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Selling a Rental: Depreciation Recapture and the Rest of the Bill

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The short answer

The gain on a rental sale is not one number taxed at one rate. The part that matches the depreciation you took on the building is taxed at up to 25 percent, the part that matches depreciation on items a cost segregation study split out is taxed at ordinary rates, and whatever is left is long-term capital gain. The net investment income tax of 3.8 percent and your state sit on top. The one piece of good news is that suspended passive losses on the property are generally released in the year you sell.

The gain is cut into pieces

Piece of the gain	Taxed at
Depreciation you took on the building itself	Up to 25 percent, as unrecaptured section 1250 gain
Depreciation on 5, 7 and 15-year items split out by a cost segregation study	Ordinary rates, up to 37 percent
Appreciation above your original cost	Long-term capital gain, 0, 15 or 20 percent
All of the above, for most high earners	Plus net investment income tax of 3.8 percent
All of the above	Plus state income tax, where your state has one

Depreciation reduces your basis whether or not you claimed it, so a return filed without depreciation does not avoid any of this. If deductions were missed, a change in accounting method can usually recover them, and it should be done before the sale rather than after.

A worked example

A rental bought for 500,000 dollars, with 100,000 allocated to land. Over ten years, 145,000 of depreciation is taken on the building. It sells for 750,000 with 50,000 of selling costs.

- Adjusted basis: 500,000 less 145,000 of depreciation equals 355,000
- Amount realized: 750,000 less 50,000 of selling costs equals 700,000
- Total gain: 345,000
- Of that, 145,000 is unrecaptured section 1250 gain taxed at up to 25 percent
- The remaining 200,000 is long-term capital gain
- The 3.8 percent net investment income tax applies to the whole 345,000 for a high earner, and state tax applies on top

> Note the shape of it: the owner who deducted 145,000 at ordinary rates over ten years pays it back at a maximum of 25 percent. The rate difference is the point of the strategy, not a loophole to be afraid of.

What cost segregation does to the sale

A cost segregation study moves part of the building into 5, 7 and 15-year groups so the deductions come early. That part is personal property, and when you sell, depreciation on it is recaptured at ordinary rates rather than 25 percent. The deferral is still usually worth it, because money deducted at 37 percent today and repaid at 37 percent years later is a free loan, but the sale is not the pleasant surprise people expect.

This also matters for an installment sale. Ordinary recapture on personal property must be reported in full in the year of sale, even if you are collecting the price over time, so a seller financing a deal can owe tax before the cash arrives.

The suspended losses you get back

Rental losses disallowed in earlier years because they were passive are generally freed in the year you dispose of the entire interest in that activity in a fully taxable sale. They offset the gain first and then your other income. Owners are often surprised to find that years of suspended losses cover a meaningful part of the bill.

Two cautions. A sale to a related party does not release them. And if you made the election to treat all of your rental real estate as one activity, selling one property is not a disposition of that activity, so the losses stay suspended.

Ways to change the answer

- A 1031 exchange defers the whole thing, recapture included, into the next property
- An installment sale spreads the capital gain across years, though not the ordinary recapture
- Holding until death gives heirs a stepped-up basis and wipes out the deferred gain entirely
- Timing the sale into a year with business losses, a large charitable gift or lower income changes the rate
- Selling a property with suspended losses in the same year you realize other passive income lets them meet

The decision belongs in the year before the sale, not in the escrow period. Once the property is listed, most of these choices are already gone.

Frequently asked questions

What is the depreciation recapture rate on a rental?

Depreciation taken on the building is taxed at up to 25 percent. Depreciation on shorter-lived items split out by a cost segregation study is recaptured at ordinary rates instead.

Can I avoid recapture by never claiming depreciation?

No. Basis is reduced by the depreciation allowed or allowable, so the tax is the same and you lose the deductions. Missed depreciation can usually be recovered through a change in accounting method.

Does a 1031 exchange eliminate recapture?

It defers it. The deferred amount carries into the replacement property and comes due when you eventually sell without exchanging, unless the property passes at death with a stepped-up basis.

Do I get my suspended passive losses back when I sell?

Generally yes, on a fully taxable sale of the entire interest to an unrelated buyer. If you elected to group all your rentals as one activity, selling one of them does not release them.

Does the 3.8 percent net investment income tax apply?

For most high earners, yes, on the gain from a passive rental. Gain from property used in a business in which you materially participate may be outside it.

General information based on federal law for tax year 2026, not tax advice for your situation. State rules vary.

Want this applied to your situation? Book a free 30-minute call with Akanchya Acharya, CPA at acharyacpa.com/contact or email akansha@acharyacpa.com.

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