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New Law: Changes to the Internal Revenue Code

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The American Jobs Creation Act of 2004 (the "Act"), signed by President Bush on October 22, 2004, made several significant changes to the Internal Revenue Code affecting real estate, including new depreciation treatment for certain leasehold improvements and changes to certain partnership provisions of the Code.

New Depreciation Rules. The Act changes the classification for "qualified leasehold improvement property" ("QLIP") from nonresidential real property that is depreciated under the qualified leasehold improvement property over 39 years to 15-year property. This change resulted from a prolonged effort by real estate groups to persuade Congress that taxpayers should not be required to recover the costs of leasehold improvements beyond their useful lives and that the 39-year recovery period for leasehold improvements extended well beyond the useful lives of such improvements.

The Act provides that QLIP placed in service after October 22, 2004 and before 2006 will be depreciated using the straight-line method over a 15-year recovery period. This property is defined under prior law (with respect to bonus depreciation) to mean any improvement to an interior portion of a building that is nonresidential real property, provided the additional following requirements are met:

- The improvement must be made by the lessor or lessee under or pursuant to a lease.
- The improvement must be placed in service more than three years after the date on which the building was placed in service.
- The improved portion of the building is to be occupied exclusively by the lessee.
- The improvement *cannot* be an expenditure attributable to any of the following:
  - Enlargements to the building.
  - Elevators or escalators.
  - Structural components benefiting a common area.
  - The internal structural framework of the building.

The Act utilizes the definition of "QLIP" under prior law with one significant modification. For purposes of the 15-year recovery period, the characterization of improvements as QLIP does not apply to a transferee. An exception to this rule is provided for transfers by reason of death, and for a variety of tax-free transactions.

In theory, QLIP can qualify for both bonus depreciation (30 percent or 50 percent) and 15-year depreciation. However, since bonus depreciation is only available for property placed in service before January 1, 2005, only QLIP placed in service after October 22, 2004, and before January 1, 2005, will qualify for both bonus depreciation and 15-year depreciation.

Changes to Partnership Rules. One change made by the Act was to increase the period over which expenses of organizing a partnership may be amortized from five years to 15 years. More importantly, the Act made changes to provisions of the Code relating to contributions of property to partnerships, distributions of property by partnerships, and sales of partnership interests, changes characterized by the legislative history as "disallowance of certain partnership loss transfers."

Under section 704(c) of the Code, tax items with respect to property contributed to a partnership by a partner must be shared among the partners so as to take account of the variation between the basis of the property to the partnership (which will generally "carry over" the contributing partner's basis) and the property's fair market value at the time of contribution. If a partner contributes to a partnership property having a value lower than its tax basis and the partnership subsequently disposes of the property, the effect of this rule will generally be to require the partnership to allocate the loss on disposition, up to the "built-in loss" at the time of contribution, to the contributing partner.

For example, if A and B form a 50-50 partnership to which A contributes $100 in cash and B contributes land with a value of $100 and a basis of $140, and if the partnership then sells the land for $90, thereby realizing a loss

of $50, the first $40 of loss will be allocated to B and the next $10 of loss will be shared equally by A ($5) and B ($5). Similarly, if the property contributed by B were depreciable over, say, a 10-year period, the depreciation deductions attributable to the excess of the basis over the fair market value, $4 per year, would have to be allocated entirely to B; only the remaining depreciation of $10 per year could be shared between A and B.

Built-In Loss

Notwithstanding the rule of section 704(c), it has sometimes been possible for a partner other than the contributing partner to obtain the benefit of such a "built-in loss." This could occur in a number of ways, for example, if the contributing partner transferred all or part of his interest in the partnership to another partner, or if the interest of the contributing partner in the partnership were redeemed. Since the contributing partner would likely have recognized a loss upon his disposition of his partnership interest, the ability of other partners to obtain the benefit of the "built-in loss" could be viewed as resulting in an unjustifiable duplication of tax benefits.

For example, if B, in the prior example had sold his interest in the partnership to C for $100, at a time when the partnership still held the property, B would have realized a loss of $40 on the sale. If the partnership had then sold the contributed property for $100, the partnership's entire $40 tax loss would have been allocated to C, thus resulting in what was effectively a double allowance of a single economic loss -- once to B who actually suffered the loss, and once to C who did not. (The noneconomic loss allocated to C would be offset by a noneconomic gain on disposition of his partnership interest, but that might not occur until many years in the future.)

