Navigating Real Estate Depreciation: Current Law and Potential 2025 Tax Changes

Executive Summary

As of early 2025, the landscape for real estate depreciation is defined by the ongoing, scheduled phase-out of enhanced tax benefits enacted under the 2017 Tax Cuts and Jobs Act (TCJA). Bonus depreciation, a key tool for accelerating deductions on qualifying property, is available at a **40% rate** for assets placed in service during the 2025 calendar year.[1] This continues the gradual reduction from the 100% rate available through 2022.[4] Standard depreciation rules under the Modified Accelerated Cost Recovery System (MACRS) apply to the remaining cost basis and assets ineligible for bonus depreciation, while Section 179 expensing remains an option subject to specific annual limits.[1]

Significant legislative activity occurred in early 2025 with the adoption of the Fiscal Year (FY) 2025 Budget Resolution (H.Con.Res. 14) by both the House and Senate, finalized on April 10, 2025.[8] This resolution does not alter existing tax law directly; rather, its primary function is to **unlock the budget reconciliation process**.[10] This procedural mechanism allows Congress to potentially pass subsequent tax and spending legislation later in the year with only a simple majority vote in the Senate, bypassing typical filibuster rules.[10] The resolution provides fiscal targets and instructions to congressional committees, setting the stage for potential tax reform.

A central proposal facilitated by this budget resolution, and strongly associated with President Trump's policy goals, involves the **restoration of 100% bonus depreciation**.[10] The proposal suggests this restoration could be **retroactive to January 20, 2025**.[11] Such a change would represent a significant reversal of the current phase-out schedule.

For real estate investors, these existing rules and potential legislative shifts carry substantial weight. Depreciation deductions directly impact taxable income and cash flow, influencing investment returns. Strategies like cost segregation studies, which identify property components eligible for faster depreciation, become particularly impactful when coupled with high bonus depreciation rates.[2] However, the current environment is marked by considerable uncertainty. Investors must operate under the established phase-down of bonus depreciation while simultaneously planning for the possibility of a significant, potentially retroactive, legislative reversal later in 2025. This juxtaposition of scheduled reductions and active political efforts to undo them

complicates long-term capital planning and investment timing.

I. Current State of Depreciation for Real Estate (Early 2025)

A. MACRS Framework for Real Property

The foundation for depreciating real property investments in the United States is the Modified Accelerated Cost Recovery System (MACRS), applicable to assets placed in service after 1986.[7] MACRS dictates the timeframe over which the cost basis of tangible property used in a trade or business or for income production can be recovered through annual depreciation deductions.[17]

Under the most commonly used framework, the General Depreciation System (GDS), MACRS assigns specific recovery periods to different types of real property. **Residential rental property** (e.g., apartment buildings) has a recovery period of **27.5 years**, while **nonresidential real property** (e.g., office buildings, retail centers, warehouses) has a recovery period of **39 years**.[2] Depreciation for these long-lived assets under GDS is typically calculated using the straight-line method, meaning the deductible amount is generally the same each full year over the recovery period.[21]

An alternative framework, the Alternative Depreciation System (ADS), utilizes longer recovery periods. For instance, under ADS, residential rental property placed in service currently has a **30-year recovery period** (changed from 40 years by the TCJA), and nonresidential real property has a 40-year recovery period.[18] Taxpayers might elect to use ADS, although this choice is generally irrevocable for that property.[18] In certain situations, using ADS is mandatory, such as when a real property trade or business elects out of the business interest expense limitations under Section 163(j).[22] A critical consequence of using ADS for real property is that it generally renders the property ineligible for bonus depreciation.[22]

It is fundamental to note that **land itself is never depreciable**, as it is not considered to wear out or become obsolete.[7] Depreciation deductions apply only to the improvements on the land, such as buildings, and certain specific land improvements like paving or fencing.[2]

While accelerated methods like bonus depreciation often capture headlines, understanding the underlying MACRS recovery periods and methods is essential. These rules form the baseline for calculating depreciation, especially as bonus depreciation percentages decrease under current law or if a taxpayer elects (or is required) to use the slower ADS method. The standard MACRS deductions become increasingly significant in determining annual tax liabilities as the availability of bonus depreciation diminishes.

