JO Knows Depreciation Changes Affecting Real Estate

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Bonus Depreciation Reduction

Bonus depreciation has been available in varying amounts for some time. This year, taxpayers generally can claim a deduction for 100% of the purchase price of qualified property in the first year, rather than spreading that cost over the asset's useful life under the modified accelerated cost recovery system (MACRS). Starting in 2023, bonus depreciation will be reduced to 80% of the purchase price, with the remaining depreciation spread out over the asset's MACRS life. Bonus depreciation will be reduced an additional 20% in each subsequent year, phasing out completely for years after 2026. This could change the timing of some purchases if the depreciation deduction is needed in a particular year. As always, the use of bonus depreciation should be a consideration when looking at the effects of the Section 199A deduction and in conjunction with the overall results of the entity and the ability of investors to take rental losses.

Increasing Limitation on Business Interest Reduction

Starting back on January 1, 2018, the Tax Cuts and Job Act ("TCJA") implemented a new limitation to business interest deductions. If the limitation applies, the interest deduction is limited to 30% of adjusted taxable income. In prior years, adjusted taxable income was calculated as taxable income plus an addback for interest, depreciation and amortization, so depreciation did not affect the deductible interest limit. In 2022, the addback for depreciation and amortization is no longer allowed, significantly decreasing the amount of deductible interest. A taxpayer who might previously have been able to deduct all its business interest may find that none of it is now currently deductible or significantly limited. The nondeductible portion will be suspended into the future until there is enough adjusted taxable income to deduct it.

A qualified real property trade or business has an option to avoid this limitation – making the irrevocable real property trade or business election. This will slow down depreciation as the business would need to follow the alternative depreciation system ("ADS") for its real property assets (30 years residential and 40 years commercial), and no bonus depreciation would be allowed for qualified improvement property (interior improvements) for commercial real estate. Bonus depreciation would still be available for property with ADS lives of 15 years or less. Residential real estate does not have qualified improvement property so the only effect ADS would have for this property class is the longer depreciable life. Also if this election is made, any previously disallowed interest as a result of this limitation would remain suspended until the property is sold.

As you can see, the removal of depreciation and amortization from the calculation of adjusted taxable income can have major effects on the interest limitation for your entity and with bonus depreciation starting to taper off, decisions on when to invest in certain property may change. You should be reviewing the effects of these changes, including whether to make the qualified real property election, to maximize your overall deductions. This is particularly important as we head into year-end planning. If you would like to stay in front of tax law changes and avoid tax surprises, we would love to chat with you.

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