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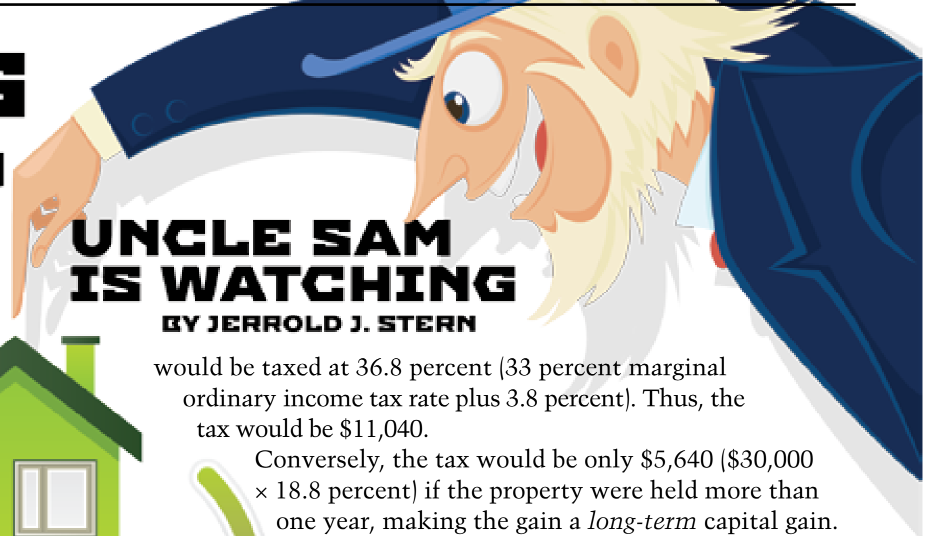
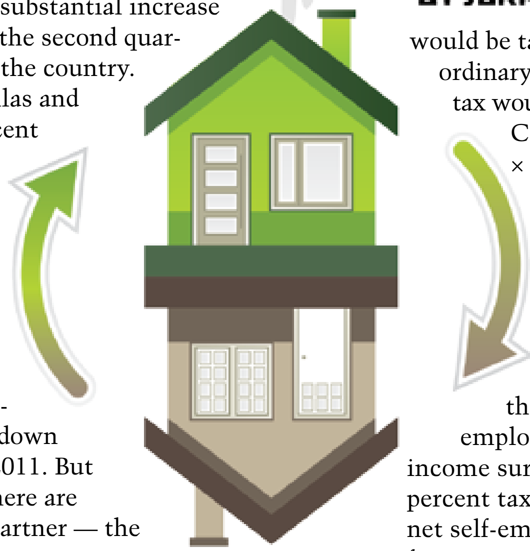
FLIPPING HOUSES?



UNCLE SAM IS WATCHING

BY JERROLD J. STERN

While the heyday for flipping houses has passed, there was a substantial increase in flipping through the second quarter of 2014 in certain areas of the country. During first quarter 2014, Dallas and Houston flips were up 28 percent and 29 percent, respectively, according to RealtyTrac. Flipping is typically assumed to have taken place when houses are sold less than a year after they are purchased.



In August 2014, RealtyTrac reported that flippers earned an average 21 percent gross return ($46,000 average profit), down from a peak of 31 percent in 2011. But as one might expect, where there are profits there is an uninvited partner — the IRS.

To a large extent, the tax treatment of flipping depends on whether the IRS considers the flipper to be a real estate *dealer* or a real estate *investor*. Investor status is generally preferred by flippers. A list of the key factors the IRS uses to determine dealer/investor status for flippers follows. However, keep in mind that no single factor is determinative. The IRS makes each dealer/investor determination based on the "facts and circumstances" surrounding the sale(s).

The most important factor may be the number of flips per year. Clearly, one flip does not normally indicate dealer status. But as the number rises, so does the possibility of dealer status. Other factors considered in determining dealer status are:

- Did the sale of the property occur shortly after the property was renovated?
- Is the flipper a real estate professional (broker/salesperson)?
- Is the flipper a part-timer or full-timer?
- What percentage of the seller's annual income is earned from flipping?
- What business behaviors are exhibited by the flipper? For instance, does the flipper have a sales office? Employees? Business cards?

