5 Steps to Calculate Capital Gains Tax

1. Calculate Your Cost Basis

The first step is to calculate your cost basis. This is the price you bought the property for, plus any money you spent on capital improvements. Capital improvements can include getting a new roof, adding landscaping, or renovating a kitchen. Subtract any depreciation you've claimed over the time you've owned the asset.

2. Subtract Your Cost Basis From the Sale Price

Once you have calculated your cost basis, you will subtract your basis from the sale price. The sale price is the amount of money you make selling the property minus any closing costs or realtor commissions.

3. Determine if This is a Short-Term or Long-Term Asset

Your investment's tax treatment depends on whether it is a short-term or long-term asset. Short-term assets, held for less than a year, are taxed at higher rates than long-term assets, held for over 12 months. Holding onto your rental property for at least a year can significantly reduce your tax burden.

4. Take into Account Depreciation Recapture

If you took depreciation deductions while you owned the rental property, the federal government expects to "recapture" those deductions when you sell. Therefore, you will have to pay 25% of the money you deducted in a depreciation tax.

5. Apply Appropriate Tax Rates (Including State Taxes)

After calculating your taxable capital gain, apply the applicable rate. Keep in mind that many states impose their own capital gains tax on top of the federal rate, which is 20% for long-term gains in the top income bracket. For example, California investors may face an additional 13%, bringing their total tax rate to over 33%.

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