How Can I Reduce Capital Gains Tax on a Rental Property?

By: Exchange Capital Management
August 31st, 2023

While owning a rental property can be a great investment, there may come a point when it's in your best interest to sell. Whether you're interested in stepping away from being a landlord or looking to purchase a new rental property elsewhere, there are a few tax strategies that can help minimize (or completely avoid) capital gains tax on the sale of a rental property.

What Are My Options?

1031 Exchange

If your intention is to sell your current rental to buy a new one, consider using a 1031 exchange. The IRS Section 1031 provision enables a "like-kind" exchange, allowing the proceeds from the sale of one rental property to be reinvested in a similar property.

Using this strategy can defer capital gains tax. If you keep a portion of the sale proceeds instead of reinvesting the entire amount, you'll owe capital gains on the money not put toward the new property.

There are some deadlines to be aware of for a 1031 exchange to be successful. You have 45 days from the sale to identify potential replacements for your rental property. The replacement must be bought 180 calendar days after you sell your original property or by the due date of the taxpayer’s return (whichever comes first). Your 1031 exchange needs to be reported to the IRS with Form 8824.

Tax-loss Harvesting

For those aiming to exit the rental business entirely, tax-loss harvesting is a valuable tactic. The goal of tax-loss harvesting is to offset your capital gains with other investment losses. If you own an investment that has lost value (an unrealized capital loss), then selling this investment in the same year as a capital gain can minimize your tax liability.

For instance, imagine you're an investor who has made a $25,000 profit by selling a property, but at the same time, you have invested in a stock position that has lost $35,000 in value. If you sell some of that position, you can use the loss to offset your $25,000 gain, resulting in no capital gains taxes.

Convert the Rental to a Primary Residence

Converting the rental property into your primary residence for a minimum of two of the last five years before selling can reduce your tax liability. Under Section 121 in the tax code, the primary residence exclusion allows individuals to exclude up to $250,000 of the profits from the sale of their primary residence if they’re single and up to $500,000 if they’re married and filing jointly.

Unfortunately, rental properties often don't get the full deduction. Your allowable deduction depends on how long the property was used for rental purposes. Additionally, any depreciation deductions you’ve previously claimed when the property was a rental cannot be excluded from your capital gains. Instead, the deducted depreciation will be subject to a depreciation recapture tax when you sell the property.

The Bottom Line

While capital gains tax applies to the sale of rental properties, these strategies can help manage the tax burden. To make an informed decision, assess whether you plan to remain in the rental business or move on, and consider your desired timeline for the sale. Understanding your goals can help determine the best strategy for your circumstances.