Tax Consequences for Investor (Non-Dealer)

Investor net income from properties held one year or less is considered *short-term* capital gain income, generally taxed at ordinary income tax rates ranging from 10 to 39.6 percent. Such gains *may* be subject to an additional 3.8 percent investment income surtax depending on the level of the investor's other taxable income.

For example, assume an investor earns $30,000 from a flip, is married and files a joint tax return, and the couple has $250,000 of taxable income before the $30,000 gain. The gain would be taxed at 36.8 percent (33 percent marginal ordinary income tax rate plus 3.8 percent). Thus, the tax would be $11,040.

Conversely, the tax would be only $5,640 ($30,000 × 18.8 percent) if the property were held more than one year, making the gain a *long-term* capital gain. Investors (but not dealers) are also eligible to benefit from installment sales as well as Section 1031 exchanges.

Tax Consequences for Dealer

In sharp contrast, *dealer* net income is subject to the regular income tax *plus* the 15.3 percent self-employment tax (but not the 3.8 percent investment income surtax). The holding period is not relevant. The 15.3 percent tax rate is applied to the first $118,500 of adjusted net self-employment income. For instance, assume the same facts as in the example, except the seller is a dealer. The tax would be $14,139 ($30,000 x 33 percent; plus $30,000 × .9235 adjustment factor × 15.3 percent). The dealer's $14,139 tax is substantially higher than the $11,040 and $5,460 tax amounts noted above for the investor. Investors and dealers may be able to avoid all taxes on their gains if they make the house their principal residence for two of the previous five years and the gain is under $250,000 for single taxpayers and $500,000 for married couples.

One tax benefit available only for dealers is that they can deduct losses in full in the year of sale. In contrast, an investor's short-term and long-term capital losses may be limited to $3,000 per year (depending on the investor's other capital gain income/loss).

Also important are the anti-flipping rules imposed by the Department of Housing and Urban Development (HUD). These rules can affect transactions with FHA mortgages.

As with all tax matters, dealers and investors must document all aspects of transactions including costs of repairs and capital improvements/renovations. Consultation with a tax accountant or tax attorney with real estate experience is critical.

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THE TAKEAWAY

Profits from flipping houses may be taxed an additional 15.3 percent if the seller is considered a dealer for tax purposes, rather than an investor. The IRS might treat the seller as a dealer if there are multiple flips per year or if the seller is a real estate professional.

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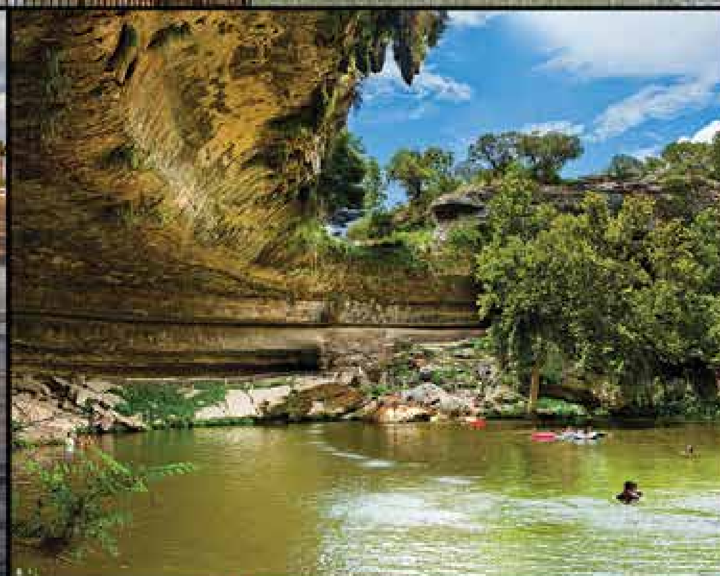

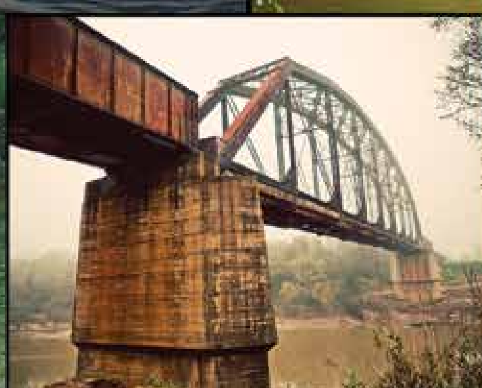


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