I think it's safe to say that most of us as real estate owners and investors have goals, that in some way, focus on making money. Whether you want to build generational wealth for your family, supplement existing income, provide quality affordable housing or free up your time so you don't have to work, you'll need money to reach those goals. The "money" we are going to discuss today is "Capital Gains".

What are Capital Gains?

Capital gains refer to the profit made from the sale of an asset, such as real estate, when the selling price exceeds the purchase price. For real estate investors, capital gains are a critical aspect of their overall investment strategy and can significantly impact their return on investment.

The first part of the definition is important, selling at a sale price that exceeds purchase price. If you don't sell for a profit, you may have some more important things to focus on than capital gains. As a bit of a recap, the factors that will affect your capital gains are some of the same factors that will affect your sales price. Things like supply and demand, location, property condition, improvements, holding period, financials and government policy.

The second, sometimes unspoken but implied part of capital gains is Capital Gains Tax. Of course, it's death and taxes in this world. Understanding factors that increase or decrease the taxes associated with capital gains is the next level of maximizing your capital gains

Here's a breakdown of what affects capital gains taxes:

Factors That Increase Capital Gains Taxes:

1. **Short Holding Period**:
    - Selling an asset within one year of purchase typically subjects gains to higher short-term capital gains tax rates, which are the same as ordinary income tax rates.
2. **High Income Level**:
    - Capital gains tax rates can be progressive, meaning higher-income individuals may face higher tax rates on their gains.
3. **State and Local Taxes**:
    - In addition to federal capital gains taxes, some states impose their own taxes on capital gains, which can increase the overall tax liability.
4. **Investment Type**:
    - Certain investments, such as collectibles or real estate investment trusts (REITs), may be subject to different tax rates.
5. **Disallowed Deductions**:
    - Failing to utilize available deductions, such as costs associated with the sale (e.g., commissions, improvements), can result in higher taxable gains.

Factors That Decrease Capital Gains Taxes:

1. **Long Holding Period**:
   - Holding an asset for more than one year usually qualifies it for lower long-term capital gains tax rates.
2. **Exemptions for Primary Residence**:
   - Homeowners may qualify for a capital gains exclusion (up to $250,000 for single filers and $500,000 for married couples) on the sale of their primary residence if they meet certain conditions.
3. **Offsetting Losses**:
   - Selling other investments at a loss can offset capital gains, reducing the overall tax burden. This is known as tax-loss harvesting.
4. **Retirement Accounts**:
   - Gains realized within tax-advantaged accounts like IRAs or 401(k)s are often tax-deferred or tax-free until withdrawal.
5. **Tax Credits and Deductions**:
   - Utilizing available tax credits and deductions can reduce overall taxable income, potentially lowering the effective capital gains tax rate.
6. **Like-Kind Exchanges**:
   - Under Section 1031 of the Internal Revenue Code, investors can defer capital gains taxes by reinvesting proceeds from the sale of an investment property into a similar property.
7. **Charitable Donations**:
   - Donating appreciated assets to a qualified charity can eliminate capital gains taxes on the donated amount, and the investor may also receive a tax deduction.

One of the best "tools" in real estate investing can become a **Capital Gains Nightmare** after a sale if there is no strategy in place. That tool is depreciation, and the nightmare can come from what is called depreciation recapture.

What is depreciation? What is depreciation recapture?

Depreciation is an accounting method that allows real estate investors to allocate the cost of a property over its useful life. It reflects the wear and tear on the property, providing a tax deduction to offset income. In the U.S., residential rental properties are typically depreciated over 27.5 years, while commercial properties are depreciated over 39 years.

- **Non-Cash Expense**: Depreciation is a non-cash expense, meaning it reduces taxable income without impacting actual cash flow.
- **IRS Guidelines**: The IRS allows property owners to claim depreciation on the building, not the land, since land does not depreciate.
- **Accelerated Depreciation**: Certain improvements may qualify for accelerated depreciation under bonus depreciation rules or Section 179.

Depreciation recapture refers to the process of taxing previously claimed depreciation when a property is sold. When you sell a depreciated asset, the IRS requires you to "recapture" the depreciation deductions.

- **Tax Rate**: Depreciation recapture is taxed at a maximum rate of **25%**, which is generally lower than ordinary income tax rates.
- **Impact on Sale Proceeds**: When calculating capital gains on the sale of a property, the amount of depreciation claimed is subtracted from the original purchase price, effectively increasing the taxable gain.
- **Net Effect**: While depreciation provides immediate tax benefits during ownership, the recapture upon sale can result in a significant tax liability, so investors should plan accordingly.

  Here’s an example.

1. **Initial Purchase**: You buy a rental property for $300,000.
2. **Depreciation Taken**: Over several years, you claim $50,000 in depreciation.
3. **Selling the Property**: If you sell the property for $400,000, your adjusted basis is now $250,000 ($300,000 - $50,000).
4. **Capital Gains Calculation**: Your capital gain is $150,000 ($400,000 sale price - $250,000 adjusted basis).
5. **Depreciation Recapture Tax**: The $50,000 of depreciation you claimed will be recaptured and taxed at 25%, which could lead to a $12,500 tax liability on that portion.

Understanding both depreciation and depreciation recapture is crucial for real estate investors, as it affects cash flow and tax liabilities.

It’s important to remember that real estate investing is a team sport. Make sure you strategize with your accountant, tax professional, 1031 advisor, real estate agent and whoever else you feel is necessary to make sure you are confident in your overall plan.