

Holiday Bonus: OBBBA Expands Bonus Depreciation Rules

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The so-called One Big Beautiful Bill Act (“OBBBA”), which was enacted on July 4, 2025, as P.L. 119-21, made a number of significant changes to the tax law. Among these was the expansion of rules governing the upfront expensing of certain depreciable property. While the changes are largely favorable to taxpayers, there are several potential traps for the unwary.

As background, in 2017, as part of the so-called Tax Cuts and Jobs Act, the Internal Revenue Code was amended to allow an upfront depreciation deduction (so-called “bonus depreciation”) for the cost of most depreciable property having a recovery period of 20 years or less, such as personal property. The percentage of bonus depreciation allowed was originally 100%, effectively allowing upfront expensing of such property, but had begun phasing out in 2023 and was scheduled to be eliminated entirely starting in 2027. For 2025, the bonus depreciation allowable would generally have been only 40% of the cost of qualified property, with the remaining 60% of the cost depreciable under the normal rules.

For qualified property that was acquired after January 19, 2025 (i.e., starting with President Trump’s second term), and not pursuant to a written binding contract entered into before that date, the OBBBA restored and made permanent 100% bonus depreciation. Generally, the definition of property eligible for bonus depreciation did not otherwise change. Thus, most depreciable property with a recovery period of 20 years or less qualifies, and such property does not need to be new as long as it is acquired by the taxpayer from an unrelated party by purchase.

Because real estate typically has a recovery period of more than 20 years, it is generally not eligible for bonus depreciation. However, under both current and prior law, a special category of real estate called qualified improvement property (“QIP”) has a recovery period of 15 years and so is generally eligible for bonus depreciation. QIP is defined as improvements made to the interior portion of an existing nonresidential building, other than enlargements, elevators or escalators, or a building’s internal structural framework.

Bonus depreciation of QIP can be a significant benefit to real estate owners, particularly office building owners making tenant improvements. However, there are several potential pitfalls. The Internal Revenue Code generally restricts a taxpayer’s business interest deductions to the sum of the taxpayer’s business interest income and 30% of the taxpayer’s “adjusted taxable income” (equal to the taxpayer’s taxable income before interest expense, depreciation, amortization, and certain other adjustments). A taxpayer that is engaged in a real estate business can elect out of this business interest limitation; however, a consequence of making this election is that a taxpayer must use the alternative depreciation system for its depreciable real property. For nonresidential real property, this increases the depreciable life from 39

years to 40 years, and for residential real property, this increases the depreciable life from 27.5 years to 30 years, both of which are relatively minor changes. However, this election also increases the depreciable life of QIP from 15 years to 20 years and makes QIP ineligible for bonus depreciation. The lack of bonus depreciation for QIP can be a very significant difference, and once made the election is irrevocable. Thus, taxpayers owning commercial real estate should think very carefully before making this election lest they lose out on potential bonus depreciation.

A second important consideration relates to state and local income tax issues. Many states, including New York, do not allow bonus depreciation and instead require qualified property to be depreciated under the regular depreciation rules. This creates a difference between federal and state taxable income. As we have previously noted in this space, the federal-state difference can interact with various loss disallowance rules in complicated and unexpected ways, and in some cases taxpayers may be better off electing not to claim federal bonus depreciation. Thus, bonus depreciation does not always create the large benefit that some taxpayers expect.

Another important change made by the OBBBA is that, in an apparent attempt to promote U.S. manufacturing activities, 100% bonus depreciation is now allowed for qualified production property (“QPP”). QPP is generally defined as any portion of U.S. nonresidential real property used for qualified production activity, if construction of the property begins after January 19, 2025 and before 2029, the property is placed in service before 2031, and the original use of the property begins with the taxpayer.

Qualified production activity includes most manufacturing, production, or refinancing activities that result in the substantial transformation of tangible personal property. QPP excludes the portion of a property that is used for offices, administrative services, lodging, parking, sales, research, software development or engineering, and certain other activities.

Because nonresidential real estate, including most factories, is generally depreciable on a straight-line basis over 39 years, 100% bonus depreciation for QPP has the potential to provide a massive tax benefit for taxpayers who qualify. However, one very important restriction is that the taxpayer owning the property must itself be the one engaged in the qualified production activity. Such activities do not qualify if they are engaged in by a lessee of the property. In light of this restriction, many commercial real estate owners would not qualify, and it remains to be seen how frequently taxpayers will be able to benefit from the QPP rules.

In sum, the changes to the bonus depreciation rules made by the OBBBA have the potential to significantly benefit certain taxpayers. However, as always, careful planning is necessary to ensure that taxpayers take full advantage of the potential benefits and to avoid traps for the unwary.

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