Tax considerations for ownership of Vacation Rental Property

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ABSTRACT

A young couple with two young children has found themselves with the income they need to invest. They come to a tax accountant to discuss their investment plan in a vacation rental property. A vacation-rental-property investment provides an issue-rich context in which students can examine tax considerations, ownership structure, and state and federal taxes. The case illustrates how the rapidly advancing field of vacation rentals is evolving due to technological advances and the tax regulations that inevitably follow rapid changes. This case introduces students to the complexities of interpreting the IRS Tax Code and providing professional advice. The goals of the case are to improve students' (1) abilities to identify tax issues for vacation-rental properties, (2) skills in recommending the appropriate ownership structure to maximize tax savings, (3) federal tax research proficiency, (4) written communication skills, and (5) client-tax planning skills. The case helps educators deliver value to students by providing an opportunity for students to practice a professional accounting scenario. Students learn to communicate the total picture clearly and objectively, translate complex information into critical knowledge, and anticipate and create opportunities to minimize tax expenses.

Keywords: vacation rental property, taxes, ownership structure, tax code

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INTRODUCTION

Steven and Jessica Valmont, a married couple, just celebrated their youngest daughter's graduation from preschool. After almost a decade of paying for childcare, they finally finished paying for childcare. In addition, Steven's income had increased exponentially. The young couple plan to invest some of their disposable income in a vacation rental property (VRP). They realized the vacation rental property they were staying in for their daughter's graduation would be a good opportunity for them to pursue. They know they need their investment to generate revenue.

Jessica is a stay-at-home mom and blogger in rural Texas, and Steven is a sales agent for a nationwide metal distributor. Their assets include their home, two vehicles, and 401Ks from work. Their combined income ranges from $300k to $410k, depending on the size of Steven's bonus. They know they cannot count on the bonus, and in the past few years, metal sales have been slow, so their income has been closer to $300k.

The Valmonts feel they have lived fiscally responsible lives and have little credit card debt, which they pay the balance monthly. Their major expenses are their home mortgage, related home expenses, a new SUV, and Steven's university loans (see Exhibit 1 for a list of income and expenses). They believe their budget would allow them to invest $2,500 per month in the VRP and the $40,000 they have saved to invest in the project without dipping into their 401Ks.

Jessica and Steven discussed using their home's $150,000 equity to finance an additional downpayment. While Steven would prefer not to tap into their home's equity due to high interest rates, Jessica convinced him that it might be their best option, even at the high rates. They agreed to discuss it with their advisor because they know investment property loans can carry a higher interest rate.

Jessica and Steven are unsure where they would like their VRP to be located. They enjoy vacationing with their young children in Florida and South Carolina. Besides their family vacations, they have not traveled much outside Texas. Their favorite places to travel are Disneyworld and the beaches in South Carolina.

In addition, the couple is unsure of the size or type of VRP they might be interested in purchasing. (See Exhibit 1 for property pricing by location and size). They prefer a small and cozy VRP when they travel, but they would like to invite family and friends on some of their trips, and they know the children will only be young for another seven years. They know they do not want a timeshare or other co-owned property but would consider the right condo if it met all their requirements. There is so much to consider, so they contacted a CPA to help them understand and plan for a successful VRP purchase.

Jessica and Steven come to your firm with this information for tax and advisory services. Your assistant has prepared the Exhibits based on your request for preliminary information in Tables 1-4 (See Appendices 1 & 2).

REQUIREMENTS

1. Review the case and IRS Code Sections covering ownership structure and vacation rental property use. Create a summary of any questions for the Valmonts to consider. Submit this to your instructor.
2. After receiving the Valmonts' answers (from your instructor), prepare the following:

   a. A one-page memo detailing the type of ownership structure the Valmonts can use for tax purposes.
   b. A one-page memo detailing the tax consequences for mixed-use properties (vacation and rental) based on the options available to the Valmonts and the different implications of each option.
3. Based on your research, prepare a memo for the Valmonts to recommend a location for their property. Include any exhibits and pro forma calculations as appendices for your memo. Make sure that the recommendations for the Valmonts are supported and referenced in your research.

INSTRUCTOR'S MANUAL

The goals of the case are to improve students' (1) abilities to identify tax issues for vacation-rental properties, (2) skills in recommending the appropriate ownership structure to maximize tax savings, (3) federal tax research proficiency, (4) written communication skills, and (5) client-tax planning skills. The case helps educators deliver value to students by providing an opportunity for students to practice a professional accounting scenario. Students learn to communicate the total picture clearly and objectively, translate complex information into critical knowledge, and anticipate and create opportunities to minimize tax expenses.

