation rentals from a regulatory standpoint but more difficult in reality. There are only a few long-term management firms on San Juan. Generally, property management is a difficult field to work in; very demanding and very competitive.

One large benefit to using the professional firms is they most likely have Errors and Omissions insurance which may cover the liability should an event occur.

We often suggest that our clients looking for long term rentals view the online newspapers or use Facebook; San Juan Buy and Sell and San Juan Island Rental/House Share. Posting on those sites may be advantageous to a property owner.

As it is more difficult to find a long-term property management firm on this island than a vacation rental manager, this may be the decision factor for some of the property owners.

General Information

The tax assessor no longer adds value to the home if it has a vacation rental permit. The value to buyers can be recognized or discounted. The vacation rental or long-term lease will narrow the size of the buyer pool for the property if the buyer had hoped to occupy their new home immediately after

closing. Further most lenders require occupancy by the borrower within 60 days of closing if the loan was intended for a primary residence.

If the lenders know that the home will be operated as a vacation rental, they will only grant a commercial loan with less attractive rate and terms than a conventional loan. Generally, not disclosing to your lender that you intend to operate a vacation rental business out of the home is considered fraud.

More buyers in our market are looking to purchase for second home or primary residence versus a rental property. However, many are willing to purchase the right home subject to the rental agreements or reserved vacation rentals, but transactions have been lost due to tenant's rights.

Cancelling vacation rental reservations is not a simple process and most management firms have a 120-day notice provision if the property is on the market for sale. In order to cancel, the vacation rental client may need to be reimbursed for their air-flights and other travel arrangements that they have made. Can you imagine making *that* phone call to the coordinator of the up and coming July family reunion?

Technically, the property management firm has earned their fees for the transaction so those are due as well. Agents will comment in the remarks section of a listing if the property is subject to any form of lease or vacation rental and whether they have a delayed closing date.

It is very difficult to have a home on the market while being an active vacation rental. An agent must arrange the showings around the vacation rental tenant so the showing activity will be less. For many homes, you can only show during a day with a turnover; after checkout, after cleaning but before the next check in. That time frame doesn't always work with your buying client's schedule.

Impacts to the Neighborhoods

Impacts to a neighborhood are very difficult to measure. For a vacation home, a tenant may travel on the roads four times a day for the 100 days the home is occupied. During long term occupancy, the tenant may travel on the roads two times a day for 300 days a year, taking the weekends off; minor differences.

For those homes on community water systems or sewer, most communities have a provision for excess use which is billed to the owners or tenants if long term.

There may be a gathering at the vacation home that results in noise beyond what the neighbors would determine is acceptable. The sheriff is available to respond to this type of disturbance. The neighbors can also contact the property management firm or the on-island person in the case of those noisy events. Based on the number of vacation rentals as compared to all homes, the sheriff is more likely responding to a primary residence disturbance.

Impacts to the Economy

Homes offered into the long-term rental pool provide local housing for islanders. Residents living and working here over the long term tend to have pride in community which results in maintenance of the home and may result in a home purchase in the future.

Vacation homes offer economic gain into the community and to the owner. While visiting, tenants enjoy retail therapy, restaurants, kayaking and whale watching. Some may end up deciding that purchasing a home here is in their future.

B&O tax is generated back from the state into our local government. However, most of the vacation rentals properties pay little or no tax as they generate less than \$90,000 in annual gross income so a small business credit applies to reduce the B&O tax liability to \$0.

Depending on the home and its amenities, deciding to use your investment as a vacation rental MAY reduce the number of homes in the long-term rental pool and may drive up the rental rates for the remaining long-term properties due to high demand and less inventory.

As the market has improved, many owners have decided it is time to sell versus having the home as a long-term rental which has added more pressure.

The vacation rental homes are mostly occupied in the summer months and this coincides with when the second homeowners return and desire to hire staff or service providers to help with their property maintenance. These service providers may be the very ones seeking long-term housing.

Bottom line Points:

Very few homes on this island “pencil out” as an investment when you take debt service into consideration. If you own the home free and clear you may enjoy some cash flow. Our rents are not high enough to balance with the price of the homes. **The investor needs to rely upon their Schedule E for tax write offs and appreciation to come out ahead on a rental property here.**

The vacation rental investment is replacing the second home purchase. Buyers have figured out that when they are not using the home, it can be rented and most buyers of second homes only use them for a few months out of the year anyway. Great tax benefits as a rental, owner use when desired; best of both worlds.

Having the home be a rental for 120 days in the summer then a long-term rental during the rest of the year is possible, but may be difficult to accomplish. You would have to change management firms as the services needed are different for each type of rental. Timing is everything; you won't get top dollar for your long-term rental when trying to find an occupant in October versus June.

Long-term rentals are in demand in our community. Not a week goes by that a prospective tenant doesn't contact our office looking for a rental house. In last week's Journal, 7 of the 8 public notices were for vacation rental permits.

The vacation rental isn't often the type of home that the long-term tenant is typically seeking. The most successful vacation rentals are waterfront or water view homes and perhaps a dock. If these were offered as long-term rentals, they may be over \$2100 per month which may be out of the range of most of the islanders seeking a long-term rental.

Solutions to Creating more Rental Housing?

If a hard-working resident must work two jobs to afford a rental or camp, we have an issue. Ask any of the general contractors looking for skilled labors, the turnover is too high.

Allowing detached guest homes on parcels that are less than 5 acres may create inventory in the rental pool. (Currently you may have a guest house on less than five acres only if it is attached to the main house)

Allowing the vacation rental of the guest houses in addition to the main house, this would generally result in the rent being lower as the guest houses are smaller homes.

Zoning and the cost of construction including hookup fees all need to be considered. Most investors have no interest in building an apartment or other multifamily units as they do not "pencil" on island, the capitalization rate is below a good investment return. The town fees for water and sewer hookups per unit and the monthly fees are too high for a typical investment proforma, so there is no incentive. At the present time, it is more cost effective to purchase existing than it is to build. It has been many years since an apartment was constructed in town by the private sector and there is a reason why.

As an author, I have tried to remain neutral in this article but as a REALTOR I find it difficult. In a perfect world, an owner of a home producing around \$25,000 per year in long-term rental income will decide their home doesn't "pencil" as well as a vacation rental and should be offered as a long-term rental. The numbers make more sense at this level as a long-term rental. The owners of high-end homes with amenities should continue to offer them as a vacation rental as it is good for our economy.

Each investor needs to do the math and make their own decision.

As for my disclosure, as usual, this article is meant for informational purposes and not intended to be all encompassing of the details. My proforma of income and expense comparison is not perfect.

Once again, I apologize for being lengthy, I am a wordy gal.