B. Bonus Depreciation: The 2025 Landscape (40% Rate, Phase-Out)

Bonus depreciation, formally known as the additional first-year depreciation deduction under Internal Revenue Code Section 168(k), allows businesses to deduct a significant percentage of the cost of qualifying assets in the year they are placed in service, rather than recovering the cost gradually over the asset's MACRS life.[1]

Under the phase-out schedule mandated by the TCJA, the applicable bonus depreciation percentage for qualified property **placed in service during the calendar year 2025 is 40%**.[1] This reduction follows the rates of 100% for property placed in service between September 27, 2017, and December 31, 2022, 80% for 2023, and 60% for 2024.[1] The phase-out is scheduled to continue, dropping to 20% for property placed in service in 2026, and eliminating bonus depreciation entirely (0%) for property placed in service in 2027 and beyond.[3]

The following table summarizes the current phase-out schedule under existing law:

Bonus Depreciation Percentage by Placed-in-Service Year (TCJA Phase-Out)

Calendar Year Property Placed in Service	Bonus Depreciation Percentage
Sept 27, 2017 - Dec 31, 2022	100%
2023	80%
2024	60%
2025	**40%**
2026	20%
2027 and later	0%

Source: Data compiled from [1]

To qualify for bonus depreciation, property must meet several criteria. Primarily, it must generally have a MACRS recovery period of **20 years or less**.[2] This requirement is particularly relevant for real estate investors. While the main structure of a residential (27.5 years) or nonresidential (39 years) building does not qualify, many components identified through cost segregation studies (discussed later) or specific types of property like Qualified Improvement Property (QIP) do meet this 20-year threshold. Other eligible assets include tangible personal property (like furniture, fixtures, machinery, equipment), depreciable computer software, water utility property, certain vehicles (subject to dollar limitations [20]), and costs of certain film, television, and live theatrical productions.[4]

A significant change introduced by the TCJA was the expansion of bonus depreciation eligibility to include **both new and used property**.[1] Previously, bonus depreciation was generally limited to new assets.[1] To qualify, used property must meet specific acquisition requirements: it must not have been used by the taxpayer or a predecessor at any time prior to acquisition, it must not have been acquired from a related party, and its basis must not be determined by reference to the adjusted basis of the property in the hands of the transferor (e.g., not acquired in a tax-free exchange).[29] This expansion dramatically increased the utility of bonus depreciation for real estate investors acquiring existing properties, as it allowed immediate deductions for qualifying used components identified through cost segregation. As the bonus rate phases down, the magnitude of this benefit for acquired properties diminishes, but the eligibility remains.

The date an asset is **placed in service**—meaning it is ready and available for its specifically assigned function—is critical for determining the applicable bonus depreciation rate.[3] For example, qualifying property placed in service on December 31, 2024, was eligible for 60% bonus depreciation, whereas the same property placed in service just one day later, on January 1, 2025, is only eligible for the 40% rate.[3]

Bonus depreciation is generally mandatory for eligible property unless the taxpayer elects out.[29] This election is made on a property-class-by-property-class basis for all qualifying property within that class placed in service during the same tax year.[29]

The clear schedule for declining bonus depreciation percentages naturally creates an incentive for businesses to accelerate investments. Completing acquisitions or improvements sooner allows capture of a higher bonus rate.[1] However, the current political discussions about potentially restoring 100% bonus depreciation introduce a conflicting consideration, potentially rewarding those who wait. This legislative uncertainty complicates investment timing decisions that would otherwise be straightforward under the existing phase-out schedule.

C. Section 179 Expensing: Current Limits and Real Property Applicability

Section 179 of the Internal Revenue Code provides an alternative mechanism for accelerating deductions. It allows taxpayers to elect to treat the cost of qualifying property as an expense in the year the property is placed in service, rather than capitalizing and depreciating it over time.[1]

However, Section 179 expensing is subject to limitations. For property placed in service in **2025**, the maximum amount a taxpayer can elect to expense is **$1,250,000**. This maximum deduction begins to phase out dollar-for-dollar if the total cost of qualifying property placed in service during the year exceeds **$3,130,000**.[1] These limits are adjusted annually for inflation.[1]

Crucially, the Section 179 deduction is also limited to the taxpayer's **aggregate taxable income derived from the active conduct of any trade or business** during the tax year.[2] Unlike bonus depreciation, Section 179 cannot be used to create or increase a net operating loss.[2] Any amount disallowed due to the taxable income limitation can be carried forward to subsequent tax years.[17]

