

Individuals and Passthrough Entities

By Susan Kalinka

Rev. Rul. 2008-16 and the Disparate Treatment of S Corporation Shareholders and Partners in the Charitable Contribution Context

Rev. Rul. 2008-16¹ offers guidance for determining the amount an S corporation shareholder may deduct when the S corporation contributes appreciated property to a charity during tax years to which the 2006 and 2007 amendments to Subchapter S apply. Code Sec. 170 often allows a taxpayer who contributes appreciated property to a charity to deduct the fair market value of the contributed property, rather than its adjusted basis. A charitable contribution deduction for the fair market value of appreciated property on the transfer of such property to a charity is extremely generous because the donor-transferor generally is not required to recognize gain on the transfer.

In 2006 and 2007, Congress amended Subchapter S to allow an S corporation shareholder to deduct its *pro rata* share of the appreciation in property contributed by the S corporation to a charity even if the shareholder's share of the fair market value of the contributed property exceeds the adjusted basis in the shareholder's S corporation stock and any indebtedness of the S corporation to the shareholder. For convenience, the phrase "indebtedness of the S corporation to the shareholder" will be referred to as "debt."

The 2006 and 2007 amendments provided advantages for S corporation shareholders similar to the advantages enjoyed by partners in the charitable contribution context. The 2006 and 2007 amendments to Subchapter S, however, are only effective for charitable contributions made by S corporations during tax years beginning after December 31, 2005, and ending before January 1, 2008. Now that the effective dates of the amendments have expired,



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an S corporation shareholder may deduct its share of the fair market value of property contributed by the S corporation to a charity only to the extent that the adjusted basis of the shareholder's stock and debt equals or exceeds the shareholder's *pro rata* share of the *fair market value of the contributed property* (not the adjusted basis of the property).

More liberal rules apply to partners than S corporation shareholders in the charitable contribution context. This column discusses Rev. Rul. 2008-16, the 2006 and 2007 amendments to Subchapter S and the current rules under Subchapters S and K concerning the ability of an owner of an interest in an S corporation or partnership to claim a deduction for its share of the entity's contributions of appreciated property to a charity.

To better appreciate Rev. Rul. 2008-16, and the rules that apply to S corporation shareholders and partners when an S corporation or partnership contributes appreciated property to a charity, it is useful to review the rules that limit the ability of owners of interests in S corporations and partnerships to claim their shares of the entities' net losses in any year. Partnerships and S corporations generally do not pay tax on the income they earn.² Instead, the items of income, gain, loss, deduction and credit of a partnership or S corporation are reported on the income tax returns of the partners or S corporation's shareholders.³ A partner or S corporation shareholder may deduct its share of the entity's losses only to the extent of the adjusted basis of the partner's interest in the partnership⁴ or, in the case of an S corporation shareholder, the shareholder's adjusted basis in its stock and debt. The limitations under Subchapters K and S on the ability of a partner or S corporation shareholder to claim its share of the entity's items of deduction and loss sometimes will be referred to as the "basis limitation rule(s)."

The losses of a partnership or S corporation that are allocated to a partner or S corporation shareholder reduce the adjusted basis of the partner's interest in the partnership (but not below zero) or the adjusted basis of the S corporation shareholder's stock and/or debt (but not below zero).⁵ If and to the extent that a partner does not have sufficient basis in its partnership interest or an S corporation shareholder does not have sufficient basis in its S corporation stock and debt to claim the entire share of the entity's losses in any year, the disallowed losses are carried forward indefinitely until the partner's adjusted basis in the partnership interest

or S corporation shareholder's adjusted basis in the corporation's stock and debt increases.⁶

A different rule applies, however, with respect to charitable contributions of appreciated property by a partnership and, under the 2006 and 2007 amendments, to such contributions by an S corporation. A partner may claim a deduction for its share of the fair market value of property contributed by the partnership to a charity, regardless of whether the partner's share of the fair market value or of the partnership's basis in the contributed property exceeds the adjusted basis of the partner's interest in the partnership. Under the 2006 and 2007 amendments to Subchapter S, an S corporation shareholder may claim a deduction for the appreciation in the contributed property, regardless of whether the amount of the appreciation exceeds the adjusted basis of the shareholder's stock and/or debt.

The rules for allowing a partner to deduct the partner's distributive share of a partnership's charitable contributions of appreciated property are much more liberal than the current rules that apply to S corporation shareholders or the rules under the 2006 and 2007 amendments. As explained above, a partner may claim a deduction for the partner's share of the *fair market value* of property contributed by the partnership to a charity, even if the adjusted basis of the partner's interest in the partnership is zero. In contrast, the 2006 and 2007 amendments to Subchapter S allow an S corporation shareholder to deduct the shareholder's *pro rata* share of the *appreciation* in the contributed property (*i.e.*, the amount by which the fair market value of the contributed property exceeds the adjusted basis of the property), even if the shareholder's basis in stock and debt is zero. The appreciation in contributed property may be significantly less than the fair market value of contributed property. Under the 2006 and 2007 amendments, an S corporation shareholder also may claim a deduction for the shareholder's share of the adjusted basis of the contributed property to the extent of the adjusted basis of the shareholder's stock and debt. To the extent that the adjusted basis of the contributed property allocated to the shareholder exceeds the adjusted basis of the shareholder's stock and debt, that portion of the adjusted basis of the contributed property is carried forward to be deducted by the shareholder when the adjusted basis of the shareholder's stock and debt increases.

As explained above, the 2006 and 2007 amendments to Subchapter S only apply to charitable

contributions made by S corporations in tax years beginning after December 31, 2005, and before January 1, 2008.⁷ Now that the amendments have expired, the treatment of S corporation shareholders differs significantly from the treatment of partners in the charitable contribution context. Under the current rules, an S corporation shareholder may claim a deduction for the shareholder's *pro rata* share of the fair market value of appreciated property contributed by the S corporation to a charity only to the extent that the *fair market value*, not the adjusted basis, of the property allocated to the shareholder does not exceed the adjusted basis of the shareholder's stock and/or debt.

The rules that allow a partner to deduct its share of the full fair market value of property contributed by a partnership regardless of the adjusted basis of the partner's interest in the partnership are inconsistent with the flow-through regime under Subchapter K that otherwise govern the ability of a partner to claim its share of the partnership's net losses and can create distortions. The current rules and the rules under the 2006 and 2007 amendments that apply to S corporation shareholders in this context also are inconsistent with the flow-through regime under Subchapter S, but in a different way.

There is no reason to treat S corporation shareholders differently from partners in this context. The rules that apply to partners are too generous, and the rules that apply to S corporation shareholders are too stingy. Congress should amend the Code to provide equal treatment of partners and S corporation shareholders who seek to deduct their shares of the entity's charitable contributions. This column offers a suggestion for amending the rules under Subchapters S and K with respect to deductions for charitable contributions of appreciated property to eliminate the disparity between S corporation shareholders and partners and to treat contributions of appreciated property to a charity by an S corporation and a partnership in a manner consistent with the flow-through regime that applies under both Subchapter K and Subchapter S.

Contributions of Appreciated Property to a Charity

Under Code Sec. 170, a taxpayer may claim a charitable contribution deduction for payments in cash and property to or for the use of certain governmental entities and nonprofit organizations listed in Code Sec. 170(c).⁸ For convenience, the an entity to which

taxpayers may make deductible charitable contributions will be referred to as a "charity."

If a taxpayer contributes appreciated property to or for the use of a charity, the amount of the charitable deduction is the fair market value of the property at the time of the contribution, reduced as provided in Code Sec. 170(e).⁹ Code Sec. 170(e) generally requires a taxpayer to reduce the amount of the charitable contribution (*i.e.*, the fair market value of the contributed property) by the amount of gain that would not have been long-term capital gain if the taxpayer sold the property at the time of the contribution.¹⁰ When a taxpayer contributes a capital asset held for more than one year, however, the taxpayer often may claim a charitable contribution deduction in an amount equal to the fair market value of the property.¹¹

There are some cases, however, where the amount of the charitable contribution deduction will be limited to the adjusted basis of the property, even if the contributed property is a capital asset.¹² A detailed discussion of the limitations on a taxpayer's ability to claim a charitable contribution deduction in an amount equal to the fair market value of the contributed property is beyond the scope of this column. For convenience, this column will assume that appreciated property contributed to a charity qualifies for a deduction in an amount equal to the fair market value of the property.

