Thinking of Becoming a Real Estate Flipper? Here's a Primer on the Tax Rules**Article Highlights:**

- Definition of Flipping
- Government Will Share in the Profits
- Tax Treatment Depends on Being a Dealer, Investor or Homeowner
- Distinguishing a Dealer from an Investor

With mortgage interest rates low and home prices finally making a comeback, flipping real estate appears to be on the rise. This activity is even the theme of several popular reality TV shows. House flipping is, essentially, purchasing a house or property, improving it and then selling it (presumably for a profit) in a short period of time. The key is to find a suitable fixer-upper that is priced under market for its location, fix it up and resell it for more than it cost to buy, hold, fix up and resell.

Are you contemplating trying your hand at flipping? If so, keep in mind that you will have a silent partner, Uncle Sam, who will be waiting to take his share of any profits in taxes. (And most likely, Sam's cousin in your state capitol will expect a share, too.) Taxes play a significant role in the overall transaction, and tax treatment can be quite different depending upon whether you are a dealer, an investor or a homeowner. The following is the current tax treatment for each.

- *<u>Dealer in Real Estate</u>* – Gains received by a non-corporate taxpayer from business operations as a real estate dealer are taxed as ordinary income (10% to 39.6%), and in addition, individual sole proprietors are subject to the self-employment tax of 15.3% of their net profit (the equivalent of the FICA taxes for a self-employed person). Higher-income sole proprietors are also subject to an additional 0.9% Medicare surtax on their earnings. Thus, a dealer will generally pay significantly more tax on the profit than an investor. On the other hand, if the flip results in a loss, the dealer would be able to deduct the entire loss in the year of sale, which would generally reduce his or her tax at the same rates.
- *<u>Investor</u>* – Gains as an investor are subject to capital gains rates (maximum of 20%) if the property is held for more than a year (long term). If held short term (less than a year, as will likely be the case for most flippers), ordinary income rates (10% to 39.6%) will apply. An investor is not subject to the self-employment tax, but could be subject to the 3.8% surtax on net investment income for higher-income taxpayers. A downside for the investor who has a loss from the transaction is that, after combining all long- and short-term capital gains and losses for the year, his or her deductible loss is limited to $3,000, with any excess capital loss being carried over to the next year. The rules get a bit more complicated if the investor rents out the property while trying to sell it, but such rules are beyond the scope of this article.
- *<u>Homeowner</u>* – If the individual occupies the property as the primary residence while it is being fixed up, he or she would be treated as an investor, with three major differences: (1) if the individual has owned and occupied the property for two years and has not used a homeowner gain exclusion in the two years prior to closing the sale, he or she can exclude gain of up to $250,000 ($500,000 for a married couple); (2) if the transaction results in a loss, the homeowner will not be able to deduct the loss or even use it to offset gains from other sales; and (3) some fix-up costs may be deemed to be repairs rather than improvements, and repairs on one's primary residence are neither deductible nor includible as part of the cost basis of the home.

Being a homeowner is easily identifiable, but the distinction between a dealer and an investor is not clearly defined in the tax code. A real estate dealer is a person who buys and sells real estate property with a view to the trading profits to be derived and whose operations are so extensive as to constitute a separate business. A person acquiring property strictly for investment, though disposing of investment assets at intermittent intervals, generally does not deal in real estate on a regular basis.

This issue has been debated in the tax courts frequently, and both the IRS and the courts have taken the following into consideration:

- whether the individual is already a dealer in real estate, such as a real estate sales person or broker;
- the number and frequency of sales (flips);
- whether the individual is more committed to another profession as opposed to fixing up and selling real estate; and
- how much personal time is spent making improvements to the "flips" as opposed to another profession or employment.

The distinction between a dealer and an investor is truly based on the facts and circumstances of each case. Clearly, an individual who is not already in the real estate profession and flips one house is not a dealer. But one who flips five or more houses and/or properties and has substantial profits would probably be considered a dealer. Everything in between becomes various shades of grey, and the facts and circumstances of each case must be considered.

If you have additional questions about flipping real estate or need assistance with your specific situation, please give this office a call.