Qualifying property for Section 179 generally includes tangible personal property such as machinery, equipment, and furniture, as well as off-the-shelf computer software.[1] The TCJA significantly expanded the applicability of Section 179 for real estate investors by making certain improvements to **nonresidential real property** eligible, provided these improvements are placed in service *after* the date the building itself was first placed in service.[20] This category, sometimes referred to as "Qualified Real Property," includes expenditures for **roofs, heating, ventilation, and air-conditioning (HVAC) property, fire protection and alarm systems, and security systems** installed on nonresidential buildings.[4] **Qualified Improvement Property (QIP)**, discussed below, is also eligible for Section 179 expensing.[4]

When both Section 179 and bonus depreciation are applicable, the Section 179 deduction is typically calculated first.[1] A business might elect to expense certain assets under Section 179 up to the dollar limit (provided they have sufficient business income) and then apply the current bonus depreciation percentage (40% for 2025) to the remaining basis of those assets and the basis of other bonus-eligible property.[1]

The choice between prioritizing Section 179 or relying on bonus depreciation involves strategic considerations. Section 179 offers a 100% deduction for specifically chosen qualifying assets up to the annual limit, which can be more advantageous than the current 40% bonus rate, but only if the taxpayer has sufficient business income and stays within the investment limit.[2] Bonus depreciation, while only 40% in 2025, has no taxable income limitation, can generate losses, and applies to a potentially larger base of assets without an upper dollar cap.[2] Therefore, the optimal strategy depends on the investor's income situation, the total amount of investment in qualifying property, and the specific types of assets being acquired or improved. As bonus depreciation phases down, Section 179 becomes relatively more attractive for eligible nonresidential real property improvements, assuming the income and investment limitations are met.

D. Qualified Improvement Property (QIP): Status and Bonus Eligibility

Qualified Improvement Property (QIP) represents a specific category of real property improvements that receives favorable depreciation treatment. QIP is defined as any improvement made **by the taxpayer** to an **interior portion** of a **nonresidential building**, provided the improvement is placed in service *after* the date the building was originally placed in service.[4] Examples can include installing new drywall, ceilings, interior doors, or upgrading interior plumbing and electrical systems.[31]

However, certain improvements are explicitly excluded from the QIP definition, namely those related to the enlargement of the building, any elevators or escalators, or the internal structural framework of the building.[4]

The treatment of QIP has a somewhat complex legislative history. The TCJA of 2017 intended to consolidate several previous categories of qualified interior improvements under the single QIP definition and assign it a 15-year recovery period, making it eligible for bonus depreciation. However, due to a drafting error (often called the "retail glitch"), the TCJA failed to assign the 15-year life, causing QIP placed in service in 2018 and 2019 to default to the 39-year recovery period for nonresidential real property, thereby making it ineligible for bonus depreciation.[22] This unintended consequence significantly impacted businesses making interior renovations, particularly in the retail and restaurant sectors.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted in March 2020, provided a retroactive technical correction.[21] It officially assigned QIP placed in service after December 31, 2017, a **15-year recovery period under GDS** (and a 20-year period under ADS).[22] This correction restored the original intent and made QIP eligible for bonus depreciation.[27]

Therefore, under current law for **2025**, QIP is treated as 15-year property under GDS, depreciated using the straight-line method.[21] Because its recovery period is 20 years or less, QIP placed in service in 2025 is **eligible for the 40% bonus depreciation**.[4]

Several nuances are important for QIP eligibility. The improvement must be made **by the taxpayer**; an investor generally cannot acquire a building and classify improvements made by a previous owner as QIP.[30] The CARES Act emphasized this requirement.[27] QIP treatment applies only to improvements made to **nonresidential** buildings; interior upgrades to residential rental properties do not qualify.[30] Care must also be taken with tenant improvement allowances paid by landlords to tenants; these may be treated as lease acquisition costs amortized over the lease term rather than QIP, depending on lease terms and how funds are used.[4] Finally, if a real property trade or business elects out of the Section 163(j) business interest expense limitation, it must use the ADS method for QIP, resulting in a 20-year recovery period and rendering the QIP **ineligible for bonus depreciation**.[4]

The history of QIP serves as a clear example of how technical errors in complex legislation can create significant disruptions and require subsequent legislative fixes. It underscores the intricacies of the tax code and the importance of precise statutory language. Furthermore, the specific targeting of QIP benefits towards nonresidential properties creates a notable difference in the tax treatment of interior upgrades compared to residential rental properties, favoring investments in commercial, retail, and industrial spaces in this regard.