The allowance of a deduction for the fair market value of appreciated property contributed to a charity is beneficial to the taxpayer. While the amount of the taxpayer's deduction is the fair market value of the property, the taxpayer generally is not required to recognize gain on the transfer of the property.¹³

Example 1. Individual A contributes stock to a charity, with an adjusted basis of \$10,000, and a fair market value of \$100,000. The amount of A's charitable contribution deduction is the \$100,000 fair market value of the stock. If A had sold the stock for its fair market value at the time of the contribution, A would have recognized \$90,000 gain (\$100,000 amount realized – \$10,000 basis). Usually the rate of tax that applies to gain on the sale of stock held for investment and held for more than one year is 15 percent.¹⁴ Thus, A probably would incur an income tax liability of \$13,500 tax on the sale of the stock (\$90,000 × 15%). If A then contributed the \$100,000 cash proceeds to a charity, the taxpayer would be permitted to claim a charitable deduction of \$100,000, reducing ordinary income, subject to

a maximum tax rate of 35 percent.¹⁵ Assuming that A's marginal income tax bracket were 35 percent at the time of the contribution, the deduction would reduce A's tax liability by \$35,000 (\$100,000 deduction × 35%). In that case, A's net tax savings would be \$21,500 (\$35,000 tax reduction as a result of the charitable contribution deduction – \$13,500 capital gain recognized on the sale of the stock).

If A contributes the stock to the charity, A may claim a deduction of \$100,000 against ordinary income, without recognizing any gain. Assuming that A's marginal income tax bracket is 35 percent, A's income tax liability is reduced by \$35,000 (\$100,000 × 35%). By contributing the stock to a charity, rather than selling the stock and contributing the sales proceeds to the charity, A saves \$13,500 in tax (the amount of tax liability A would incur on the sale of the stock).

Congress is generous in allowing a taxpayer to claim a charitable contribution deduction in an amount equal to the fair market value of contributed property without requiring the taxpayer to recognize gain on the contribution. Arguably, the allowance is consistent with the rules that apply to gifts of property to noncharitable donees. A taxpayer who transfers appreciated property to a donee as a gift does not recognize gain when the taxpayer receives nothing in exchange for the gift. In general, a taxpayer recognizes gain on a transfer of appreciated property only if and to the extent that the amount realized in exchange for the property exceeds the taxpayer's adjusted basis in the transferred property.¹⁶ When property is transferred by gift and the taxpayer receives nothing in return, the taxpayer does not realize a gain because there is no amount realized on the transfer.

Nevertheless, Congress could have required taxpayers to recognize gain on the transfer of appreciated property to a charity. In such a case, the taxpayer enjoys an economic benefit (the deduction) in exchange for the contribution. The amount realized by the taxpayer is either the amount of the charitable contribution deduction or the amount of reduction in the taxpayer's income tax liability attributable to the deduction.

It might not be feasible to treat the reduction in the tax liability as the amount realized. Such treatment would require circular computations. The reduction in tax could not be determined until after both the

amount of gain and the amount of the charitable contribution deduction for the property could be calculated. Congress might have decided to allow taxpayers to transfer property tax-free to charities in such cases because of the complex computations that would be required to determine the taxpayer's amount realized on the transfer.

Of course, Congress could have avoided complex computations by requiring taxpayers to treat the amount of the charitable contribution deduction as the amount realized on the transfer of the property to the charity. Indeed, it would be appropriate to require a taxpayer to recognize gain on the contribution of appreciated property to a charity when the taxpayer claimed a charitable contribution deduction in an amount equal to the fair market value of the contributed property. Nevertheless, Congress might have decided to allow taxpayers to enjoy the tax-free transfers to encourage taxpayers to transfer valuable assets to charities.

Rev. Rul. 2008-16

Rev. Rul. 2008-16 illustrates the application of the 2006 and 2007 amendments to Subchapter S in cases where the shareholder's *pro rata* share of the S corporation's adjusted basis in appreciated property contributed to a charity exceeds the adjusted basis of the shareholder's S corporation stock and debt. This section provides an overview of S corporation taxation and describes the application of Rev. Rul. 2008-16 in that context.

While an S corporation generally does not pay tax on its income,¹⁷ an S corporation is required to compute its taxable income every year.¹⁸ The taxable income of an S corporation is computed in the same manner as the income of an individual, except that an S corporation is not allowed to claim certain deductions, including the deduction for charitable contributions.¹⁹ Instead, charitable contributions made by an S corporation flow through separately to the S corporation's shareholders²⁰ and retain their character as charitable contributions in the hands of the shareholders.

If and to the extent that the amount of a shareholder's *pro rata* share of the S corporation's deductions and losses exceeds the adjusted basis of the shareholder's stock and debt, such items of loss and deduction are carried forward indefinitely until the shareholder has sufficient basis to claim the deductions and/or losses.²¹ In any year in which an S corporation shareholder's *pro rata* share of the

corporation's items of loss and deduction exceeds the adjusted basis of the shareholder's stock and debt, the aggregate basis of the shareholder's stock and debt (before reduction for the shareholder's *pro rata* share of corporate losses and deductions) is allocated among the shareholder's *pro rata* share of each item of loss or deduction.²² The amount of the available basis of stock and debt (the "limitation") allocated to any item of loss or deduction is an amount that bears the same ratio to the amount of the limitation as the item of loss or deduction bears to the total of the losses and deductions for the year.²³

As explained earlier, an S corporation shareholder may claim a *pro rata* share of the S corporation's items of loss and deduction only to the extent of the adjusted basis of the shareholder's stock and debt.²⁴ The basis of an S corporation shareholder's stock and debt is adjusted to reflect the shareholder's *pro rata* share of the items of the S corporation's income, gain, loss and deduction.²⁵ The S corporation shareholder's *pro rata* share of items of income and gain increases the adjusted basis of the shareholder's stock and debt.²⁶ Distributions to an S corporation shareholder and items of loss and deduction allocated to the shareholder reduce the adjusted basis of the shareholder's stock and debt.²⁷ Increases in an S corporation shareholder's stock and debt basis that are attributable to items of income and gain and decreases in basis as a result of distributions from the S corporation to the shareholder are taken into account before determining whether the shareholder has sufficient basis to claim its share of the corporation's items of deduction and loss.²⁸

In 2006, Congress amended Code Sec. 1367 to reduce the decrease in the adjusted basis of an S corporation shareholder's stock and debt attributable to the S corporation's contribution of appreciated property to a charity. As amended, Code Sec. 1367 provides that the amount of the basis reduction is equal to the shareholder's *pro rata* share of the S corporation's adjusted basis in the contributed property.²⁹

The Tax Technical Corrections Act of 2007³⁰ added Code Sec. 1366(d)(4) to complement the 2006 amendments to Code Sec. 1367. Under Code Sec. 1366(d)(4), the basis limitation rule applies only to the extent that the shareholder's *pro rata* share of the S corporation's adjusted basis in appreciated property contributed to a charity exceeds the adjusted basis of the shareholder's stock and debt. The shareholder may claim a charitable contribution in an amount equal to the sum of the shareholder's *pro rata* share of the appreciation in the contributed property, plus

the shareholder's *pro rata* share of the adjusted basis in the contributed property to the extent that such basis does not exceed the adjusted basis of the shareholder's stock and debt.³¹ The 2006 amendments to Code Sec. 1367 and Code Sec. 1366(d)(4) are effective only for tax years beginning after December 31, 2005, and before January 1, 2008.³²

Example 2. In its 2007 tax year, an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$20,000 and a fair market value of \$50,000. The adjusted basis of the shareholder's stock in the S corporation is at least \$20,000 immediately before the contribution. The shareholder is treated as having made a \$50,000 charitable contribution (the shareholder's \$20,000 *pro rata* share of the corporation's adjusted basis, plus the shareholder's \$30,000 *pro rata* share of the appreciation in the contributed property). After the contribution, the adjusted basis of the shareholder's stock is reduced by \$20,000 (the shareholder's *pro rata* share of the corporation's adjusted basis in the contributed property).³³

Rev. Rul. 2008-16 illustrates the application of the 2006 and 2007 amendments to Subchapter S in a case where the adjusted basis of an S corporation shareholder's stock and debt is less than the adjusted basis of appreciated property contributed by the S corporation to a charity. In the example, A is the sole shareholder of an S corporation. At the beginning of the S corporation's 2007 tax year, the adjusted basis of A's stock in the S corporation is \$50x. The S corporation does not have any indebtedness to A. During 2007, the S corporation makes a charitable contribution of unencumbered real property, with an adjusted basis of \$100x and a fair market value of \$190x, in a transaction that qualifies for a deduction in an amount equal to the fair market value of the property. In 2007, the S corporation has taxable income of \$30x and a long-term capital loss of \$25x.