LEARNING OBJECTIVES

1. Improve students' abilities to identify tax issues for VRPs.
2. Improve students' abilities to recommend the appropriate ownership structure given tax goals.
3. Improve federal tax research proficiency for VRPs.
4. Develop professional writing skills.
5. Improve client-tax planning skills.

RELEVANT COURSES

- Personal Income Taxation
- Advanced Income Tax
- Financial Planning
- Estate Planning

SUGGESTIONS FOR CLASSROOM USE

This case illustrates the tax complexities that arise when investing in a VRP. This type of investment has become prevalent since businesses like VRBO and Airbnb make it easier for individuals to manage and market their VRP. The students utilize the IRS Tax Code to benefit hypothetical clients in a scenario they will likely encounter after graduation; some may even see themselves investing in a VRP.

Students must analyze the assigned IRS Tax Code Sections, receive feedback from the client, and prepare a tax memo. Answering questions in a text is a stark difference from working with hypothetical clients. Providing an opportunity for project-based learning enhances learning.

Students formulate a clear understanding of the tax implications of buying a VRP and the types of ownership structure the client chooses. Students analyze the scenarios the Valmonts choose and create financial plans for each scenario.

Instructors can use this project as a half-semester or capstone project in their courses. They can also modify the data and states selected to make it more relevant to their students. In addition, instructors can remove the specific code section in Requirement #2 and have the students search the IRS Tax Code for the relevant code sections, expanding the assignment or making it more challenging.

REQUIREMENTS

1. Review the case and IRS Code Sections covering ownership structure and vacation rental property use. Create a summary of any questions for the Valmonts to consider. Submit this to your instructor. (LO 1)
2. After receiving the Valmonts' answers (from your instructor), prepare the following:
   a. A one-page memo that details the type of ownership structure the Valmonts can use for tax purposes (See Appendix 3 for an example memo).
   b. A one-page memo detailing the tax consequences for mixed-use properties (vacation and rental) based on the options available to the Valmonts and the different implications of each option (See Appendix 4 for an example memo). (LO 2, 3, & 4)
3. Based on your research, prepare a memo for the Valmonts to recommend a location for their property. Include any exhibits and tables you use as appendices for your memo. Make sure that the recommendations for the Valmonts are supported and referenced in your research. See Appendix 5 for a sample memo. (LO 3, 4, & 5)

Example Answers to #1

1. What are the Valmonts' primary goals for investing in a vacation rental property?
2. What are the Valmonts' financial resources and constraints?
3. What are the Valmonts' preferences regarding the location, size, and type of vacation rental property?

*Additional answers are available from the corresponding author, Paul R. Goodchild, Ph.D., CPA (MA) at pgoodchild@tamut.edu

RESEARCH METHODOLOGY

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LITERATURE REVIEW: BENEFITS OF USING CASES IN CLASS

The case method has been a cornerstone of teaching in disciplines like law and business for many years. It involves presenting students with real-world scenarios or problems that require them to apply theoretical knowledge and critical thinking skills to develop solutions. This method has recently gained popularity as a pedagogical approach in accounting education (Merriam & Caffarella, 1999).

Improved student engagement

One primary benefit of using cases in class is increased student engagement. Cases provide an interactive and immersive learning experience that encourages students to participate actively in discussions, debates, and problem-solving activities. By grappling with complex situations, students develop a deeper understanding of the subject matter and its practical implications (Kolb, 1984).

Enhanced critical thinking and problem-solving skills

Cases challenge students to analyze information, identify key issues, evaluate alternatives, and formulate solutions. This process hones their critical thinking and problem-solving skills, which are essential for success in both academic and professional settings (Piaget, 1950; Wilson et al., 2016).

Development of communication and teamwork skills

Case discussions and group projects foster collaboration and communication among students. They learn to articulate their ideas, listen to different perspectives, and work together to achieve common goals. These skills are vital for effective teamwork and leadership in the workplace (Vygotsky, 1978).

Bridging the gap between theory and practice

Cases bridge the gap between theoretical concepts and real-world applications. They demonstrate how accounting principles and practices are used in various contexts, making the subject matter more relevant and meaningful for students. This practical approach can enhance their understanding and retention of knowledge (Christensen, 1981).

Preparation for the professional world

Cases prepare students for the complexities they will encounter in their future careers by simulating real-world challenges. They develop the skills and confidence to tackle ambiguous situations, make informed decisions, and navigate ethical dilemmas. This practical experience can give them a competitive edge in the job market (Kolb, 1984).

Conclusion

Using cases in accounting education offers numerous benefits, from increased engagement and critical thinking to improved communication and teamwork skills. By providing a practical and immersive learning experience, cases can enhance students' understanding of accounting concepts, prepare them for the challenges of the professional world, and inspire them to become successful and ethical accounting professionals (Morris, 2020).