E. Cost Segregation: Unlocking Accelerated Deductions

Cost segregation is a tax planning strategy widely used by real estate investors to accelerate depreciation deductions. It involves conducting a detailed, often engineering-based, study of a building's components to identify and reclassify assets from the building's structural category (27.5-year or 39-year MACRS life) to categories with shorter recovery periods.[2]

Typically, a cost segregation study identifies:

- **Tangible Personal Property (Section 1245 property):** Assets like carpeting, cabinetry, decorative fixtures, and specialized electrical or plumbing serving equipment. These often qualify for a **5-year or 7-year** MACRS recovery period.
- **Land Improvements (Section 1250 property):** Assets outside the building structure, such as parking lots, sidewalks, fencing, landscaping, and exterior lighting. These generally qualify for a **15-year** MACRS recovery period.[2]

The primary goal of cost segregation is to maximize the portion of the property's cost basis allocated to these shorter-lived asset classes, thereby increasing depreciation deductions in the early years of ownership compared to depreciating the entire building cost over 27.5 or 39 years.[2]

The synergy between cost segregation and bonus depreciation is powerful. Assets identified through a cost segregation study that have a MACRS recovery period of **20 years or less**—which includes virtually all 5-year, 7-year, and 15-year property identified—are eligible for bonus depreciation.[2] During the 100% bonus depreciation era (late 2017-2022), this meant investors could often immediately expense a significant portion (e.g., 15-30% or more) of a property's acquisition or construction cost in the first year.

With the bonus depreciation rate at **40% for 2025**, the immediate expensing benefit is reduced but still substantial. For example, if a cost segregation study on a $1 million nonresidential property identifies $200,000 worth of 5, 7, and 15-year property, the investor could claim $80,000 ($200,000 x 40%) in bonus depreciation in 2025, in addition to the standard MACRS depreciation on the remaining 60% of the short-lived assets and the 39-year building structure.[16]

Cost segregation studies can be performed on newly constructed properties, acquired properties (including used buildings, leveraging the TCJA change allowing bonus on used assets [2]), and properties undergoing significant renovation.[4] Importantly, a study does not necessarily need to be performed in the year of acquisition or construction. It can often be implemented for properties placed in service in prior years.[4] In such cases, the taxpayer typically files Form 3115, Application for Change in Accounting Method, to claim the "catch-up" depreciation resulting from the reclassification, potentially including the bonus depreciation percentage that was applicable in the year the property was originally placed in service.[4] This retroactive application provides a valuable planning opportunity for investors who may not have utilized cost segregation initially.

The effectiveness of cost segregation is directly linked to the prevailing bonus depreciation rate. While cost segregation provides benefits even without bonus depreciation by simply shifting costs to shorter recovery periods, the availability of bonus depreciation significantly amplifies the upfront tax savings. As the bonus rate declines, the *incremental* value provided by bonus depreciation decreases, but the underlying value of accelerating deductions through cost segregation remains.

II. The FY 2025 Budget Resolution & Potential Tax Law Changes

A. Legislative Context: The Budget Resolution's Path and Purpose (H.Con.Res.

14)

In the U.S. Congress, a budget resolution serves as an internal framework or blueprint outlining spending and revenue targets over a specified period, typically ten years.[8] Crucially, a budget resolution is **not a law**; it does not require the President's signature and does not directly change any federal programs or tax statutes.[10]

Its primary significance lies in its ability to provide **budget reconciliation instructions** to specific congressional committees.[10] These instructions set targets for deficit reduction or allow for deficit increases within specified limits. Legislation subsequently drafted by those committees that complies with these instructions (known as a reconciliation bill) receives procedural advantages, most notably protection from filibusters in the Senate. This allows a reconciliation bill to pass the Senate with only a **simple majority (51 votes)**, rather than the 60 votes typically needed to end debate on major legislation.[8]

The process for the FY 2025 budget resolution (H.Con.Res. 14) unfolded as follows:

- The House of Representatives passed its initial version on February 25, 2025.[8]
- The Senate subsequently amended and passed its version on April 5, 2025.[10]
- The House then voted to adopt the Senate-amended version on April 10, 2025.[8]

Because both chambers adopted the identical resolution text, the **budget reconciliation process for FY 2025 was officially unlocked**.[10] This action cleared a critical procedural hurdle, creating the legislative pathway for Republicans to potentially advance significant tax legislation later in the year using the simple-majority threshold in the Senate. The resolution itself did not enact any tax changes, but it enabled the process through which such changes could be made.

