Tax Matters

Can Capital Losses Offset Gains from the Sale of Low-Basis Real Property?

November 1, 2024

Suppose a real estate investor is planning to sell a property that she has held for many years. Due to accumulated depreciation, the property's adjusted basis has significantly decreased. The same investor also has some realized losses on stocks. Could the investor use those losses to offset some of the gains from the sale?

In general, capital losses realized on stocks or other assets may offset capital gains, but not ordinary income,[1] from the sale of a property. Therefore, it is important to understand which portion of the gain from the sale would be treated as capital gain and which would be treated as ordinary income.

Let's start at the top. The total gain on the sale of property — calculated as the difference between the sale price and the adjusted basis — is divided into two components. The first component is the gain from appreciation in property value (i.e., the sale price minus the original purchase price), which is recognized as a long-term capital gain and taxed at a maximum federal rate of 20% (plus a 3.8% Net Investment Income Tax, or "NIIT").*

The second component is the gain from previously taken depreciation deductions, which can be further categorized as "Unrecaptured" and "Recaptured." The portion corresponding to straight-line depreciation is considered unrecaptured and is treated as long-term capital gain, taxed at a special increased maximum federal rate of 25% (plus a 3.8% NIIT).'[2]

Any depreciation exceeding straight-line depreciation is considered "additional depreciation", which is subject to "recapture" and taxed as ordinary income at a maximum federal rate of 37% (plus a 3.8% NIIT).*

A significant portion of the gain due to depreciation of real property may be treated as a long-term capital gain that can be offset with capital losses

Now let's turn back to our example. The investor can indeed use the losses from stocks to offset the capital gains from the sale of real estate, first those taxed at 25% (plus 3.8%) and then those taxed at 20% (plus 3.8%). If the investor's property has been depreciated over many years, the additional depreciation — the part subject to "recapture" — may be relatively small. As a result, a significant portion of the gain due to depreciation may be treated as a long-term capital gain that can be offset with capital losses.

So, when it comes to real estate, depreciation has two tax characters. During the useful life of the property, depreciation can be used as an ordinary deduction against passive income. Later, upon the sale of the property, a substantial portion of such cumulative depreciation may be treated as a long-term capital gain. What this means for investors is losses realized from underperforming stocks (or other capital losses, including those carried forward from prior years) can be used to offset a meaningful portion of gains from the sale of real estate.

**Source: IRS. As of October 2024.Tax rates and other tax information is subject to change.*
This is a hypothetical example and does not take into consideration an investor's complete tax situation.

[1] Other than up to $3,000

[2] For simplicity, let's assume that the investor does not have any capital gains aside from those from the sale of the property.

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