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Flipping Has Tax Consequences

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If you are looking at making a quick hundred-thousand on real estate flipping, you may find it is quick, but not as lucrative as you thought.

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Article Body:
If you are looking at making a quick hundred-thousand on real estate flipping, you may find it is quick, but not as lucrative as you thought.

With housing prices on the rise across the nation, flipping has become the hottest investment trend. You buy a property and quickly resell it at a higher price.

Most people even believe flipping to be more lucrative than the stock market. Plus, you get the rush of making a deal. Plus there is a physical object to look at to judge your investment by.

But if you aren't careful when flipping that real estate, your investment strategy could be a party that the IRS attends.

Bill Rucci of Rucci, Bardaro and Barrett says that many of today's real estate investors are completely uninformed when they begin their transactions.

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

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

The rollover rule was replaced in 1997 with current law that allows for the taxfree sale of personal property in many cases. This works great if you are selling your primary residence after living in it for many years, but if you're selling a house you haven't lived in, your in a different group. The residence will be considered an investment property, and the tax considerations are completely different and more costly.

"We have tens of thousands of people getting into real estate," says Mark Zilbert, a Realtor. "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."

Instead of running a fast game, a tax-smart flipper could benefit from a slower investment pace.

Investment profit, whether stocks or real estate, is considered capital gain and is taxed at two levels. The tax rate depends on how long you own the property.

Keep it for less than a year and your short-term gains will be taxed as ordinary income. That means you could be facing up to 35%. If you hold the property longer than a year, you will pay a long-term capital gains rate that maxes out a 15% for most taxpayers.

Not all flippers have a year to wait. Not even for taxes.

But you must beware how much you flip.

When you complete several transactions in a short time, the IRS could consider your transactions as a business rather than an investment strategy. Then you have to pay the higher ordinary income tax rates.

The IRS is watching flippers closely.

"The IRS is out looking for these transactions," says Rucci. "If the IRS decides your investment is a business; that what you are 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% in self-employment taxes. That is what the government is pushing for."

Tax costs won't deter many flippers. One way of looking at it is that you don't pay taxes unless you make money.

The easiest way to pay less tax on a flip is using the capital-gains technique. Simply hold onto the property for more than a year and pay the long-term capital gains. You can try to time your real estate sale during the same tax year you suffer a loss on another long-term asset. Then use the loss to offset your gain.

If you want to avoid taxes altogether on the property, simply move in. You must live there for two years out of the last five years. When you sell it, up to $250,000 of your profit is excluded from taxation, double that if you are married and file jointly.

You can also defer paying taxes on your real estate gain by exchanging the property for another property, known as a like-kind or Section 1013 exchange.

No matter what you do, make sure that you keep good records. You can really benefit from proper documentation when claiming real estate investment deductions.