B. Reconciliation Mechanics: How Tax Changes Could Be Enacted (Incl. Baselines)

The reconciliation instructions embedded within the adopted FY 2025 budget resolution direct the committees responsible for taxes—the House Ways and Means Committee and the Senate Finance Committee—on the maximum net fiscal impact their legislation can have over the 10-year budget window (FY 2025-2034).[10]

The final resolution, reflecting the Senate amendments adopted by the House, contains differing instructions and, critically, different baseline assumptions for each chamber's tax-writing committee:

- **House Ways & Means Committee:** Instructed to report legislation producing net

tax cuts of up to **$4.5 trillion** over ten years. This figure is measured against a **"current law" baseline**, which assumes that temporary tax provisions, like many from the TCJA, expire as scheduled under existing law.[10] The full $4.5 trillion allowance was also made contingent upon other House committees achieving at least $2 trillion in mandatory spending cuts.[10]
- **Senate Finance Committee:** Instructed to report legislation producing net tax cuts of up to **$1.5 trillion** over ten years. This figure, however, is measured against a **"current policy" baseline**.[10] This baseline controversially assumes that major expiring tax provisions (primarily from the TCJA) are *already extended* in the baseline itself.[10]

The difference between these baselines is profound and strategically significant. Extending the expiring individual and estate tax provisions of the TCJA is estimated to cost roughly $3.8 trillion to $4.6 trillion over ten years relative to current law.[8]

- Under the **"current law" baseline** used for the House instructions, extending these provisions consumes most of the $4.5 trillion allowance.[8]
- Under the **"current policy" baseline** used for the Senate instructions, the cost of extending these same provisions is effectively scored as $0 within the budget window, because their continuation is assumed in the baseline.[8]

The practical effect of the final adopted resolution, incorporating the Senate's baseline approach, is that it allows for approximately $3.8 trillion in TCJA extensions (which are "costless" under the current policy baseline for scoring purposes) *plus* an additional $1.5 trillion in net tax cuts. This sums to a total potential deficit increase of roughly **$5.3 trillion** over ten years relative to actual current law.[8] The use of the current policy baseline allows proponents to frame the extension of expiring cuts as merely maintaining the status quo (costing $0 against that specific baseline), thereby creating significant apparent room within the reconciliation instructions for *additional* tax cuts, such as restoring 100% bonus depreciation or implementing other priorities, which might not have fit under the tighter "current law" cap initially passed by the House. This budgetary maneuver, while technically permissible under reconciliation rules, effectively masks a larger fiscal impact compared to a traditional current law measurement.

Legislation passed via reconciliation must also comply with other procedural constraints, notably the Senate's "Byrd Rule," which prohibits provisions deemed extraneous to the budget, including those that do not produce a change in outlays or revenues, or those that increase the deficit beyond the 10-year budget window.[8] This rule can influence the design and permanence of tax policy changes enacted through reconciliation.

While the budget resolution sets the fiscal parameters and enables the process, the specific tax policies to be included in the eventual reconciliation bill remain subject to negotiation and drafting within the Ways and Means and Finance Committees. The resolution establishes the outer boundaries for the tax package, but the detailed content must still be developed, debated, and ultimately passed by both chambers before becoming law.

C. The Proposal: Restoring 100% Bonus Depreciation

A prominent tax policy proposal under discussion, strongly advocated by President Trump and facilitated by the FY 2025 budget reconciliation process, is the restoration of 100% bonus depreciation.[10]

The core elements of this proposal are:

- To increase the bonus depreciation percentage back to **100%** from the current 40% rate.[10]
- To make this change effective **retroactively to January 20, 2025**, the date of President Trump's inauguration.[11]

The stated rationale for restoring 100% bonus depreciation is to encourage businesses to invest more readily in capital assets like equipment, machinery, software, and qualifying real property improvements (like QIP or components identified via cost segregation).[13] Allowing immediate expensing of these investments is argued to boost economic activity, enhance productivity, and improve business cash flow.[13]

