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Leveraging Bonus Depreciation, Cost Segregation, and the "STR Exception" for Active Income Offsets

Some investors with high risk tolerance are exploring a strategy that combines bonus depreciation, cost segregation, and the short-term rental ("STR") exception to unlock substantial tax benefits when buying and operating a rental property (e.g., an Airbnb or VRBO). For high-income taxpayers who are already comfortable with the risks of owning and operating an STR, recent changes in bonus depreciation and classification rules can create a powerful timing advantage.

If executed correctly, this can allow accelerated depreciation deductions to offset active income such as wages or business profits, not just passive rental income. If executed incorrectly, the strategy can result in significant IRS penalties and fines. Here's how it works, very generally. As a reminder, none of us is a CPA and so the purpose of this is simply to outline the structure and encourage anyone interested to pursue this only with reliance and approval of a capable accounting professional who understands this strategy much more intimately.

Bonus Depreciation

Under the *One Big Beautiful Bill (OBBB)*, Internal Revenue Code §168(k) now permanently allows 100% first-year bonus depreciation. This provision was originally enacted to stimulate business investment and permits taxpayers to deduct the entire cost basis of qualifying assets in the year they are placed in service.
Key points:

- Applies to most tangible personal property with a recovery period of 20 years or less, and certain qualified improvements.
- Can apply to the full purchase price, not just the equity (leveraged purchases qualify for the full amount, not just the equity component).
- Eliminates the need to depreciate qualifying property over its normal schedule (e.g., 5, 7, or 15 years for fixtures and improvements, or 27.5 years for the building itself).

Example:
If you purchase $200,000 of qualifying improvements and personal property, you can deduct the full $200,000 in year one—even if the property is mortgaged.

Cost Segregation
Why it matters:

Bonus depreciation doesn't apply to the residential building itself (27.5-year property), so you need to identify and separate components of the property that have shorter depreciable lives.
The process entails hiring a qualified cost segregation engineer who can break down the purchase price into:

- Land (non-depreciable)
- Personal property (5–7 year life)
- Land improvements (15-year life)
- Building structure (27.5-year life)

It's worth noting that cost segregation studies can be very expensive (a range of $5,000-$15,000 for valid studies), so this is a hefty transaction cost to be considered when judging the net benefit of the strategy.

Example:
On a $1,000,000 purchase:

- Land: $400,000 (no depreciation)
- Personal property: $50,000 → eligible for 100% bonus depreciation
- Land improvements: $50,000 → eligible for 100% bonus depreciation
- Building: $500,000 → depreciated over 27.5 years

In this example, $100,000 could be deducted in year one via bonus depreciation—plus normal annual depreciation on the building.

Passive vs. Active Loss Rules
Under the default rules, rental activities are considered passive, meaning losses can only offset other passive income. To use these losses against wages or business income, you must either qualify as a real estate professional (hours and material participation tests) OR use the short-term rental (STR) exception.

The "STR Exception"

Under the IRS definition, a rental is not considered "rental activity" (and therefore not automatically passive) if the average period of customer use is 7 days or less (there's another version that allows for 30 days or less if significant personal services akin to hotel services are provided).

If an STR is not treated as a rental activity, you can qualify as materially participating in a trade or business, which makes the losses *non-passive*. In that case, the losses become usable against W-2 or business income. For someone with significant income from their primary business, this could be a very appealing benefit.

In order to meet the STR threshold of "material participation" in the rental activity, the investor must meet at least one of three different tests:

1. Participate more than 500 hours during the year, or
2. Your participation is substantially all the participation in the activity, or
3. Participate more than 100 hours and no one else participates more than you.

Key nuances:

- You can own the STR personally or through a wholly owned business entity.
- You must track and document your participation hours meticulously because this tax strategy has attracted significant recent attention from the IRS.
- "Average stay" is calculated as total days rented ÷ number of bookings, and the number of bookings has to be significant enough to qualify as a business.
- There's also the personal use test, limiting the owner's personal use in the STR property to 10% of the rentals or 14 days.
- That personal use test just means if the owner (or anyone else) "rents" the property for something less than the full market rental value.
- However, if the owner's primary business rents the property and pays FMRV, then that rental wouldn't count against the personal use limits.

Pulling It All Together: Example

- Purchase price: $1,000,000
- Land value: $400,000
- Cost segregation identifies $100,000 of bonus-eligible assets
- Bonus depreciation deduction: $100,000 in year one
- If structured as a qualifying STR with material participation, the $100,000 deduction can offset active income (e.g., W-2 wages, business profits).
- At a 37% federal tax rate, that's a $37,000 federal tax savings in year one—plus state tax savings if applicable.

Existing Property Lookback Strategy

All of this considers the application of this strategy for newly acquired property (since Jan 20, 2025). For existing property strategy that was acquired between Sept 27, 2017 and Jan 20, 2025, there may still be an opportunity to apply this strategy on a less than complete basis (without having to file any amended returns for prior tax years). For assets acquired before Sept 27, 2017 (the enactment of the Tax Cuts and Jobs Act), this strategy is not available.

In order to eligible, existing property must be the taxpayer's first use of the property, must not have been acquired from a related party, and must have been placed in service after the acquisition.

Note that the same STR requirements apply for existing property accelerated depreciation losses to be applied against active income.

Example for Application to Existing Property

- STR purchased in 2020 for $1,000,000, depreciated straight-line over 27.5 years.

- 2025 cost segregation identifies:
  - Land: $400,000 (non-depreciable)
  - Personal property & land improvements: $150,000 (eligible for shorter life)
  - Building: $450,000 (27.5-year)
- Form 3115 filed in 2025 results in an immediate $150,000 catch-up deduction in that year. It is worth reiterating that 3115 offers a one-time adjustment that does not require the filing of amended returns for earlier years.
- At a 37% federal rate, that's a $55,500 federal tax savings (plus state tax savings), usable against active income if STR exception rules are met.

Risks & Considerations

Like any complex income tax strategy, the application is rife with opportunities for missteps and is coming under scrutiny. The devil, as they say, is in the details.

- IRS scrutiny: As mentioned above, the STR exception (which the IRS considers a "loophole") claims are increasingly audited, so thorough documentation is critical.
- Recapture tax: Accelerated depreciation can be "recaptured" at sale so it's important to plan the exit strategy accordingly. And if the capital gains tax rates go up between now and the eventual sale, then that will certainly diminish the net benefit over time. For example, if $250,000 is depreciated early then upon a subsequent sale (unless a 1031 exchange), the taxpayer should expect to recognize $250,000 at the capital gains rate at the time of sale (or possibly higher rate if personal property is recaptured at ordinary income tax rates).
- Cash flow: Tax savings don't guarantee positive cash flow; property must still operate profitably. Just like with QOZ investing, the investor needs to first get comfortable with the idea of the STR investment itself before focusing on the potential ancillary tax benefits.
- State law variations: It's possible that some states do not conform to federal bonus depreciation rules.

Final Thoughts

There's a lot to unpack here, and yet it's still just the tip of the iceberg. Long story short, this is a bit outside our normal area of expertise and certainly feels like a higher risk strategy than we're typically advising. But for high-income taxpayers with significant active income to offset who are both (i) willing to operate and manage an STR (and document their substantial participation) and (ii) comfortable with the risks of IRS challenge and real estate market exposure, it could be a home run.

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