

Fix-And-Sit: A New Fixer Upper Strategy

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One of the newest fixer upper strategies has to do with taking advantage of the way the tax code is written.

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Done right, flipping fixer uppers is perhaps one of the easiest ways to get into real estate investing. Usually you want to get in and out of the property as quickly as possible, because every day you own a house has costs associated with it. Interest on loans, taxes, insurance, electricity, heating, water, and other ongoing expenses can add up.

{bot_wrgoogle}However, there is another way to invest in a fixer upper. It is a strategy that let's you take your time. In fact, it requires you to wait two years before you sell. It also requires that you live in the house.

Your Fixer Upper Home

Since the tax law changes of the 1990s, you can sell your home and pay no capital gains tax on your profit. Have your accountant review your case and verify that you have met the requirements, but essentially you get to sell tax free if you have lived in the home at least two of the past five years, and you are allowed to take such a tax-free profit every two years. The total gain you can have without paying taxes is limited to \$250,000, or \$500,000 for a married couple.

Some of you may recall that you used to be allowed this capital gains tax exemption just once in your life. What's more, until you claimed it, you had to always roll your gain from selling a home into another home, always buying-up. Now you can take the money and run, buy a cheaper condo, or do whatever you want with it. This is a major change.

How do you take advantage of this tax law? If you could predict appreciation rates on homes in various cities (good luck), you could move from one quickly appreciating home to another each two years and pocket the profits tax free. What if you don't want to gamble on your predictions and you don't want to move to a new town every couple years? Then look for fixer upper right where you live.

You see, most investors "flip" a fixer upper quickly, meaning they pay ordinary income tax rates on the profits. They don't even own the property long enough to qualify for the lower long-term capital gains rate. Depending on whether they get classified as business or an investor, this means they can pay as much as 50% out in state and federal taxes. They lose half of their profit!

The alternative? Let's suppose you find a home in a neighborhood where homes are selling for around \$180,000. It's dirty and in disrepair, so the owner is asking only \$136,000. You negotiate and eventually get it for \$126,000. You live in the home, spending about \$8,000 to clean it up and bring it up to the standards (and value) of the surrounding homes.

After two years home values are up 10%. Your home is worth about \$198,000 (\$180,000 plus 10% or \$18,000), and you sell it for that. After all the costs of buying and selling and repairing it, you have a profit of about \$50,000. You buy the next home and repeat the process. Note: perhaps \$32,000 is a more accurate estimate of profit, since the same appreciation that provided \$18,000 of your gain means you'll pay that much more for the next one. In any case, this profit is entirely tax-free!

You can see how powerful this fixer upper strategy is. It doesn't prevent you from pursuing other real estate investing plans at the same time either. You need to live somewhere in any case, so why not take advantage of the law and make some money from your home?

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