Under Rev. Rul. 2008-16, the results to A are as follows. The \$50x adjusted basis of A's stock first is increased by \$30x to reflect A's *pro rata* share of the S corporation's taxable income.³⁴ Thus, the adjusted basis of A's S corporation stock is \$80x before the reduction to reflect A's *pro rata* share of the S corporation's deductions and losses. The \$80x adjusted basis of A's S corporation stock then is decreased (but not below zero) by A's *pro rata* share of the sum of

the S corporation's adjusted basis in the contributed property (\$100x)³⁵ and A's *pro rata* share of the S corporation's long-term capital loss (\$25x).³⁶ In this case, A's *pro rata* share of the aggregate amount of the S corporation's losses and deductions (\$125x) exceeds the adjusted basis of A's stock in the S corporation (\$80x). Thus, the maximum amount of A's *pro rata* share of the S corporation's losses and deductions is limited to \$80x, the adjusted basis of A's stock in the S corporation.³⁷

Code Sec. 1366(d)(4) provides that, for tax years beginning after December 31, 2005, and before January 1, 2008, the basis limitation rule does not apply to a contribution by an S corporation of appreciated property to the extent that the shareholder's *pro rata* share of the fair market value of the contributed property exceeds the shareholder's *pro rata* share of the corporation's adjusted basis of the contributed property. Thus, the basis limitation rule does not apply to A's \$90x *pro rata* share of the amount of deductible appreciation in the contributed property (\$190x fair market value of A's *pro rata* share of the contributed property – \$100x A's *pro rata* share of the adjusted basis of the contributed property).

When an S corporation shareholder's *pro rata* share of the corporation's losses and/or deductions exceeds the sum of the shareholder's adjusted basis in stock and debt, the limitation on losses is allocated *pro rata* to each item of loss or deduction.³⁸ If the basis limitation applies to a charitable contribution deduction in tax years beginning after December 31, 2005, and before January 1, 2008, the limitation amount allocable to the deduction is determined by reference to the shareholder's *pro rata* share of the corporation's adjusted basis in the contributed property.³⁹

Thus, in determining the amount of A's basis limitation allocable to the charitable contribution deduction, A will multiply A's \$80x limitation times a fraction, the numerator of which is the \$100x adjusted basis of the contributed property, and the denominator of which is \$125x, the total amount of A's *pro rata* share of the S corporation's items of loss and deduction for the tax year (\$100x adjusted basis of the contributed property + \$25x the capital loss). Thus, \$64x ($\$80x \times \$100x/\$125x$) is allocated to the charitable contribution deduction. The remaining \$16x ($\$80x \times \$25x/\$125x$) is allocated to the capital loss.

In Rev. Rul. 2008-16, the IRS concluded that the amount of the charitable contribution deduction that

A was allowed to claim in 2007 was \$154x. This amount was comprised of A's *pro rata* share of the appreciation in the property (\$90x), plus the amount of the loss limitation allocated to A's *pro rata* share of the corporation's adjusted basis in the contributed property (\$64x). At the end of 2007, the adjusted basis of A's stock in the S corporation was reduced to \$0 to reflect the \$16x reduction in basis attributable to the capital loss and the \$64x reduction in basis attributable to the charitable contribution deduction.⁴⁰ The IRS also concluded that A would carry forward the disallowed portion of the charitable contribution deduction (\$36x) and the capital loss (\$9x) to be treated as incurred by the S corporation in the succeeding tax year with respect to A.

Did the IRS Adopt an Appropriate Result in Rev. Rul. 2008-16?

In Rev. Rul. 2008-16, the IRS interpreted Code Sec. 1366(d)(4) to mean that if an S corporation makes a charitable contribution of appreciated property during a tax year beginning after December 31, 2005, and before January 1, 2008, the amount of the charitable contribution deduction the shareholder may claim may not exceed the sum of (1) the amount by which the shareholder's *pro rata* share of the fair market value of the contributed property exceeds the shareholder's *pro rata* share of the adjusted basis of the property; plus (2) the amount of the loss limitation under Code Sec. 1366(d) that is allocable to the adjusted basis in the contributed property. The IRS's conclusion in the revenue ruling is quite generous. No matter how small an amount of the shareholder's *pro rata* share of the corporation's adjusted basis of the property that the shareholder may deduct, the shareholder is entitled to deduct the full amount of the shareholder's *pro rata* share of the appreciation in the property.

The language of the statute supports the IRS's interpretation of Congress's intent. Code Sec. 1366(d)(4) provides:

(d) Special rules for losses and deductions.

(4) Application of limitation on charitable contributions. In the case of any charitable contribution of property to which the second sentence of section 1367(a)(2) applies [*i.e.*, limiting the amount of the reduction in the adjusted basis of

an S corporation shareholder's stock and debt], paragraph (1) [*i.e.*, the basis limitation rule under Code Sec. 1366(d)] shall not apply to the excess (if any) of—

(A) the shareholder's *pro rata* share of such contribution, over

(B) the shareholder's *pro rata* share of the adjusted basis of such property.

The foregoing language indicates that Code Sec. 1366(d)(4) limits a shareholder's deduction for the shareholder's *pro rata* share of the adjusted basis of property contributed to a charity by an S corporation, but does not limit the deduction for the shareholder's *pro rata* share of the appreciation in the value of the contributed property. However, a more logical approach would limit the shareholder's deduction to the portion of the adjusted basis and the fair market value of the property in excess of the adjusted basis of the contributed property that is proportionate to the shareholder's basis in the corporation's stock and debt.

The Code Sec. 1366 regulations adopt a similar, *pro rata* approach in applying the basis limitation rules of Code Sec. 1366(d)(1). Code Sec. 1366(d)(1) provides:

(d) Special rules for losses and deductions.—

(1) Cannot exceed shareholder's basis in stock and debt.—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any tax year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation ..., and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder ...

The Code Sec. 1366 regulations provide that if a shareholder's *pro rata* share of the aggregate amount of losses and deductions of the S corporation exceeds the sum of the adjusted basis of the shareholder's stock and debt, then the limitation on losses and deductions under Code Sec. 1366(d)(1) must be allocated among the shareholder's *pro rata* share of each loss or deduction.⁴¹ Under the regulations, the amount of the limitation allocated to any item of loss or deduction is an amount that bears the same ratio to the amount

of the limitation as the item of loss or deduction bears to the total items of loss and deduction.⁴² Adopting a *pro rata* rule for the limitation on an S corporation shareholder's ability to deduct the shareholder's *pro rata* share of the fair market value of the corporation's charitable contributions would be consistent with the Code Sec. 1366(d)(1) regulations.

If the IRS had adopted a *pro rata* rule in Rev. Rul. 2008-16, shareholder A would have been allowed to deduct \$121.60x of A's \$190 *pro rata* share of the S corporation's charitable contribution in 2007. This amount would reflect the amount of A's *pro rata* share of the \$190x fair market value of the contributed property proportionate to the \$64x portion of A's \$100x *pro rata* share of the adjusted basis of the contributed property to which the basis limitation did not apply ($\$190x \times \$64x$ portion of the basis limitation / $\$100x$ A's total *pro rata* share of the S corporation's adjusted basis in the contributed property). In that case, A would carry forward the \$68.40x disallowed portion of the charitable contribution.

