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Tax Consequences of Flipping Real Estate

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During the heyday of continually rising real estate values, "flipping" -- buying a property and then reselling it at a higher price -- was all the rage.

In regions where property prices have fallen, flipping has flopped. But it still can be a worthwhile investment option as long as you also are aware of its potential pitfalls. Or, as accountant Bill Rucci warns, "It may not be as lucrative as you first thought."

Many people view real estate investing as more lucrative than the stock market. Plus, flippers enjoy the tangible aspect of the deal. Because property is "real," you can look at a house and neighborhood and get a personal take on whether it's a good investment.

If you're not careful with your real estate flips, though, your investment strategy could produce a sizable payoff for an unintended partner: the Internal Revenue Service.

Real estate tax confusion

Rucci, a CPA and partner in the Boston-based accounting firm Rucci, Bardaro and Barrett, says that many of today's real estate investors go into the transactions completely uninformed.

"There is a huge misconception on the part of some people who think they can buy a residential home, not necessarily their personal residence, fix it up and then sell it; and then get what we used to call 'the old rollover provisions,' where you used the money you made to buy another piece of property for more than what you sold," says Rucci.

But, says Rucci, there are two problems with that approach. "One, that rule existed for personal residences only; and two, it doesn't exist anymore."

The rollover rule was replaced in 1997 by the current law that allows, in many cases, for the tax-free sale of a personal property. This is a great tax break if you're selling your primary residence after having lived in it for several years, but it does nothing for you, taxwise, if you're selling a house in which you have never lived. In this case, the residence is an investment property, and the tax considerations are completely different and definitely more costly.

High expectations, higher taxes
Just as costly is the mind-set of many real-estate speculators.

"We had tens of thousands of people getting into real estate. There was a gold-rush mentality that, 'If I invest in condos, I'll make money,'" says Mark Zilbert, a Realtor and real estate broker whose Zilbert Realty Group created an offshoot in 2005, CondoFlip, to tap the then-hot Miami marketplace where his company is based.

"The majority of buyers understand that they can flip for a profit, understand what it means dollarwise, but they don't understand that taxes could reduce just how much of a profit they make," says Zilbert.

Lonnie Davis, a CPA with the Philadelphia office of CBIZ Accounting, Tax and Advisory Services, agrees.

"The biggest issue during the real estate boom with prices rising very quickly, was that people wanted to capitalize on their gains, to take the money and run, so to speak," says Davis.

Invest in patience as well as properties
Instead of running, a tax-smart flipper could benefit from a slightly slower investment pace.

Investment profit, regardless of whether it comes from sale of stocks or real estate, is considered capital gain and is taxed at two levels. The tax rates depend on how long you own the property.

Hold an asset for a year or less and you'll face short-term gains that are taxed at ordinary income-tax rates. This could be as high as 35 percent. If your investment time table is lengthier, federal tax laws reward you. By holding an asset for more than a year, you'll face the long-term capital gains rate that maxes out, in most instances, at 15 percent.

Not all flippers, however, are able to wait on their profit, even when facing the threat of higher taxes.

"They have this brilliant idea to buy a house, buy a residential piece of property, fix it up and sell it; and then they want to do it for a new piece of property," says Rucci. When flippers find out they don't get the residential replacement rollover, they say "'OK, I made money. I'll pay the tax and buy another house.'"

Such an approach could indeed net more cash. But continual property flipping also could create additional tax problems.

IRS eyes flippers
When you complete several real estate transactions in a short time, don't be surprised to learn that the IRS might consider your property transactions as a business or trade rather than as an

investment strategy, says Davis. In that case, there's no way to get out of paying the higher ordinary income tax rates.

So what's the business-versus-investment determining factor when it comes to property flipping? As with many tax issues, it depends.

"It's a facts-and-circumstances test," says Davis. "There's no rule of thumb that says: Buy three houses, you'll get capital gains; buy five and you're a dealer-trader. The IRS looks at whether the activity is really a business.