DECLARATION OF GENERATIVE AI AND AI-ASSISTED TECHNOLOGIES IN THE WRITING PROCESS

While preparing this work, the author used Gemini, Google's AI language model, and Grammarly AI. Gemini and Grammarly were used to assist in case development and to expand potential student responses. After using these tools, the authors reviewed and edited the content and take full responsibility for the publication's content.

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APPENDIX 1

Table 1 - Vacation Rental Property Pricing

Location	Price	Square Footage	Bedrooms	Bathrooms	Yard Acreage	HOA Fees
South Carolina						
Myrtle Beach	$200,000	1,200	2	2	0.1	
Hilton Head	$350,000	2,000	3	2.5	0.25	$500 per month
Kiawah Island	$500,000	3,000	4	3.5	0.5	$1,000 per month
Florida						
Panama City Beach	$200,000	1,000	2	2	0.1	
Sanibel Island	$350,000	1,800	3	2	0.2	
Naples	$500,000	2,500	4	3	0.3	$700 per month

APPENDIX 2

Sample projected financial projections (can be used for each property, or professors can create a second set of financials)

Table 2

Income Statement (For the Year Ended December 31, 2XX1)		
Revenues	Amount	
Rental Revenue	$ 60,000	
Cleaning Fees Charged to Customers	2,500	
Total Revenue		$ 62,500
Expenses		
Mortgage Interest	8,000	
Property Taxes	9,000	
Insurance	2,400	
Utilities	3,600	
Cleaning and Maintenance	7,200	
Property Management Fees	4,800	
Advertising & Marketing	5,000	
Repairs & Replacements	5,000	
Depreciation	11,000	
Total Expenses		56,000
Net Income		$ 6,500

Table 3

Balance Sheet (As of December 31, 2XX1)		
Assets	Amount	
Property Value	$ 300,000	
Furniture and Fixtures	10,000	
Appliances	5,000	
Security Deposits (held)	1,000	
Prepaid Expenses	500	
Total Assets		$ 316,500
Liabilities	Amount	
Mortgage Payable	268,000	
Accrued Expenses	2,000	
Total Liabilities		$ 270,000
Equity		
Owner's Investment	40,000	
Retained Earnings	6,500	
Total Equity		46,500

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Total Liabilities and Equity	$ 316,500

Table 4

Cash Flow Statement (For the Year Ended December 31, 2XX1)		
Cash Flows from Operating Activities	Amount	
Rental Income Received	63,000	
Expenses Paid	-32,200	
Net Cash from Operating Activities		$ 30,800
Cash Flows from Investing Activities		
Purchase of Furniture	-500	
Net Cash from Investing Activities		-500
Cash Flows from Financing Activities		
Mortgage Payments	-15,000	
Owner's Contribution	0	
Net Cash from Financing Activities		-15,000
Net Increase in Cash		15,300
Cash at the Beginning of the Year		0
Cash at the End of the Year		$ 15,300

APPENDIX 3

MEMORANDUM
To: Steven and Jesica Valmont
From: Student Group
Date: May 18, 2XX1
Re: Vacation Rental Property Ownership Options

You asked us to describe options for rental property ownership, excluding timeshare and co-ownership. Here are some options you might consider:

1. **Sole Proprietorship**: Owning a vacation rental property as a sole proprietor means you have complete control and responsibility. While this option provides maximum autonomy, it also means you are personally liable for any debts or legal issues related to the property. Title to the property would be held in your names personally, and rental income and expenses would be reported on Schedule E of your federal income tax return.
2. **Limited Liability Company (LLC)**: Forming an LLC for vacation rental property ownership offers liability protection by separating the property from your assets. This structure can be beneficial for reducing or eliminating personal risk while still affording flexibility in managing the property. The title to the property would be held in the name of the LLC. Because Texas is a community property state, the LLC could be treated as a "disregarded entity" irrespective of the fact that both of you are its owners or "members." This would eliminate the need to file a separate federal tax return for the LLC and permit its rental income and expenses to be reported on Schedule E of your federal income tax return.
3. **Corporation**: Owning and operating a vacation rental property in a corporation can provide various tax benefits and limited liability protection. However, setting up and maintaining a corporation can involve more complex legal and financial requirements than other choices. Absent an election under Subchapter S of the Internal Revenue Code, a corporation is a separate taxpayer, files a separate federal tax return, and pays tax at a flat rate of 21%. Should you make an election and qualify the corporation as an "S Corporation," a separate tax return is prepared for the corporation. However, its income is reported on your federal income tax return and is subject to individual tax rates ranging from 10% to 37%.

Determining the most suitable ownership structure for your vacation rental property is essential based on your goals, risk tolerance, and long-term plans.