Allowing an S corporation shareholder to deduct the portion of the shareholder's *pro rata* share of the fair market value of appreciated property contributed by the S corporation to a charity in proportion to the shareholder's *pro rata* share of the S corporation's adjusted basis in the property that is allowed under the basis limitation rules is consistent with the treatment of other items of income, gain, loss and deduction allocable to the shareholder. Subchapter S treats an S corporation's items of income and deduction earned and incurred by an S corporation as if the shareholder had directly earned and incurred the shareholder's *pro rata* share of those items. Under the basis limitation rules, the shareholder is allowed to deduct the shareholder's *pro rata* share of items of deduction and loss to the extent that the shareholder's *pro rata* share of the S corporation's income and the amount that the shareholder has invested in the S corporation. The adjusted basis of an S corporation's stock and debt reflects the shareholder's investment in the corporation. The adjusted basis of an S corporation's stock and debt is increased by the amount of money and the adjusted basis of property that the shareholder has contributed to the S corporation (*i.e.*, amounts that the shareholder has invested in the S corporation). As explained earlier, an S corporation shareholder includes in income a *pro rata* share of the S corporation's items of income, regardless of whether the income is distributed to the shareholder. To the extent that the shareholder's *pro rata* share

of items of the S corporation's income and gain are not distributed to the shareholder, the shareholder is treated as if the shareholder contributed those items to the S corporation (or invested those items in the S corporation), thereby increasing the adjusted basis of the shareholder's stock and/or debt, have been used to pay for the items of deduction and loss. To the extent that an S corporation shareholder is subject to the basis limitation rules and is only permitted to deduct a portion of each item of deduction and loss, the shareholder is treated as incurring or paying for a portion of the cost of each item of deduction and loss. If Congress or the IRS were to allow the shareholder in such a case to deduct the shareholder's *pro rata* share of the S corporation's adjusted basis in appreciated property contributed to a charity, the shareholder would be treated as contributing a portion of the property to the charity. The items of deduction and loss carried forward because of the basis limitation rule are treated as paid or incurred in a later year when the adjusted basis of the shareholder's stock and debt increases. Thus, when the shareholder's *pro rata* share of the adjusted basis in the contributed property exceeds the shareholder's adjusted basis in stock and debt, the shareholder should be treated as having contributed a smaller portion of the contributed property, rather than an amount equal to the shareholder's *pro rata* share of the entire appreciation in the property.

The carryover of a portion of an S corporation shareholder's *pro rata* share of the fair market value of contributed property probably would provide a smoother transition from the basis limitation rules under the 2006 and 2007 amendments to the current rules that apply for determining the amount of an S corporation's charitable contributions that a shareholder may deduct. The following example illustrates the author's interpretation of the application of the current rules to the example provided in Rev. Rul. 2008-16:

Example 3. Individual A is the sole shareholder of an S corporation. At the beginning of the S corporation's 2008 tax year, the adjusted basis of A's stock in the S corporation is \$50x. The S corporation is not indebted to A. During 2008, the S corporation makes a charitable contribution of unencumbered real property, with an adjusted basis of \$100x and a fair market value of \$190x, in a transaction that qualifies for a charitable contribution deduction in an amount equal to the \$190x fair market value of the property. In

2008, the S corporation has taxable income of \$30x and a long-term capital loss of \$25x.

In determining the amount of A's *pro rata* share of the S corporation's \$190x charitable contribution deduction and the S corporation's \$25x long-term capital loss that A may deduct, the \$50x adjusted basis of A's S corporation stock is first increased by A's *pro rata* share of the S corporation's \$30 taxable income.⁴³ Thus, the maximum amount of A's *pro rata* share of the S corporation's \$215x items of deduction and loss (\$190x charitable contribution deduction + 25x long-term capital loss)⁴⁴ that A may deduct in 2008 is limited to the \$80x adjusted basis of A's the S corporation stock.

Under the Code Sec. 1366 regulations, A must allocate the \$80x basis limitation between A's *pro rata* share of each item of deduction and loss.⁴⁵ The amount of the \$80x limitation allocated to A's \$190x *pro rata* share of the S corporation's charitable contribution is \$70.70x ($\$80x \times \$190x \text{ charitable contribution} / \$215x \text{ total items of deduction and loss}$). The amount of the \$80x limitation allocated to A's \$25x *pro rata* share of the S corporation's long-term capital loss is \$9.30x ($\$80x \times \$25x \text{ long-term capital loss} / \$215 \text{ total items of deduction and loss}$). At the end of 2008, the adjusted basis of A's the S corporation stock is reduced to \$0. A will carry forward \$119.30x of the disallowed charitable contribution and \$15.70 of the disallowed long-term capital loss.

If Code Sec. 1366(d)(4) allowed an S corporation shareholder to deduct only a *pro rata* portion of the fair market value of appreciated property contributed by the S corporation to a charity, the carry forward of the remaining fair market value of the contributed property would be consistent with the current rules which focus only on the amount of the charitable contribution deduction allowed under Code Sec. 170 (*i.e.*, the fair market value of contributed property), and not the basis of the contributed property. Allowing an S corporation shareholder to claim a charitable contribution deduction in an amount equal to a *pro rata* portion of the fair market value of the contributed property would be more consistent with the rules for determining the adjusted basis of an S corporation shareholder's stock and debt. As explained earlier, the amount of an S corporation shareholder's *pro rata* share of the S corporation's items of deduction and loss that

the shareholder may claim in any year is limited to the adjusted basis of the shareholder's stock and debt.⁴⁶

Admittedly, no authority could be found describing the application of the post-2007 rules for determining the effect on the adjusted basis of an S corporation shareholder's stock and debt when the S corporation contributes appreciated property to a charity. Likewise, no authority could be found describing the application of the basis limitation rules to an S corporation shareholder's *pro rata* share of the deduction of the fair market value of such property. The Treasury has stated that it is considering guidance regarding the issue.⁴⁷ Nevertheless, it is likely that, under current law, an S corporation shareholder's *pro rata* share of the fair market value of property contributed by the S corporation to a charity reduces the adjusted basis of the shareholder's stock and debt and that the amount of the charitable contribution deduction (*i.e.*, the shareholder's *pro rata* share of the fair market value of the contributed property) the shareholder may claim in any year is limited to the shareholder's basis immediately before the contribution. Otherwise, Congress would not have enacted legislation to change that result.

The rules for determining the adjusted basis of a shareholder's stock and debt are similar.⁴⁸ For convenience, this column will discuss only adjustments to the basis of an S corporation shareholder's stock in the corporation.

Under Code Sec. 1367, the adjusted basis of a shareholder's stock in an S corporation is increased to reflect the shareholder's *pro rata* share of the S corporation's items of income, including tax-exempt income.⁴⁹ The adjusted basis of an S corporation shareholder's stock is reduced (but not below zero) to reflect the shareholder's *pro rata* share of the S corporation's items of deduction and loss, including expenses that are not deductible and not properly chargeable to a capital account.⁵⁰

The deduction for charitable contributions made by an S corporation is not taken into account in determining the S corporation's taxable income.⁵¹ Thus, the deduction for charitable contributions is an expense that is not deductible and not properly chargeable to a capital account. Under the 2006 and 2007 amendments to Subchapter S, the amount by which the adjusted basis of an S corporation shareholder's stock is reduced is the shareholder's *pro rata* share of the adjusted basis of appreciated property contributed by the corporation.

Some have argued that an S corporation shareholder's *pro rata* share of the amount of gain that is

not recognized by an S corporation on a contribution of appreciated property should increase the adjusted basis of the shareholder's stock, allowing the shareholder to deduct the shareholder's *pro rata* share of the fair market value of the contributed property.⁵² Then, as argued, the adjusted basis of the shareholder's stock would be reduced to reflect the amount of the deduction (*i.e.*, the shareholder's *pro rata* share of the fair market value of the contributed property) taken into account by the shareholder.⁵³

There is no statutory authority for this position. As explained earlier, the adjusted basis of an S corporation shareholder's stock is increased to reflect the shareholder's *pro rata* share of the S corporation's items of taxable and tax-exempt income. The unrecognized gain on the contribution of appreciated property to a charity, however, is not taxable income and, at the same time, is not tax-exempt income. Thus, the unrecognized gain should not increase basis.

The unrecognized gain on the contribution of appreciated property to a charity is not taxable income because it is not included in gross income. Under Code Sec. 61, "gross income" is generally defined to mean all income from whatever source derived, including gains in dealings in property.⁵⁴ For this purpose, the term "gain" is defined as the amount by which the amount realized on a sale or other disposition of property exceeds the adjusted basis of the property.⁵⁵ When a taxpayer contributes appreciated property to a charity and receives nothing in return, there is no amount realized on the transfer. Thus, the taxpayer does not realize any gain on the transfer of appreciated property to a charity, and the taxpayer realizes no income on the transfer.

The unrealized gain on the contribution of appreciated property, however, is not tax-exempt income because it is not excluded from income under any provision of the income tax code. Moreover, if an item is not "income," it cannot be tax-exempt "income." Thus, the unrealized gain is not tax-exempt income. Accordingly, it is not appropriate to increase the adjusted basis of an S corporation shareholder's stock to reflect the shareholder's *pro rata* share of the unrealized gain on the contribution by the S corporation of appreciated property to a charity.

