Which Politician Pitched a 25% Tax on Flipping Houses?

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Vermont senator and presidential candidate Bernie Sanders has just proposed a 25 percent tax on house flippers. (1) The section “Housing for All” on his campaign website recommends to,

“Place a 25 percent House Flipping tax on speculators who sell a non-owner-occupied property, if sold for more than it was purchased within 5 years of purchase.” (2)

Now, one might think that an unrepentant capitalist and real estate investor like myself may come at this from a somewhat biased perspective. Perhaps.

Although, I should state up front that I certainly don’t hate Senator Sanders and actually agree with him on a decent number of issues. Furthermore, I am a buy and hold investor. By hitting flippers right in their pocket book, this tax would actually probably help me by reducing the competition I get from flippers.

That being said, I would implore Senator Sanders to reconsider. This is a very unfair tax proposal that will do exactly the opposite of what it’s intended to do.

Double Dipping

Right off the bat, there is an inherit unfairness in this proposal. Home flippers, after all, are already taxed. U.S. tax law allows for $250,000 of capital gains to be excluded from tax on home sales ($500,000 if filing jointly)—but that is only for your principal residence. This does not relate to real estate investors at all. Every real estate investment you sell will be subject to a capital gains tax. Yes, you can defer that tax with a 1031 exchange, but that merely postpones it. Eventually, you will have to pay the taxman his due.

Furthermore, no flipper even pays capital gains on their profits; they pay normal income taxes. This is because the tax code requires you to own a property for at least two of the last five years before sale to claim the profit as a capital gain. Profits from flips are taxed as a short-term capital gain, which is considered the same as personal income.

As of this writing, the highest personal income bracket is 37 percent. Adding a 25 percent tax on the front end would increase that tax to over half of the profit made for investors in the top bracket.

Those in lower brackets aren't hit as hard, but they are hurt nonetheless. In addition, those in the higher brackets almost always have employees, some of whom would almost certainly be laid off if business reduces.

Unsurprisingly, no mention is made of compensating an investor with a tax credit if he or she spends months renovating a property only to sell it for a loss. The whole scheme smells of over-taxation and unfairness.

Tax X, Get Less of X

Let us return to Economics 101 for its very first lesson: If you tax something, you get less of it. Supply and demand is not a hugely complicated concept, at least initially. If the price of something goes up, which an added tax would accomplish, the demand for that thing will go down. If demand goes down, then supply will go down to meet it so the market stays in equilibrium.

So, what exactly will happen if we have less house flipping? The answer is not hard to discern.

I have met a lot of house flippers in the last 10 years, and not a single one of them flipped houses without renovating them first. Sure, it might happen occasionally, but the vast majority of flippers are also renovators. While our own company doesn't flip very often, our strategy resembles flippers until the final decision at which stage we choose to rent.

I just looked at our balance sheet. We have spent $1 on renovations for every $2.20 we spent on purchasing properties. Over 31 percent of the money we put into the properties we bought was to upgrade it. I suspect most investors have a similar story to tell, as a survey by BiggerPockets and Memphis Invest in 2012 concluded that individual real estate investors spent a whopping $9.2 billion to repair housing.

Does this sound at all like a bunch of "speculators" as Sanders' website contends? No, this is buying an asset and putting money into upgrading that asset before selling it to an end-buyer. Many of these upgrades involve large amounts of time and "sweat equity."

Indeed, the two-year window Sanders leaves open would penalize almost every house hacker, as well. These are usually people just getting started in the business, who don't have a large sum of money in their bank account.

Given the United States is currently facing a housing shortage (the very one Senator Sanders is upset about) of as many as 7.2 million of affordable and available rental homes, should we really be de-incentivizing those who make unlivable or barely livable houses and apartments livable again? (3)

Even wholesaling helps facilitate this process, as most properties that are wholesaled are wholesaled to flippers or buy and hold investors, who intend to do the renovations themselves. Wholesaling is simply a conduit often used to bring dilapidated houses to those who will rehab them.

And while those who renovate and flip luxury homes might not address a pressing crisis in this country, they certainly aren't creating any problems. On the other end though, in blighted communities, local residents simply don't have the capital to renovate the many dilapidated properties there. Without real estate investors putting money in to flip or hold, these neighborhoods will fall even further into disrepair—and the people who live there further into despair, too.

