

Is Your Real Estate Business Eligible for Enhanced Depreciation Opportunities?

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Historically, depreciation has created tax-advantaged returns for real estate owners and investors. Depreciation has shielded taxpayers from income taxes on otherwise positive cash flowing properties. Below is a discussion on some of the methods available for taxpayers to accelerate depreciation. There are several options and scenarios real estate businesses need to consider when assessing what is the most beneficial for them.

Additional First Year Depreciation (Bonus Depreciation)

Bonus depreciation enables taxpayers to accelerate the depreciation of property purchased that has a recovery period of 20 years or less and is depreciated using the modified accelerated cost recovery system (MACRS). For real estate businesses, this typically includes, but is not limited to, qualified improvement property (QIP), furniture, fixtures, land improvements, flooring, cabinets and appliances.

Currently, any qualifying assets placed into service on or after January 1, 2024 are eligible for bonus depreciation equal to 60% of the purchase price. This benefit will

continue to drop by 20% per annum until bonus depreciation phases out completely for assets placed in service on or after January 1, 2027.

The following chart illustrates the phase out:

Date Property is Placed in Service is on or after	Percentage of Eligible Bonus Depreciation
September 27, 2017	100%
January 1, 2023	80%
January 1, 2024	60%
January 1, 2025	40%
January 1, 2026	20%
January 1, 2027	0%

Owners of nonresidential real estate may utilize bonus depreciation on qualified improvement property (QIP). QIP is defined as property that is an interior improvement, placed in service after the date the building was first placed in service, made by the taxpayer, and placed in service after December 31, 2017. It does not include elevators and escalators, internal structural framework and improvements that relate to the enlargement of the building. Taxpayers that are considering offering tenant allowances should be aware that these costs could be deemed lease acquisitions costs and amortized over the life of the lease. If bonus depreciation is deemed more beneficial, care must be taken when drafting lease agreements. One consideration for owners of nonresidential real estate regarding the eligibility of utilizing bonus depreciation on QIP is if the business makes the irrevocable election out of business interest expense limitation. Should they make this election, QIP will be ineligible for bonus depreciation.

When considering bonus depreciation, real estate businesses need to assess the state implications for their owners. Many states do not conform to federal bonus depreciation and modify their income to disallow the accelerated depreciation.

This adjustment may increase state taxable income, thereby affecting cash flows if distributions are required to cover state income tax expense for the owners. If the partnership does not provide for tax distributions, this can cause unexpected higher state taxable income to investors and can be an especially sensitive issue with passive investors.

Section 179 Deduction

Under Internal Revenue Code Section 179, eligible taxpayers may elect to expense qualifying property up to certain dollar limitations. To be eligible, property must be purchased for use in a trade or business.

Unlike bonus depreciation, it cannot create a net loss for the business. Tangible personal property (e.g., furniture, fixtures, carpets, etc.) is eligible for this deduction. For real estate businesses, the cost of “qualified real property” is also eligible, which includes QIP (discussed above) as well as the following expenditures made for non-residential real property after the property was originally placed in service: roofs, HVAC, fire protection and alarm/security systems. Land improvements are not eligible.

For tax year 2024, the maximum deduction under Section 179 is \$1,220,000 with a dollar for dollar phase out once the amount of qualified Section 179 property placed in service exceeds \$3,050,000. Disallowed deductions due to trade or business limitations are carried forward indefinitely and can potentially be utilized in a future tax year.

As with bonus depreciation, businesses also need to understand the state tax implications.

There could be significant state impact on owners and investors depending on the location of the property and the residence of the taxpayer.

Cost Segregation Studies

Cost segregation studies offer real estate businesses a valuable way to accelerate depreciation. These studies identify and quantify various components within both

purchased and constructed assets, allowing businesses to depreciate certain building components over shorter timeframes. Many of these identified assets qualify for bonus depreciation, further increasing the depreciation deduction.

Cost segregation studies do not need to be performed in the year the building was purchased or constructed. Businesses can implement studies in subsequent tax years. If a business chooses to implement a study in a future year, they must recalculate the depreciation that was in effect the year the building was placed in service. For example, a real estate business purchases and places a property in service during 2023. They have a cost segregation performed in tax year 2024. The business can still utilize 80% bonus on any eligible property when the adjustment is made on the 2024 tax return since it relates to a 2023 purchase.

Tangible Property Regulations

The tangible property regulations (sometimes referred to as the “repair regulations”) are often overlooked and underutilized by real estate businesses. [Prior to the implementation of the repair regulations](#), taxpayers had to capitalize the cost of any asset that had a useful life in excess of one year and depreciate the cost of the asset over the asset’s life. There was no clear definition of what a repair was, leading taxpayers to capitalize improvements that can now be expensed. The repair regulations, issued in 2014, provided guidance to taxpayers as to what improvements could be considered a repair and expensed in the year incurred. These regulations have enabled taxpayers to deduct significant improvements, which under old law may have been capitalized.

One of the most beneficial aspects of the repair regulations is that the expenditure is considered an expense, not a capitalized fixed asset with additional rules and limitations on its depreciation. There are no state adjustments that need to be made. In addition, there is no potential for a recapture of gain attributable to prior depreciation taken on the asset upon disposition. Lastly, there is no phase out or dollar limitation on the amount of qualifying improvements that can be expensed. Unless there is an Act of Congress, this provision is in the tax law indefinitely.

Conclusion

The above discussion highlights some of the high-level items that real estate businesses need to analyze when strategizing how to maximize their depreciation. Careful planning and analysis of future projects is critical to make sure depreciation is utilized in the most efficient manner.

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