On the other hand, the allowance of a deduction for the full amount of an S corporation shareholder's *pro rata* share of the appreciation in property contributed by the S corporation to a charity is somewhat consistent with the rules that apply in

limiting a partner's share of a partnership's charitable deductions when the amount of the contribution is the fair market value of the contributed property.⁵⁶ Nevertheless, the partnership rules are much too generous and can create distortions.

It would be better if Congress were to amend Subchapters K and S to provide for a flow-through to a partner or S corporation shareholder of the portion of the fair market value of contributed property in an amount that is proportionate to the portion of the adjusted basis of the contributed property that is otherwise allowable under the generally applicable basis limitation rules for S corporation shareholders and partners. Now that the 2006 and 2007 amendments to Subchapter S have expired, Congress should amend the rules for determining the amount of the deduction an S corporation shareholder and a partner may claim for its share of the entity's charitable contributions of appreciated property.

Deduction for a Partner's Distributive Share of the Partnership's Contributions of Appreciated Property to a Charitable Organization

The rules for allowing a partner to deduct the partner's distributive share of a partnership's charitable contributions of appreciated property are more liberal than the rules that apply to S corporation shareholders. When a partnership contributes appreciated property to a charity, each partner is allowed to claim a deduction in an amount equal to the partner's distributive share of the fair market value of the property.⁵⁷ In Rev. Rul. 96-11,⁵⁸ the IRS ruled that the adjusted basis of a partner's interest in the partnership is reduced (but not below zero) only by the partner's distributive share of the partnership's adjusted basis in the contributed property.

Moreover, the IRS has ruled privately that a partner may deduct its distributive share of the partnership's charitable contributions of appreciated property even if the adjusted basis of the partner's interest in the partnership does not equal or exceed the adjusted basis of property contributed by the partnership to a charity.⁵⁹ In LTR 8405084,⁶⁰ the IRS relied on Code Sec. 704(d) to reach that result. Code Sec. 704(d) provides that a partner may only deduct the partner's distributive share of partnership losses to the extent of the adjusted basis of the partner's interest in the partnership. The

IRS reasoned that the amount of a partner's distributive share of a partnership's charitable contributions is not limited to the adjusted basis of the partner's interest in the partnership because Code Sec. 704(d) applies only to partnership losses, and not to a partnership's charitable contributions.

There are other grounds for allowing a partner to deduct its distributive share of the partnership's charitable contributions in excess of the partner's adjusted basis in the partnership. Reg. §1.704-1(d) provides, in part:

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the tax year, the basis shall first be increased under section 705(a)(1) [*i.e.*, to reflect contributions of money and property by the partner to the partnership, allocations of items of partnership income and gain, including tax-exempt income, and allocations of the excess of the partnership's deductions for depletion and the basis of property subject to depletion] and decreased under section 705(a)(2) [*i.e.* to reflect distributions by the partnership to the partner and allocations of the partnership's items of deduction, loss, and expenses that are not deductible and not chargeable to a capital account], except for losses of the tax year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)] exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to the partner's distributive share of each item of loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. ...⁶¹

Code Sec. 702(a)(4), providing that a partner takes into account the partner's distributive share of the partnership's charitable contributions, is not mentioned in Regulation section 1.704-1(d), which limits a partner's ability to claim the partner's distributive share of the other items of the partnership's loss and deduction to the adjusted basis of the partner's interest in the partnership. Thus, it seems that a partner may deduct the partner's distributive share of a partnership's charitable contributions, regardless of the adjusted basis of the partner's interest in the partnership.

There is no policy reason for allowing a partner to claim its full share of a partnership's charitable contribution of appreciated property when the adjusted basis of the contributed property exceeds the adjusted basis of the partner's interest in the partnership. Moreover, the allowance of a deduction in excess of the adjusted basis of a partner's interest in the partnership may create distortions.

Example 4. In Year 1, A and B form the AB Partnership, agreeing to share in capital, profits and losses equally. A contributes \$50,000 in cash to the partnership. B contributes a building with an adjusted basis of \$0 and a fair market value of \$50,000. B had purchased the building for \$50,000 for use in his business and had claimed \$50,000 in depreciation deductions with respect to the building before contributing the building to the partnership. Thus, the adjusted basis of A's partnership interest is \$50,000, and the adjusted basis of B's partnership interest is \$0.⁶² The partnership's adjusted basis in the building that B contributed is \$0, the same as the basis of the land in B's hands at the time of the contribution.⁶³

The partnership uses the \$50,000 cash that A contributed to purchase a parcel of land. Assume that the partnership does not earn any income or incur any expenses for three years after its formation. Thus, the adjusted basis of A's partnership interest is still \$50,000 and the adjusted basis of B's partnership interest is still \$0. In Year 3, the partnership's land has increased in value to \$100,000. At that time, the partnership contributes the land to a charity in a transaction that qualifies for a charitable contribution deduction of \$100,000.

Each partner claims a charitable contribution deduction of \$50,000, in accordance with the partners' agreement to share equally in partnership income and losses. The adjusted basis of each partner's interest in the partnership is reduced (but not below zero) by the partner's \$25,000 share of the partnership's adjusted basis in the contributed property. Thus, the adjusted basis of A's interest in the partnership is reduced from \$50,000 to \$25,000. The \$0 adjusted basis of B's interest in the partnership is not reduced even though B enjoys the benefit of a \$50,000 charitable contribution.

The result in Example 3 is not appropriate. A invested \$50,000 in the partnership. In contrast, B had taken advantage of his \$50,000 cash investment in the building by claiming \$50,000 in depreciation before contributing the building to the partnership in Year 1. The decrease in the adjusted basis of A's interest in the partnership reduces A's ability to claim A's share of later partnership losses (other than charitable contributions), as well as A's ability to receive tax-free distributions of cash from the partnership. As explained earlier, Code Sec. 704(d) limits the ability of a partner to deduct the partner's share of partnership losses to the extent of the adjusted basis of the partner's interest in the partnership. Under Code Sec. 731, a partner recognizes gain on the receipt of a distribution of money from the partnership only to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.⁶⁴

In contrast, the deduction for the charitable contribution does not reduce B's ability to deduct B's share of other partnership losses or receive tax-free distributions of money from the partnership. B never had sufficient basis in B's partnership interest to deduct B's share of partnership losses (other than charitable contributions) or to receive tax-free distributions of money before the partnership made the charitable contribution.

It was not necessary for the IRS to allow a partner to claim a deduction for the partner's distributive share of a partnership's charitable contributions where the partner's share of the partnership's adjusted basis in the contributed property exceeds the adjusted basis of the partner's interest in the partnership. As explained earlier, the IRS justified its conclusion by interpreting the term "losses" (for which a deduction is limited to the adjusted basis of a partner's interest in the partnership under Code Sec. 704(d)) to mean only items of loss, and not items of deduction. There is no statutory definition of the term "loss" for purposes of Code Sec. 704(d). However, in other contexts it is assumed that the term loss means the amount by which items of deduction and loss exceed the partnership's items of income and gain for the year. In other contexts where Congress limits a taxpayer's ability to claim losses, the term "loss" is defined to mean the amount by which the deductions incurred in an activity and allowable for the tax year exceed the gross income received or accrued by the taxpayer from that activity during the tax year.⁶⁵ The Code Sec. 704(d) regulations refer to "items of loss specified in section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)]" as being allowed to the extent of the adjusted basis of the

partner's interest in the partnership.⁶⁶ Code Sec. 702(a) (7) (which requires a partner to take into account the partner's distributive share of the partnership's items of taxable income or loss) includes "other items of income, gain, loss, deduction, or credit, to the extent provided in regulations prescribed by the Secretary." The use of the word "other" indicates that the word "loss" means net loss (after subtracting deductible expenses and losses from gross income).

Moreover, the rules for computing the adjusted basis of a partner's interest in a partnership, which require a reduction in the adjusted basis for the partner's distributive share of "losses of the partnership," indicate that the term "loss" means net loss. Code Sec. 705 provides that the adjusted basis of a partner's interest in a partnership is reduced (but not below zero) by the partner's distributive share of "losses of the partnership."⁶⁷ Nevertheless, in Rev. Rul. 96-11,⁶⁸ the IRS interpreted the term "losses" for purposes of Code Sec. 705 to include an item of deduction, *i.e.*, the adjusted basis of appreciated property contributed by the partnership to a charity. It would be appropriate to apply the same interpretation to the term "losses" under Code Sec. 704(d).

