Flipping Real Estate: Consider the Tax Consequences

Buying a house, condo, or other form of real estate as an investment and selling it quickly can be lucrative, even as interest rates fall and house prices cool. However, there are risks involved in "flipping" real estate. For example, financing the deal and selling the real estate quickly in the current market could pose a problem. In addition, there are tax issues to consider. Even those investors who are able to realize a profit on the sale of properties may find that taxes take a big bite out of their gains. And, while buying and selling real estate may appear to be "easy money," the IRS frowns on individuals collecting significant earnings on real estate sales without first forming a business. If you are thinking about investing in real estate, you should be aware of the potential tax consequences associated with rapid turnover of properties.

Some investors purchase houses or condos still under construction hoping they will be able to sell the properties at a much price by the time the project has been completed, while others seek out run-down houses in attractive locations and sell them after renovating the properties. Both strategies can be risky, however, as the combination of capital gains taxes, legal fees, and realtor commissions could leave the seller with little or no profit, especially if the intention is to flip the property quickly.

Capital Gains Exclusions

If you sell your home after owning it for at least two years, the profit on the sale is free of Federal taxes up to $250,000 for individuals and $500,000 for married couples. Due to this generous exemption, many people do not owe capital gains taxes when they sell their own homes. Different rules apply, however, if the house being sold is not the seller's primary residence, or if the home is sold after the owners lived in it for less than two years. If a property is bought and sold within a year, the seller must pay short-term capital gains taxes on the profit. Short-term gains are taxed at the same rate as ordinary income, which could be as high as 35%. Investment properties sold more than one year after purchase are subject to long-term capital gains taxes—currently 15% for most taxpayers.

Before investing in residential real estate, consider how you would handle sudden changes in market conditions. What would you do if the price failed to rise as expected between the time you purchased the real estate and the time you had intended to sell it? You could, of course, flip the property as planned, accepting a smaller profit or even a loss on the investment. If you realized profits elsewhere in your portfolio in the same year, offsetting losses against capital gains may be a viable tax strategy. You may also deduct the capital loss against other income, up to a limit of $3,000 in a single tax year. If your overall capital loss totals more than $3,000, the excess can be *carried over* to the next year.

Alternatively, you could hold on to the property at least long enough to qualify for long-term gains rates on any profit. Consider whether you would be prepared to rent out the property until market conditions improve.

“Like-Kind” Exchanges

To ease your immediate tax burden when selling an investment property and retain capital for reinvestment, you can take advantage of Section 1031 of the Internal Revenue Code. Section 1031 allows sellers to defer payment of capital gains taxes on a real estate sale, provided the profits are reinvested in a similar property. This “like-kind” exchange must meet certain requirements to qualify for tax deferment. The sale must be declared as part of a 1031 exchange before the transaction takes place, and the proceeds from the sale must be rolled over immediately into the replacement property or placed in a trust account held by an intermediary until the new asset is purchased. The seller has 45 days to identify a replacement property, and the closing on the new property must occur within 180 days of the sale.

To qualify as a 1031 exchange, the replacement building or land must be used for business or investment, and it may not serve as the seller’s personal residence or vacation home. Under the “like kind” rules, the new property must be of equal or greater value than the property being sold, and the new mortgage should also be the same as or larger than the debt on the previous property. Any profit taken out of escrow by the seller becomes taxable.

While the 1031 exchange can be a useful means of deferring taxes, keep in mind that, if you flip several properties within a short period of time, the IRS could determine that your activities constitute a business or trade. If you are classified as a dealer rather than an investor, you will be liable to pay ordinary income tax rates on real estate sales, regardless of how long the properties were held, as well as 15.3% in self-employment taxes. There are no definitive criteria used by the IRS to distinguish a private investor from a dealer/trader. If, however, you derive all or most of your income from your real estate investments, you will likely be viewed as a self-employed trader for tax purposes.

Before making any real estate investment, educate yourself as thoroughly as possible about local market conditions, bearing in mind that, if speculation in the area is rampant, a price bubble could be forming. Draft a plan outlining out your objectives and how you intend to reach them, taking into account the tax consequences of each step. Weigh carefully how much financial risk you can realistically manage when investing in real estate and how long you can afford to wait for returns. Ideally, real estate holdings should be balanced against other assets in your investment portfolio.

For more information on the tax consequences of flipping real estate, consult your tax professional.

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