The Act prevents this loss duplication, effective for property contributed to a partnership after October 22, 2004, by amending section 704(c) to provide that any built-in loss can be taken into account only in determining the amount of items allocated to the contributing partner, but that, in determining the amount of items to be allocated to other partners, the basis of the contributed property shall be treated as equal to its fair market value at the time of contribution. This rule apparently applies on a property-by-property basis; that is, it applies to any individual item of property that has a built-in loss, regardless of whether there is an aggregate built-in loss in all properties contributed by a particular partner. It also applies regardless of the magnitude of the built-in loss, with no *de minimis* exception. The legislative history suggests that the rule denying a built-in loss to a transferee of a contributing partner will not apply to a corporation succeeding to the tax attributes of a contributing corporate partner (for example, as a result of a corporate merger), but no exception is made for other carryover basis transactions; accordingly, there is considerable uncertainty regarding application of the new rule in the case of tiered partnerships and similar structures – uncertainty that will not be resolved until the issuance of guidance by the IRS.

Distributions to Partners

Section 734 of the Code provides for adjustments to the basis of partnership property by reason of certain distributions of property made to partners. For example, if the distributee partner recognizes gain as a result of a distribution (or the basis of the distributed property is "stepped down" in the distributee's hands), the partnership may increase the basis of its remaining assets. If the distributee partner recognizes a loss (or the basis of the distributed property is "stepped up" in the distributee's hands), the partnership may decrease the basis of its remaining assets. Under Code section 734, a partnership, unless it has in effect an election under Code section 754, is not required to adjust the basis of its property as a result of a distribution of property to a partner, even if the potential adjustment would decrease basis.

For example, assume that D, E and F form a partnership to which each contributes $100, in exchange for a one-third interest. The partnership uses $200 to acquire a parcel of vacant of land and retains the remaining $100 in the form of marketable securities. The value of the land subsequently declines to $80, but the value of the securities holds constant at $100. The partnership then distributes $60 to D (equal to one-third of the sum of $80 (the fair market value of the land) plus $100 (the fair market value of the securities)), in liquidation of his interest in the partnership. D recognizes a loss of $40 on this transaction. However, in the absence of an election under Code section 754, the partnership is not required to reduce the basis of the land (or of the securities), so that, if the land were then sold for its fair market value of $80, the partnership would recognize a loss of $120, which would be allocated $60 to E and $60 to F. Since the economic loss to E and F was only $40 each, this regime effectively "duplicates" D's $40 loss. (As under the section 704(c) rules, the allowance of a noneconomic loss to E and F would be offset by a noneconomic gain on disposition of their partnership interests, but that might not occur until many years in the future.) If a partnership happened to have a Code section 754 election in effect, a downward adjustment to the basis of the land would be required in this example.

Effective for distributions after October 22, 2004 (subject to limited exceptions), the Act has amended Code section 734 to require a downward basis adjustment whenever the sum of (1) the loss recognized to the distributee partner and (2) any step-up to the basis of distributed property exceeds $250,000. In other words, if the potential adjustment under Code section 734 is a downward adjustment of more than $250,000, the adjustment is mandatory whether or not a section 754 election is in effect. (Downward basis adjustments of $250,000 or less will still be required if a section 754 election happens to be in effect.)

Code section 743 contains an analogous rule to that of section 734, providing for adjustments to the basis of partnership assets upon the transfer of a partnership interest. (Code section 743 adjustments, however, affect only the

tax items of the transferee partner.) Like Code section 734 adjustments, these adjustments have historically been made only when a section 754 election is in effect. Subject to limited exceptions, effective for transfers after October 22, 2004, the Act makes Code section 743 adjustments mandatory when a partner transfers his interest in a partnership at a time when the partnership's aggregate basis in its assets exceeds the assets' value by more than $250,000.

Although the motivation for this rule was similar to that of the amendment to Code section 734, the mechanics of this rule are different. Unlike the rule under section 734, the mandatory section 743 adjustment is triggered by the difference between total basis and total value in the hands of the partnership, rather than by the amount of the potential adjustment occasioned by the distribution of partnership property. President Bush promised major tax reform during his second term. In light of the complexity and far reaching nature of these relatively narrow changes, which are keeping Treasury, the IRS and tax practitioners fully occupied, one can only imagine what lies in store.

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