Admittedly, the Code Sec. 704(d) regulations do not include charitable contributions in the list of "losses" that are subject to the basis limitation. Nevertheless, charitable contributions might have been excluded from the list because the Treasury intended to limit a partner's ability to deduct the partner's distributive share of the partnership's charitable contributions of appreciated property if and to the extent that the partner's share of the partnership's adjusted basis in the contributed property exceeded the adjusted basis of the partner's interest in the partnership. Moreover, there is no evidence in the legislative history of Code Sec. 704(d) indicating that Congress intended to allow a partner to claim a deduction for the partner's distributive share of partnership charitable contributions in excess of the adjusted basis of the partner's interest in the partnership.

The legislative history of Code Sec. 705 supports the author's interpretation of Code Sec. 704(d). The House Report explains:

The adjustments to the basis of a partner's interest in a partnership [under Code Sec. 705] are necessary to prevent inappropriate or unintended benefits or detriments to the partners. Thus, a partner's distributive share of nontaxable income (such as exempt income or depletion allowances in excess of basis) is added to the basis of his interest in the partnership so that the benefit of such tax-exempt income will

not be lost to the partner. Otherwise, the partner would eventually incur a ... gain with respect to such amounts [for example, on a sale or redemption of the partner's interest in the partnership]. Similarly, the partner's share of nondeductible expenditures must be deducted from his basis in order to prevent such amounts from eventually constituting a ... loss to him [for example, on a sale or redemption of the partner's interest in the partnership].⁶⁹

Allowing a partner to claim a charitable deduction for the partner's entire share of the fair market value of appreciated property contributed by a partnership to a charity when the partner's share of the partnership's adjusted basis in the contributed property exceeds the adjusted basis of the partner's interest in the partnership is inconsistent with Congress's intent. Because the deduction for a charitable contribution by a partnership is not taken into account for purposes of determining a partnership's taxable income, the charitable contribution deduction is an item that is not deductible and not chargeable to a capital account. Thus, the partner's share of the partnership's adjusted basis in contributed property should reduce the adjusted basis of a partner's interest in the partnership. To the extent that the partner's share of the adjusted basis of the contributed property exceeds the adjusted basis of the partner's interest in the partnership, a portion of the deduction should be disallowed to the partner under Code Sec. 704(d) and carried forward to future years when the adjusted basis of the partner's interest in the partnership increases.

The rationale for limiting the allowable amount of the charitable contribution deduction for a partner's share of the fair market value of appreciated property contributed by a partnership to a charity is the same as the rationale for limiting the allowable amount of the charitable contribution deduction for an S corporation shareholder's *pro rata* share of the fair market value of appreciated property contributed by an S corporation to a charity. Like Subchapter S, Subchapter K treats a partner as if the partner actually earned or incurred the partner's share of partnership items of income, gain, deduction and loss earned or incurred by the partnership. Like the adjusted basis of an S corporation shareholder's stock and debt, the adjusted basis of a partner's interest in the partnership reflects the partner's investment in the partnership. The adjusted basis in a partner's interest in a partnership is increased by the amount of money and the adjusted basis of property that the partner has contributed to the partnership. A partner includes in income the partner's distributive

share of the partnership's items of income, regardless of whether any partnership income is distributed to the partner. As explained earlier, the partner's share of the partnership's items of income and gain increase the adjusted basis of the partner's interest in the partnership. Thus, to the extent that a partner's share of partnership income and gain is not distributed to the partner, the partner is treated as if it contributed the items of income and gain to the partnership (or invested those items in the partnership). Like the Code Sec. 1366 regulations, the Code Sec. 704(d) regulations treat a partner as paying for a *pro rata* share of each of the items of deduction and loss that are subject to the basis limitation rule *i.e.*, to the extent of the partner's investment in the partnership.⁷⁰

The *pro rata* share the partner's distributive share of each item of deduction and loss carried forward is treated as paid by the partner in a later year when the adjusted basis of the partner's interest in the partnership is increased.⁷¹ Thus, when the partner's share of the adjusted basis of appreciated property contributed by the partnership to a charity exceeds the adjusted basis of the partner's interest in the partnership, the partner should be treated as having contributed only a portion of the partner's share of the contributed property. It is surprising that the IRS allows a partner to deduct the partner's share of the fair market value of appreciated property in cases where the adjusted basis of the contributed property exceeds the adjusted basis of the partner's interest in the partnership.

The Treatment of S Corporation Shareholders Should Not Differ from the Treatment of Partners in the Charitable Contribution Context

As explained earlier, current law seems to allow an S corporation shareholder to deduct the shareholder's *pro rata* share of the corporation's charitable contribution of appreciated property only to the extent that the fair market value of the contributed property does not exceed the adjusted basis of the shareholder's stock and debt. The adjusted basis of the shareholder's stock and debt then is reduced (but not below zero) in an amount equal to the shareholder's *pro rata* share of the fair market value of the contributed property. In contrast, a partner may deduct the partner's distributive share of the fair market value of such contributed property, regardless of whether the partner's share of

the adjusted basis of the contributed property exceeds the adjusted basis of the partner's interest in the partnership. The adjusted basis of the partner's interest in the partnership then is reduced (but not below zero) in an amount equal to the partner's share of the adjusted basis in the contributed property.

The author could find no authority explaining the reason for the disparate treatment of S corporation shareholders and partners in the charitable contribution context. Indeed, the language of the applicable Code sections for determining the amount of the allowable deduction and the basis adjustments is the same.

Both Code Secs. 705 and 1367 require a reduction of the adjusted basis of a partner's interest in a partnership or an S corporation shareholder's adjusted basis in stock and/or debt by the amount allocated to the partner or S corporation shareholder of expenditures of the partnership or S corporation "not deductible in computing its taxable income and not properly chargeable to a capital account."⁷² In Rev. Rul. 96-11, the IRS interpreted this language to require a decrease in the adjusted basis of a partner's interest in the partnership in an amount equal to the partner's share of the partnership's adjusted basis in appreciated property contributed by the partnership to a charity even if the partner is allowed to claim a deduction in an amount equal to the partner's share of the fair market value of the contributed property.

The IRS reached its conclusion in Rev. Rul. 96-11 by considering the role that the adjustments to the basis of a partner's interest in a partnership play in preventing duplications of income and deduction. The adjustments to the basis of an S corporation shareholder's stock and debt serve the same purpose. The adjusted basis of an S corporation shareholder's stock and debt is increased by the shareholder's *pro rata* share of the S corporation's tax-exempt income so that the shareholder will not recognize that income on a later sale or redemption of the stock and debt. Similarly, the adjusted basis of an S corporation shareholder's stock and debt is decreased by the shareholder's *pro rata* share of the corporation's expenditures that are not deductible in computing taxable income and not properly chargeable to a capital account so that the shareholder will not be entitled to deduct a loss on a later sale or redemption of the stock or debt.

In Rev. Rul. 96-11, the IRS also concluded that the basis of a partner's interest should be reduced only by the partner's share of the partnership's basis in appreciated property contributed to a charity because of the

role that basis plays in determining the partnership's taxable income and therefore, the amount of income allocated to the partners. The IRS explained:

In determining whether a transaction results in exempt income within the meaning of §705(a)(1)(B), or a nondeductible, noncapital expenditure within the meaning of §705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income. Pursuant to §703(a)(2)(C), the contribution of [appreciated property to a charity] by [a partnership] is not taken into account by [the partnership] in computing its taxable income. Consequently, the contribution results in a permanent decrease in the aggregate basis of the assets of [the partnership] that is not taken into account by [the partnership] in determining its taxable income and will not be taken into account for federal income tax purposes in any other manner. Therefore, for purposes of §705(a)(2)(B), the contribution of [the appreciated property to a charity], and the resulting permanent decrease in partnership basis, is an expenditure of the partnership not deductible in computing its taxable income and not properly chargeable to a capital account.