While restoring 100% bonus depreciation is clearly a high priority for its proponents, its ultimate inclusion in a reconciliation bill, along with its final form (particularly the retroactive effective date), is not guaranteed. It must be incorporated into the legislative text drafted by the tax-writing committees and its estimated fiscal cost must fit within the overall deficit targets established by the budget resolution.[10] The Congressional Research Service, citing Joint Committee on Taxation estimates, noted that extending 100% bonus depreciation through 2034 would cost approximately $378 billion, plus associated interest costs.[13] This cost, while significant, may be easier to accommodate within the Senate's $1.5 trillion "current policy" allowance, as it doesn't directly compete for space with the ~$3.8 trillion cost of extending the base TCJA provisions under that specific baseline.[33]

The proposed retroactive effective date of January 20, 2025, is unconventional. Tax legislation typically aligns effective dates with the beginning or end of a calendar year or taxable year.[11] Implementing a mid-January effective date could introduce administrative complexities for taxpayers and the IRS, potentially requiring amended returns or adjustments for property placed in service between January 20 and the date the legislation is enacted. If enacted, this retroactivity could mean taxpayers who placed property in service early in 2025 under the assumption of a 40% bonus rate might need to recalculate depreciation to claim the full 100%, similar to the adjustments needed after the CARES Act corrected the QIP error.[30]

The push to restore 100% bonus depreciation reflects a political desire to return to a key policy feature of the TCJA era.[13] However, its significant cost necessitates balancing it against other tax priorities within the fiscal constraints defined by the budget resolution. The use of the "current policy" baseline provides more flexibility, but trade-offs among various tax cut proposals may still be required during the legislative drafting process.[12]

D. Related Business Tax Provisions Under Discussion

The FY 2025 reconciliation process is expected to address several other significant business tax provisions beyond bonus depreciation, many of which were included in the Tax Relief for American Families and Workers Act of 2024 that passed the House but stalled in the Senate.[11] Key items likely to be considered include:

- **Research and Development (R&D) Expensing (Section 174):** There is broad, bipartisan support for restoring the ability of businesses to immediately deduct domestic R&D expenditures.[37] Under current law, which took effect for tax years beginning after December 31, 2021, these costs must be capitalized and amortized over five years (15 years for foreign R&D).[10] Reverting to immediate expensing is seen as a pro-growth measure.[38]
- **Business Interest Expense Limitation (Section 163(j)):** Another TCJA provision that became less favorable involved the limitation on the deductibility of business interest expense. Since 2022, the limit has been calculated based on 30% of adjusted taxable income (ATI) using earnings *before* interest and taxes (EBIT).[11] Prior to 2022, the calculation used the more generous earnings *before* interest, taxes, depreciation, and amortization (EBITDA).[10] There is support, particularly among business groups, for returning to the EBITDA-based calculation, although consensus may be less broad than for R&D expensing.[37] This issue is particularly relevant for highly leveraged businesses, although many real estate businesses elect out of the Section 163(j) limitation entirely (in exchange for using the slower

ADS depreciation method).[4]

Beyond these "Big Three" business provisions, the reconciliation bill could potentially include other changes, such as:

- Lowering the corporate income tax rate, perhaps to 15% for domestic manufacturers.[10]
- Modifying the $10,000 cap on the state and local tax (SALT) deduction for individuals, potentially raising the cap or repealing it, possibly offset by limiting SALT deductions for businesses.[10]
- Extending or modifying the Section 199A qualified business income (QBI) deduction for pass-through entities.[14]
- Repealing or modifying clean energy tax incentives enacted in the Inflation Reduction Act.[10]
- Extending or expanding incentives related to Qualified Opportunity Zones (QOZs).[14]

The inclusion and final design of any of these provisions, including bonus depreciation, will depend on complex negotiations within Congress. Changes to bonus depreciation are unlikely to occur in isolation but will be part of a larger package involving numerous trade-offs between competing business and individual tax priorities, all needing to fit within the fiscal boundaries set by the budget resolution. The fate of bonus depreciation is thus linked to the broader dynamics of the reconciliation negotiations.

III. Strategic Implications for Real Estate Investors

A. Planning for Potential 100% Bonus Depreciation

The prospect of 100% bonus depreciation being restored, potentially retroactively to January 20, 2025, requires careful consideration by real estate investors. If enacted, this change could dramatically alter the tax implications of investments made during the year.

- **Impact on 2025 Investments:** Investors placing qualifying property in service after the proposed January 20, 2025 effective date could realize significantly larger first-year deductions than anticipated under the current 40% rate.[14] This applies notably to assets identified through cost segregation (5, 7, and 15-year property) and Qualified Improvement Property (QIP).
- **Investment Timing:** The potential for 100% bonus might incentivize accelerating planned acquisitions or significant improvement projects into 2025 to capture the

immediate expensing benefit.[14] However, this must be weighed against the risk that the legislative change does not occur or is delayed. Acting solely based on speculation carries risk.