APPENDIX 4

MEMORANDUM
To: Steven and Jesica Valmont
From: Student Group
Date: May 18, 2XX1
Re: Tax Consequences of "Mixed-Use" Vacation Rental Property Section 280 A
You have asked us to describe the tax consequences of vacation rental property ("vacation home") ownership, which depend on how the property is used. We understand that you anticipate "mixed-use" of the property—some use of the property by you personally and some by tenants. There are three possible taxable outcomes when vacation homes are subject to "mixed-use," and each one is explained below.

1. Vacation Home Use Is Primarily Personal: If the vacation home is rented for no more than 14 days in a year, the vacation home is treated as a personal residence. The rental income received is excluded from your gross income and, therefore, not subject to tax. Property expenses are not deductible other than mortgage interest and real estate taxes, which are deductible as itemized deductions to the extent permitted and beneficial. The deductibility of taxes from all sources is limited to $10,000 annually, and the increased standard deduction in effect since 2018 has eliminated the benefit of itemizing deductions for some taxpayers.
2. Vacation Home Use Is Primarily Rental: If (i) the vacation home is rented for more than 14 days in a year and (ii) is not used as a personal residence for more than the greater of 14 days or 10% of the total days rented, the vacation home is treated as a rental property. If there are any personal use days during the year, property expenses are allocated between personal use days and rental use days. Real estate taxes allocated to personal use are deductible as itemized deductions to the extent permitted and beneficial. However, mortgage interest allocated to personal use is not deductible because the vacation home does not qualify as a personal residence. Expenses allocated to rental use are deductible and may exceed rental income, resulting in a rental loss. Using any rental loss to offset your income from other sources can be subject to "at-risk" and "passive activity loss" rules.
3. Vacation Home Use Is Primarily Mixed: If (i) the vacation home is rented for more than 14 days in a year and (ii) is used as a personal residence for more than the greater of 14 days or 10% of the total days rented, the vacation home is treated as both a personal residence and a rental property. Expenses of the property are first allocated between personal use days and rental use days, and then the rental expenses are deductible only to the extent of rental income in a specific order: (i) Real estate taxes and mortgage interest; (ii) operating expenses; and (iii) depreciation. Any rental expenses disallowed due to the rental income limitation are carried forward into future years subject to the same deduction rules. Real estate taxes and mortgage interest allocated to personal use are deductible as itemized deductions to the extent permitted and beneficial.
4. When Vacation Home Use Is Primarily Mixed, Authorities Differ on Allocation Method for Taxes and Interest: Before applying the deduction limits, rental expenses must be allocated between personal and use days. The IRS reports that the proper method to allocate real estate taxes and mortgage interest is based on the total days of use. Because real estate taxes and mortgage interest accrue evenly over the year, the courts have held that those expenses should be allocated based on the days in a year (365 or 366). Both authorities agree that other

rental expenses (operating expenses and depreciation) should be allocated based on total days of use.

Because the tax consequences of "mixed-use" vacation rental property can vary widely based on personal versus rental use, it is essential for you to carefully consider and estimate the after-tax cost of your investment and how that result affects your overall financial goals.

APPENDIX 5

Sample memo with opinion.
MEMORANDUM
To: Steven and Jesica Valmont
From: Student Group
Date: May 18, 2XX1
Re: Vacation Rental Property Ownership Options

We have considered your question regarding the most advantageous location for your rental property. We focused on the pertinent tax implications and considered your personal preferences. Based on my analysis, South Carolina is the most favorable location for your VRP.

Tax Implications

The most critical tax consideration is the 14-day rule. Under Section 280A of the Internal Revenue Code, a VRP is treated as a personal residence if rented for no more than 14 days a year. The rental income received is excluded from your gross income and is not subject to tax. However, you cannot deduct property expenses other than mortgage interest and real estate taxes. On the other hand, if the VRP is rented for more than 14 days, it is treated as a rental property, and you can deduct rental expenses, even if they exceed rental income.

Given your preference to use the VRP with family and friends, South Carolina's regulations align best with your situation. Florida's laws are less clear on the matter, and while Texas's laws are explicit, they are less favorable than South Carolina's. Ultimately, South Carolina's laws provide a more concrete framework for maximizing tax benefits while using the property personally.

Personal Preferences

In addition to the tax implications, your personal preferences support the recommendation for South Carolina. You have expressed a desire to invite family and friends to use the VRP, and South Carolina's regulations allow for greater personal use while still providing rental property tax benefits.

Other Considerations

While the 14-day rule is a primary tax consideration, other factors, such as state and local taxes, could affect your decision. However, the 14-day rule is a significant factor in choosing the location for your VRP.

Recommendation

Based on our analysis of the tax implications and your personal preferences, we recommend that you locate your VRP in South Carolina. This location offers the most favorable tax benefits while accommodating your desired personal use of the property. Please let us know if you have any questions or want to discuss this matter further.