* * *

Reducing the partners' bases in their partnership interests by their respective shares of the permanent decrease in the partnership's basis in its assets preserves the intended benefit of providing a deduction (in circumstances [in which a charitable contribution deduction is allowed in an amount equal to the fair market value of the contributed property]) for the fair market value of appreciated property without recognition of the appreciation. By contrast, reducing the partners' bases in their partnership interests by the fair market value of the contributed property would subsequently cause the partners to recognize gain (or a reduced loss), for example, upon a disposition of their partnership interests, attributable to the unrecognized appreciation in [the contributed property] at the time of [its] contribution.⁷³

The same concerns affect S corporation shareholders. Because the adjusted basis of an S corporation

shareholder's stock and debt is reduced by the shareholder's *pro rata* share of the fair market value of appreciated property contributed by the S corporation to a charity, the shareholder is required to recognize gain (or a reduced loss) on a later disposition or redemption of the stock or debt attributable to the unrecognized appreciation in the contributed property. For this reason, the adjusted basis of an S corporation shareholder's stock and/or debt should be reduced only in an amount equal to the shareholder's *pro rata* share of the corporation's adjusted basis in the contributed property.

It is surprising that the IRS has not issued a revenue ruling or other guidance concerning the tax consequences to S corporation shareholders on the contribution of appreciated property to a charity by an S corporation. If the IRS had interpreted the language under Subchapter S concerning adjustments to basis and the basis limitation rules in the charitable contribution context as it has interpreted the same language under the partnership tax rules, there would not have been a need for Congress to enact the amendments to Code Secs. 1366 and 1367.

Conclusion

Rev. Rul. 2008-16 and the 2006 and 2007 amendments to Code Secs. 1366 and 1367 offer S corporation shareholders an opportunity to claim a larger deduction for their *pro rata* shares of an S corporation's charitable contributions in tax years beginning after December 31, 2005, and before January 1, 2008, than is allowed under current law. The amount of the deduction allowed under the amendments was not quite as generous as the rules that apply in the partnership context. It is unfortunate that the amendments only applied for a two-year period and have now expired.

Both the American Bar Association Section on Taxation and the American Institute of Certified Public Accounts have suggested that Congress should permanently extend the amendments.⁷⁴ If Congress extends the amendments, it might be appropriate to allow an S corporation shareholder, as well as a partner, to deduct the taxpayer's share of the entity's charitable contributions of appreciated property in an amount equal to the taxpayer's share of the fair market value of the property in proportion to the adjusted basis of the taxpayer's share of the adjusted basis of the property that does not exceed the adjusted basis of the taxpayer's interest in the entity.

ENDNOTES

- * The author would like to thank Vice Chancellor Glenn G. Morris for his comments on an earlier draft of this column.
- ¹ Rev. Rul. 2008-16, IRB 2008-11, 585.
- ² See Code Secs. 701 (partnership not subject to income tax), 1363(a) (S corporation generally not subject to income tax).
- ³ Code Sec. 702 (in computing their income tax liability, partners take into account their distributive shares of partnership items of income, gain, loss, deduction and credit); Code Sec. 1366(a) (in determining their income tax liability, S corporation shareholders take into account their *pro rata* shares of the S corporation's items of income, gain, loss, deduction and credit).
- ⁴ Code Sec. 704(d).
- ⁵ Code Secs. 705(a)(2)(A) (adjusted basis of a partner's interest in the partnership), 1367(a)(2)(B), (C) (adjusted basis of an S corporation's stock), 1367(b)(2)(A) (adjusted basis of indebtedness of an S corporation to the shareholder). The adjusted basis of a partner's interest in the partnership and the adjusted basis of an S corporation shareholder's stock first is reduced by the amount of any distributions from the entity to the partner or shareholder before taking into account the losses that are allocated to the partner or shareholder and tax-free to the partner or shareholder. Code Secs. 705(a) (adjusted basis of partner's interest in the partnership), 1367(a)(2)(A) (adjusted basis of an S corporation shareholder's stock). The adjusted basis of a partner's interest in the partnership and an S corporation shareholder's adjusted basis in the S corporation's stock and indebtedness also are reduced to take into account the amount of any items of the entity that are not deductible and not chargeable to a capital account. Code Secs. 705(a)(2)(B) (adjusted basis of a partner's interest in the partnership), 1367(a)(2)(D) (adjusted basis of S corporation's stock), 1367(b)(2)(A) (adjusted basis of indebtedness of the S corporation to the shareholder).
- ⁶ Code Secs. 704(d) (carryover of partnership losses), 1366(d)(2)(A) (carryover of S corporation losses).
- ⁷ Act Sec. 3(j) of the Tax Technical Corrections Act of 2007 (P.L. 110-172), 110th Cong., 2d Sess. (2007) (coordinating Code Sec. 1366 with the amendments to Code Sec. 1367 under Act Sec. 1203(a) of the Pension Protection Act of 2006 (P.L. 109-280), 109th Cong., 2d Sess. (2006) ("Pension Protection Act"); Act Sec. 1203(a) of the Pension Protection Act (amending Code Sec. 1367).
- ⁸ Code Sec. 170(a)(1), (c).
- ⁹ Reg. §1.170A-1(c)(1).
- ¹⁰ Code Sec. 170(e)(1)(A). *But see* Code Sec. 170(e)(3) (allowing a corporation to claim a charitable contribution deduction in an amount equal to more than the basis of the property on the contribution of certain types of inventory).
- ¹¹ Under Code Sec. 170(e)(1)(A), the amount of any charitable contribution otherwise taken into account under Code Sec. 170 (*i.e.*, the fair market value of property other than money contributed to a charity) is reduced by the amount of gain which would not have been long-term capital gain (determined without regard to Code Sec. 1221(b)(3)) if the property contributed had been sold for its fair market value at the time of the contribution. For purposes of Code Sec. 170, any property, the sale of which would have resulted in long-term capital gain or Code Sec. 1231 gain, is referred to as "capital gain property." Code Sec. 170(b)(1)(C)(iv). For this purpose, property used in a trade or business as defined in Code Sec. 1231(b) is treated as a capital asset, except to the extent that gain on the sale of the property at the time of its contribution would be treated as ordinary income under Code Sec. 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a). Code Sec. 170(e), flush language). Rules similar to the rules under Code Sec. 751 that apply to a charitable contribution of partnership interest apply to a charitable contribution of stock in an S corporation for determining whether a portion of the gain recognized on the sale of the contributed S corporation stock would be treated as ordinary income for this purpose. *Id.*
- ¹² See, *e.g.*, Code Sec. 170(e)(1)(B)(i) (taxpayer may claim a charitable contribution deduction in an amount equal to the adjusted basis of tangible personal property contributed to a charity and the charity's use of the property is not related to its charitable purpose or function). See also Code Sec. 170(e)(1)(B)(ii) (contribution of capital gain property to or for the use of a private non-operating foundation). However, a taxpayer also may deduct the fair market value of qualified appreciated stock contributed to a private nonoperating foundation. Code Sec. 170(e)(5).
- ¹³ When a taxpayer transfers appreciated property to a charity in exchange for money or property that is worth less than the fair market value of the contributed property (*i.e.*, a bargain sale to a charity), the taxpayer is required to recognize as gain a portion of the appreciation in the property. Code Secs. 170(e)(2), 1101(b).
- ¹⁴ Code Sec. 1(h)(1)(C), (3). *But see* Code Sec. 1(h)(1)(B) (five percent (zero percent in tax years beginning after 2007) tax rate on adjusted net capital gain for taxpayers in low marginal income tax brackets).
- ¹⁵ Code Sec. 1(i)(2).
- ¹⁶ Code Sec. 1001(a).
- ¹⁷ Code Sec. 1363(a).
- ¹⁸ Code Sec. 1363(b).
- ¹⁹ Code Sec. 1363(b).
- ²⁰ Code Sec. 1366(a), (b).
- ²¹ Code Sec. 1366(d)(2).
- ²² Reg. §1.1366-2(a)(4).
- ²³ *Id.* For purposes of determining the items of loss and deduction that are allowed for the tax year, the total amount of items of loss and deduction for the tax year is the sum of the shareholder's *pro rata* share of items of loss and deduction for the tax year, and the items of loss and deduction disallowed and carried forward from prior years. *Id.*
- ²⁴ Code Sec. 1366(d)(1).
- ²⁵ Code Sec. 1367.
- ²⁶ Code Sec. 1367(a)(1). The adjusted basis of indebtedness of the S corporation to the shareholder is increased only if and to the extent that the initial basis of the indebtedness was reduced as a result of the shareholder's *pro rata* share of losses and deductions in prior years. Code Sec. 1367(b)(2)(B).
- ²⁷ Code Sec. 1367(a)(2). The adjusted basis of any indebtedness of the S corporation to the shareholder is reduced (but not below zero) only if and to the extent that the shareholder's *pro rata* share of the S corporation's items of deduction and loss exceed the adjusted basis of the shareholder's stock in the corporation. Code Sec. 1367(b)(2)(A).
- ²⁸ Reg. §1.1367-1(f).
- ²⁹ Code Sec. 1367(a)(1)(B), as amended by Act Sec. 1203(a) of the Pension Protection Act of 2006 (P.L. 109-280).
- ³⁰ The Tax Technical Corrections Act of 2007 (P.L. 110-172). Act Sec. 3 of the Tax Technical Corrections Act of 2007 was intended to amend Act Sec. 1203(a) of the Pension Protection Act of 2006 (P.L. 109-280). Joint Committee on Taxation, *Description of the Technical Tax Corrections Act of 2007*, available at www.house.gov/jct/X-119-07.pdf.
- ³¹ Tax Technical Corrections Act of 2007 (P.L. 110-172).
- ³² Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2007*, 2 JCX-119-07 (Dec. 18, 2007).
- ³³ See Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* 271, JCX-38-06 (Aug. 3, 2006).
- ³⁴ Reg. §1.1367-1(f).
- ³⁵ Code Sec. 1367(a)(2), flush language.
- ³⁶ Code Sec. 1367(a)(2)(B).
- ³⁷ Code Sec. 1366(d)(1).
- ³⁸ Reg. §1.1366-2(a)(4).
- ³⁹ Code Sec. 1366(d)(4).
- ⁴⁰ Code Sec. 1367(d)(2).
- ⁴¹ Reg. §1.1366-2(a)(4).
- ⁴² *Id.*
- ⁴³ Code Sec. 1367(a)(1); Reg. §1.1367-1(f)(1).