Removing an Exit for Motivated Sellers

There are certainly a few sharks out there, but as this community here on BiggerPockets can attest to, most investors are honest and ethical businesspeople. The sharks out there can easily find another scam. But the good investors will be chased out, as well, or have to reduce their efforts.

Again, many of the properties investors buy are dilapidated. Or the sellers live out of state or just inherited the property and would love nothing more than to get rid of it. Others are behind on their mortgage or taxes and desperate to sell.

These sellers need investors willing to buy properties quickly or properties in bad condition. Reducing the investor market for these properties will reduce these sellers' options dramatically and lead to more mortgage and tax foreclosures.

Unintended Consequences: The Housing Addition

Perhaps unsurprisingly, Senator Sanders also recommends the most tried and failed of affordable housing techniques: rent control. (4)

"In America today, more than two-thirds of states preempt or limit the ability of their communities to establish rent control or stabilization rules to protect the American people against excessive increases in rent. That has got to change.

"We need to establish a national rent control standard and allow cities and states to go even further to protect tenants from the skyrocketing price of housing."

Economics is a field embittered with constant arguing. Whereas biologists and chemists seem to get along with each other for the most part, economists are constantly at each other's throats given how relevant their findings are to policy. Thus, it is particularly relevant that the economics field has reached a rare consensus: Rent control does not work.

While it shouldn't be surprising that libertarian economists, such as those at the Cato Institute, oppose rent control, liberal economists almost all fully agree. (5) The left-leaning Brookings Institute found that, "While rent control appears to help current tenants in the short run, in the long run it decreases affordability, fuels gentrification, and creates negative spillovers on the surrounding neighborhood." (6)

(Ironically, another thing Sanders complains about is gentrification.)

Paul Krugman is the most famous liberal economist in the world today, and he agrees with the Brookings Institute wholeheartedly, stating in a *New York Times* opinion piece,

"The analysis of rent control is among the best-understood issues in all of economics, and—among economists, anyway—one of the least controversial. A poll of the American Economic Association found 93 percent of its members agreeing that 'a ceiling on rents reduces the quality and quantity of housing.' Almost every freshman-level textbook contains a case study on rent control, using its known adverse side effects to illustrate the principles of supply and demand."

The poll he references can be found here. Other polls of economists have found the same result. (7)

Rent control also almost certainly adds to urban blight, as conservative economist Thomas Sowell and others have shown. Indeed, the most potent illustration I've seen of what rent control can do was a presentation that showed devastated buildings and asked "bomb damage or rent control?" (8) It was genuinely hard to tell.

While rent control is a separate issue than a tax on house flippers, they are inspired by the same fallacy. Indeed, the history of government interventions in the housing market has been mostly a failure. (9) While they see a real problem (housing being unaffordable in many cases), they offer an ad hoc government solution that actually exacerbates the problem by discouraging the construction of (in the case of rent control) and renovation of (in the case of flipping) housing, which will increase the housing stock and put downward pressure on prices and rents.

Some taxes are necessary, but too much and/or poorly designed ones will stagnate the economy. In the same vein, some regulation is necessary, but regulation does not necessarily stabilize an economy or reign in predatory businesses. In fact, regulation can often make the economy less stable and help entrench big businesses over smaller firms. (10)

Conclusion

Taxing home flippers 25 percent before they even pay a penny of income or capital gains taxes doesn't make any economic sense. It's unfair, removes many sellers' options, will hurt many small businesses and likely lead to layoffs, will increase urban blight, and will decrease the availability of housing, leading to higher prices and rents.

But even further, Senator Sanders reserves most of his condemnations for the "billionaire class." There are certainly billionaires in real estate (one of whom sits in the Oval Office right now). But house flippers are not among them. Some millionaires, sure, but house flippers are almost always local, often small businesses. Many, like our own, are family businesses, too.

Taxing home flippers isn't going to reduce income inequality any more than it will create affordable housing. It's a middle-class and upper-middle class tax, and one with an exceptionally poor design that will make everything it intends to improve worse. Hopefully Senator Sanders will reconsider this wrongheaded proposal.