- **Value of Cost Segregation:** A return to 100% bonus depreciation would substantially amplify the value of conducting cost segregation studies.[4] The ability to immediately write off the entire cost of identified 5, 7, and 15-year components, rather than just 40% plus standard depreciation, offers a powerful cash flow advantage. Investors undertaking new construction, acquisitions, or major renovations should strongly consider commissioning these studies.
- **Offsetting Income:** For investors with significant taxable income, 100% bonus depreciation can provide substantial tax savings. For those qualifying as Real Estate Professionals (REPS) or meeting material participation standards for Short-Term Rentals (STRs), the enhanced depreciation could generate larger deductible losses to offset active income sources like W-2 earnings or other business income.[14]

The uncertainty surrounding the potential change creates a planning challenge. Should an investor act based on current law (40% bonus) or delay decisions hoping for 100%? Delaying risks missing the current 40% benefit if the law doesn't change, while acting now means potentially foregoing a larger retroactive deduction if 100% bonus is enacted later. A prudent approach may involve prioritizing investments with strong underlying economic fundamentals irrespective of the bonus rate, while ensuring tax strategies like cost segregation are employed to maximize benefits under whatever law ultimately prevails.[14] Flexibility in planning is key.

B. Navigating the Current 40% Rate and Legislative Uncertainty

While awaiting potential legislative changes, investors must operate under the existing tax framework.

- **Value of 40% Bonus:** Even at the reduced 40% rate, bonus depreciation still offers a valuable acceleration of deductions compared to standard MACRS depreciation, particularly when applied to shorter-lived assets identified through cost segregation.[1] Its benefits should not be overlooked while speculating on future changes.
- **Placed-in-Service Dates:** Meticulous record-keeping of the exact dates assets are placed in service remains critical, as this determines eligibility for the 40% rate versus the prior 60% rate or the future 20% rate under current law.[3]
- **Capitalization Policies:** With lower bonus depreciation rates, the financial impact of classifying an expenditure as a deductible repair versus a capitalized

improvement becomes more pronounced.[3] Investors should review their capitalization policies and ensure compliance with the tangible property regulations (e.g., Regs. Sec. 1.263(a)). Utilizing elections like the de minimis safe harbor for expensing small-dollar items can also provide immediate deductions.[3]
- **Stay Informed:** Closely monitoring legislative developments concerning the FY 2025 reconciliation bill through reliable channels, including tax professionals and reputable financial news sources, is essential for timely planning adjustments.[16]

The reduction in bonus depreciation highlights the enduring importance of fundamental tax planning. Practices such as accurate asset classification, careful analysis of repair versus capitalization expenditures, and diligent record-keeping become even more crucial for optimizing tax outcomes when the availability of highly accelerated depreciation is diminished or uncertain.[3] Maximizing standard MACRS deductions and appropriately claiming repair expenses regains significance.

C. Key Considerations: State Taxes, Recapture, and Investor Status (REPS/STR)

Effective tax planning for real estate depreciation requires looking beyond the federal bonus depreciation rate and considering several other critical factors:

- **State Tax Conformity:** A significant number of states do **not** automatically conform to the federal bonus depreciation rules under Section 168(k).[4] Some states explicitly decouple, requiring taxpayers to add back the federal bonus deduction when calculating state taxable income. Others may conform to an older version of the federal rules or have their own specific depreciation methods. This lack of conformity can substantially reduce the net cash flow benefit of federal bonus depreciation, as a large federal deduction might trigger a higher state tax liability. Investors must verify the specific depreciation rules for each state in which they own property.
- **Depreciation Recapture:** The tax benefits of depreciation deductions, including bonus depreciation, are often subject to recapture upon the sale of the property. When a depreciable property is sold at a gain, the portion of the gain attributable to previously claimed depreciation deductions may be taxed at different rates than the portion attributable to market appreciation.[2] For Section 1250 property (which includes buildings and their structural components), depreciation claimed in excess of straight-line (less common now for real property) is recaptured as ordinary income. Straight-line depreciation claimed on real property is generally subject to "unrecaptured Section 1250 gain," taxed at a maximum rate of 25%.[5] Depreciation on Section 1245 property (tangible personal property identified via cost segregation) is generally recaptured as ordinary income to the extent of the

gain.[30] Investors must factor these potential future recapture taxes into their analysis when evaluating the long-term benefits of accelerated depreciation.[24]