"Are you buying, renovating and holding multiple properties? What's the frequency of the buying and selling? If you're acquiring 15 properties in a year and that's pretty much what you do, then the IRS will likely determine that you're a dealer."

And make no mistake about it, the IRS is looking closely at these transactions. Much attention has been given recently to the tax gap: the amount of money the IRS believes it is owed but hasn't been able to collect. Collecting taxes on real-estate-flip profit is one way to close that gap.

"The IRS is out looking for these transactions," says Rucci. "If the IRS decides your investment is a business; that what you're doing is to earn a living, the property changes from a capital asset to a means of producing income that's subject to ordinary tax rates, plus the additional burden of another 15.3 percent in self-employment taxes. And that's what the government is pushing for."

Zilbert agrees.

"There's going to be a wake-up call for tens of thousands of people," says Zilbert. "They made good money. Still, they'll see a dramatic reduction from what they thought they would make."

Flipping the tax tables

Tax costs, though, aren't going to deter some flippers, says Zilbert, especially those who are able to purchase in areas where property is still appreciating, albeit at a slower pace, or who have held the property long enough to see substantial gains.

"I work with many investors who say, 'We love to pay taxes, because it means we're making money.'"

But there are ways to pay less tax on a property-flip profit.

The easiest is the aforementioned capital-gains technique. Simply hang on to the property for more than a year and you'll pay long-term capital gains taxes instead of higher ordinary rates. As long as you're planning your capital-assets strategy, see if you can sell the money-making real estate during the same tax year that you suffer a loss on another long-term asset. That way, you can use the loss to offset your gain.

Want to avoid taxes altogether? Move into the investment property and turn it into your primary residence. As long as you live there for two years (or a total of 730 days -- and the occupation time doesn't have to be sequential) out of the last five, says Davis, the IRS will accept that it was your home. Then when you sell it, up to $250,000 (twice that if you're married and file jointly with your spouse) of your profit is excluded from taxation.

You can also defer tax on your real estate gain by exchanging it for another property, known as a like-kind or Section 1031 exchange.

"The parameters here basically can be pretty broad, as long as you trade an investment property, or business property, for a similar one," says Davis. "For instance, you can swap undeveloped land for developed land, or vice versa. You can swap a residential rental home for a commercial property. The only restriction: The exchanged property can't be a personal asset. It has to be an income-producing asset."

Keep in mind that a like-kind exchange will only postpone your tax bill. When you ultimately dispose of the investment property you acquired in the exchange, you'll owe taxes.

Some property speculators incorporate in an effort to reduce or avoid taxes, but Davis says, "Whether you incorporate or not really doesn't change the tax law. The main benefit of incorporation is that you segregate your business activities from your personal so there's no personal liability, but incorporating doesn't change tax consequences."

In fact, incorporating could make tax matters worse. "If you incorporate, that lends more credibility to the fact that it is a business, because you're letting the world know that there's an entity out there doing this," says Rucci.

Proven tax-reduction tactic

Finally, when flipping properties, make sure you follow one of the time-tested ways to reduce taxes: Keep good records. Such documentation can help you claim real estate investment deductions.

When you invest in a property and then make improvements, those costs can be used to offset your eventual tax bill. Rucci recommends a separate checking account for each piece of property. Commingling the costs associated with several investment properties, or even one investment property and your personal bank account, can lead to confusion and potential tax problems.

Rucci helped a client who came to the Boston CPA's office for help in answering IRS questions about three property flips. Rucci was able to convince the tax examiner that the client was indeed an investor, not a businessman buying and selling real estate, thus avoiding any self-employment tax assessments.

However, Rucci didn't have as much success when it came to write-offs on the properties. The client had not been keeping good records of his real estate improvements, and the IRS disallowed some of the property-related deductions.

"Now that he's our client, he'll be doing a better job in that area," says Rucci.