- ⁴⁴ Code Sec. 1367(a)(2)(D) and (b)(2)(A) provide that the adjusted basis of an S corporation shareholder's stock and debt is reduced by the shareholder's *pro rata* share of any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account. Code Sec. 1363(b)(2) provides that the items referred to in Code Sec. 703(a)(2) (including the deduction for charitable contributions under Code Sec. 170) are not deductible in determining an S corporation's taxable income. Thus, the deduction for charitable contributions is an item that is not deductible and not properly chargeable to a capital account. Where the amount of the deduction for a charitable contribution of appreciated property is the fair market value of the property, the S corporation shareholder's adjusted basis in stock and indebtedness must be reduced by the fair market value of the contributed property. Similarly, Code Sec. 1366(d)(1) limits an S corporation shareholder's ability to claim a deduction for the shareholder's *pro rata* share of an S corporation's charitable contributions (including the fair market value of appreciated property if allowable under Code Sec. 170), along with the shareholder's *pro rata* share of the corporation's other items of deduction and loss, to the adjusted basis of the shareholder's stock and debt.
- ⁴⁵ Reg. §1.1366-2(a)(4).
- ⁴⁶ Code Sec. 1366(d)(1).
- ⁴⁷ Kevin I. Fromer, Assistant Secretary for Legislative Affairs, Letter to Senator Richard G. Lugar (Aug. 2, 2007), 2007 WL 2261552.
- ⁴⁸ Compare Code Sec. 1367(a) (stock basis) with Code Sec. 1367(b)(2). There are two primary differences between the adjustments to the basis of an S corporation shareholder's stock and the adjustments to the basis of any indebtedness. In determining the amount of deductions and losses that an S corporation shareholder may claim in any year, the basis of the shareholder's stock is reduced before the basis of indebtedness is reduced. Code Sec. 1367(b)(2)(A). In cases where the adjusted basis of indebtedness of the S corporation to the shareholder has been reduced to allow the shareholder to claim deductions and losses, the adjusted basis of the indebtedness is increased, up to the amount of the original basis of the indebtedness, before the adjusted basis of the shareholder's stock is increased. Code Sec. 1367(b)(2)(B).
- ⁴⁹ Code Sec. 1367(a)(1). See also Code Sec. 1367(b)(1)(B) (restoration of basis in indebtedness of the corporation to the shareholder).
- ⁵⁰ Code Sec. 1367(a)(2). See also Code Sec. 1367(b)(1) (reduction in the adjusted basis of indebtedness of the corporation to the shareholder).
- ⁵¹ Code Sec. 1363(b)(2).
- ⁵² See, e.g., Jeffrey R. Hoops, Partner, Ernst & Young, LLP, on behalf of the American Institute of Certified Public Accountants, *Written Testimony (for the Record) Before the U.S. House of Representatives Committee on Small Business Hearing Entitled, Modernizing the Tax Code: How Updating the Internal Revenue Code Can Better Serve Small Business* (Apr. 10, 2008), available at www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-hoops.pdf.
- ⁵³ Jeffrey R. Hoops, Partner, Ernst & Young, LLP, on behalf of the American Institute of Certified Public Accountants, *Written Testimony (for the Record) Before the U.S. House of Representatives Committee on Small Business Hearing Entitled, Modernizing the Tax Code: How Updating the Internal Revenue Code Can Better Serve Small Business* (Apr. 10, 2008), available at www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-hoops.pdf.
- ⁵⁴ Code Sec. 61(a)(3).
- ⁵⁵ Code Sec. 1001(a).
- ⁵⁶ The American Institute of Certified Public Accountants has argued that increasing the adjusted basis of an S corporation shareholder's stock in an amount equal to the shareholder's *pro rata* share of fair market value of the contributed property and then reducing the adjusted basis of the stock by the amount of the deduction allowed to the shareholder would be consistent with the current treatment of charitable contributions in the partnership context. See, e.g., *Written Statement (for the Record) Before the U.S. House of Representatives Committee on Small Business, Hearing Entitled "Modernizing the Tax Code: How Updating the Internal Revenue Code Can Better Serve Small Business* (Apr. 10, 2008).
- ⁵⁷ See Reg. §1.170A-1(c)(1) (amount of charitable contribution of property other than money is the fair market value of the property at the time of the contribution, reduced as provided by Code Sec. 170(e)(1), (3) and Reg. §§1.170A-4 and 1.170A-4A)).
- ⁵⁸ Rev. Rul. 96-11, 1996-1 CB 140.
- ⁵⁹ LTR 8405084 (Nov. 3, 1983).
- ⁶⁰ *Id.*
- ⁶¹ Reg. §1.704-1(d)(2).
- ⁶² See Code Sec. 722 (adjusted basis of a partner's interest in the partnership acquired by a contribution of property is the amount of money, plus the adjusted basis of any property contributed to the partnership at the time of the contribution).
- ⁶³ Code Sec. 723.
- ⁶⁴ Code Sec. 731(a).
- ⁶⁵ See, e.g. Code Sec. 465(d) (definition of the term "loss" for purposes of Code Sec. 465, limiting a taxpayer's ability to claim losses to the extent of the amount the taxpayer has at risk in the activity generating the losses).
- ⁶⁶ Reg. §1.704-1(d)(2).
- ⁶⁷ Code Sec. 705(a)(2)(A).
- ⁶⁸ Rev. Rul. 96-11, 1996-1 CB 140.
- ⁶⁹ H.R. REP. NO. 1337, 83rd Cong. 2d Sess. A225 (1954), reprinted in 1954 U.S. Code Cong. & Admin. News 4017; S. REP. NO. 1622, 83rd Cong., 2d Sess. 384 (1954).
- ⁷⁰ Reg. §1.704-1(d)(2). Admittedly, the partner's distributive share of charitable contributions is not taken into account under Reg. §1.704-1(d)(2). Nothing in the legislative history of Code Sec. 704(d), however, suggests that Congress intended to allow a partner to claim a deduction for the partner's distributive share of partnership charitable contributions in excess of the adjusted basis of the partner's interest in the partnership.
- ⁷¹ Reg. §1.704-1(d)(2).
- ⁷² Code Secs. 705(a)(2)(B), 1367(a)(2)(D).
- ⁷³ Rev. Rul. 96-11, 1996-1 CB 140.
- ⁷⁴ Statement of the American Bar Association Section on Taxation, available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6443> (last visited May 1, 2008); Jeffrey R. Hoops, Partner, Ernst & Young, LLP, on behalf of the American Institute of Certified Public Accountants, *Written Testimony (for the Record) Before the U.S. House of Representatives Committee on Small Business Hearing Entitled, Modernizing the Tax Code: How Updating the Internal Revenue Code Can Better Serve Small Business* (Apr. 10, 2008), available at www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-hoops.pdf.

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