- **Investor Activity Level (Passive vs. Active - REPS/STR):** The ability to utilize depreciation deductions, especially if they generate a net rental loss, depends heavily on the investor's participation level and classification under the passive activity loss (PAL) rules.
  - **Passive Investors:** Generally, losses from rental real estate activities are considered passive losses. These can typically only be deducted against passive income from other sources. Excess passive losses are suspended and carried forward to future years or deducted upon disposition of the activity.
  - **Real Estate Professional Status (REPS):** Taxpayers who qualify as real estate professionals under Section 469(c)(7) can potentially treat their rental real estate activities as non-passive.[16] If they also meet material participation standards for those activities, losses (amplified by bonus depreciation) can be deducted against non-passive income, such as wages or other business income, providing a significant tax advantage.[16]
  - **Short-Term Rental (STR) Material Participation:** Even without REPS status, investors in short-term rentals (average stay of 7 days or less, or 30 days or less with significant personal services) may be able to treat the activity as a non-passive trade or business if they meet material participation tests.[16] This can allow STR losses, including depreciation, to offset other active income.[16] The potential return of 100% bonus depreciation would make qualifying under REPS or the STR rules even more valuable for high-income earners seeking tax offsets.[16]

A comprehensive analysis of depreciation strategies must therefore adopt a holistic view. Focusing solely on the federal bonus depreciation percentage is insufficient. The true economic impact depends on the interplay between federal rules, state tax law conformity [4], the eventual tax cost of depreciation recapture upon sale [2], and the investor's individual circumstances regarding passive activity loss limitations.[16]

IV. Conclusion and Recommendations

The tax environment for real estate depreciation in 2025 is characterized by a scheduled reduction in benefits under current law, juxtaposed with significant legislative efforts aimed at reversing this trend. Bonus depreciation is currently available at a 40% rate for qualifying property placed in service during 2025, continuing the phase-out mandated by the TCJA.[1] However, the successful passage of the FY 2025 Budget Resolution has opened a procedural pathway for Congress to potentially enact major tax changes later in the year via reconciliation.[8] A key proposal under consideration is the restoration of 100% bonus depreciation, possibly retroactive to January 20, 2025.[13] This potential shift, combined with the ongoing utility of cost segregation studies and specific rules for Qualified Improvement Property, creates both opportunities and significant planning uncertainty for real estate investors.

Given this landscape, real estate investors should consider the following actionable steps:

1. **Engage Expert Advisors:** The complexity of depreciation rules, cost segregation, state conformity, and potential legislative changes necessitates consultation with qualified tax professionals specializing in real estate and, where appropriate, experienced cost segregation engineers.[4] Personalized advice is crucial for navigating these issues.
2. **Scenario Modeling:** When evaluating potential acquisitions or improvement projects, model the financial outcomes under both current law (40% bonus depreciation in 2025, phasing down further) and potential future law (100% bonus depreciation). Understanding the investment's sensitivity to these tax variables can inform decision-making.
3. **Prioritize Investment Fundamentals:** While tax benefits are important, investment decisions should primarily be driven by sound economic fundamentals, market conditions, and property-specific analysis.[14] Tax optimization strategies like cost segregation should enhance, not dictate, investment choices.
4. **Stay Abreast of Legislation:** Monitor the progress of the FY 2025 reconciliation bill closely. Developments regarding the extension of TCJA provisions, the restoration of bonus depreciation, R&D expensing, and Section 163(j) rules will directly impact planning.[16]
5. **Verify State Tax Rules:** Never assume state conformity with federal depreciation rules. Always confirm the specific treatment of bonus depreciation and Section 179 expensing in the relevant states where properties are located.[4]
6. **Maintain Meticulous Records:** Accurate and detailed documentation of property costs, improvement expenditures (distinguishing repairs from capital improvements), and precise placed-in-service dates is essential for substantiating depreciation deductions and navigating potential future legislative changes or IRS inquiries.[3]

In conclusion, while the potential return of 100% bonus depreciation offers an enticing prospect for enhancing real estate investment returns, investors must currently plan based on the 40% rate applicable in 2025. Strategic use of cost segregation, understanding QIP rules, and careful consideration of state taxes, recapture, and passive loss limitations remain critical components of effective tax planning in this evolving legislative environment.

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