

## Part I

### Section 1366.— Pass-through of items to shareholders

26 CFR 1.1366-2: Limitations on deduction of pass-through items of an S corporation to its shareholders  
(Also § 1367; 1.1367-1.)

Rev. Rul. 2008-16

#### ISSUE

If an S corporation makes a charitable contribution of appreciated property in a taxable year beginning after December 31, 2005, and before January 1, 2008, what is the amount of the charitable contribution deduction that a shareholder may claim in circumstances where § 1366(d) of the Internal Revenue Code (Code) limits the shareholder's pro rata share of the S corporation's losses and deductions for the taxable year in which the property is contributed?

#### FACTS

Individual A is the sole shareholder of S Corporation X. At the beginning of X's 2007 taxable year, A has a basis of \$50x in the X stock. During 2007, X 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 under § 170(c). The charitable contribution is not subject to the limitations of § 170(e)(1). In 2007, X has §1363 taxable income of \$30x and a long-term capital loss of \$25x.

#### LAW

Section 170(a) allows as a deduction any charitable contribution (as defined in § 170(c)) the payment of which is made during the taxable year. The deduction allowable by § 170(a) is subject to the limitations of § 170(b).

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in § 170(e)(1) and § 1.170A-4(a), or § 170(e)(3) and § 1.170A-4A(c).

Section 1363(b)(2) provides that the taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that the deductions referred to in § 703(a)(2), including the deduction for charitable contributions provided in § 170, shall not be allowed to the corporation.

Section 1366(a)(1)(A) provides that, in determining the tax of a shareholder, there shall be taken into account the shareholder's pro rata share of the corporation's items of income, loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder. Section 1366(a)(1) provides further that the items

referred to in § 1366(a)(1)(A) include amounts described in § 702(a)(4). Section 702(a)(4) refers to charitable contributions (as defined in § 170(c)).

Section 1366(a)(1)(B) provides that, in determining the tax of a shareholder, there shall be taken into account the shareholder's pro rata share of any nonseparately computed income or loss.

Section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(a) for any taxable 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.

Section 1366(d)(2)(A) generally provides that any loss or deduction which is disallowed for any taxable year by reason of § 1366(d)(1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

Section 1.1366-1(a)(2)(i) and (iii) provides that each S corporation shareholder must take into account separately the shareholder's pro rata share of the S corporation's gains and losses from sales or exchanges of capital assets and the corporation's charitable contributions.

Section 1.1366-1(a)(3) provides that each shareholder must take into account separately the shareholder's pro rata share of the nonseparately computed income or loss of the S corporation.

Section 1.1366-1(b)(1) provides, in part, that the character of any item of income, loss, deduction, or credit described in § 1366(a)(1)(A) or (B) is determined for the S corporation and retains that character in the hands of the shareholder.

Section 1.1366-2(a)(4) generally provides that if a shareholder's pro rata share of the aggregate amount of losses and deductions exceeds the sum of the adjusted basis of the shareholder's stock in the corporation and the adjusted basis of any indebtedness of the corporation to the shareholder, then the limitation on losses and deductions under § 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions.

Section 1367(a)(1)(B) provides that the basis of each shareholder's stock in an S corporation is increased for any period by any nonseparately computed income determined under § 1366(a)(1)(B).

Section 1367(a)(2)(B) provides that the basis of each shareholder's stock in an S corporation is decreased for any period (but not below zero) by the items of loss and deduction described in § 1366(a)(1)(A).

Section 1.1367-1(f) provides that increases in an S corporation shareholder's stock basis that are attributable to income items described in § 1367(a)(1)(B) are made before decreases in such basis that are attributable to items of loss or deduction described in § 1367(a)(2)(B).

Section 1203(a) of the Pension Protection Act of 2006 (Pension Act), P.L. 109-280, 120 Stat. 780 (2006), amended Code § 1367(a)(2) to provide that the decrease in shareholder basis under § 1367(a)(2)(B) by reason of a charitable contribution (as defined in § 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. The Technical Explanation of the Pension Act, Technical Explanation of H.R. 4, "The Pension Protection Act of 2006," JCX-38-06 page 271, provides the following illustration of § 1203:

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500. The shareholder will be treated as having made a \$500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by \$200. (Footnote 306: This example assumes that basis of the S corporation stock (before reduction) is at least \$200.)

Section 3(b) of the Tax Technical Corrections Act of 2007 (Technical Corrections Act), P.L. 172, 121 Stat. 2473 (2007), added § 1366(d)(4), which concerns the application of the basis limitation rule of § 1366(d)(1) to charitable contributions of appreciated property by S corporations. Generally, under § 1366(d)(1), the amount of losses and deductions which a shareholder of an S corporation may take into account in any taxable year is limited to the shareholder's adjusted basis in his stock and indebtedness of the corporation. Section 1366(d)(4) provides that, in the case of a charitable contribution of property, § 1366(d)(1) shall not apply to the extent of 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. Thus, the basis limitation rule of § 1366(d)(1) does not apply to the amount of deductible appreciation in the contributed property. See Description of the Tax Technical Corrections Act of 2007, JCX-119-07, pages 2-3.

The Pension Act amendment to § 1367(a)(2) and the Technical Corrections Act amendment to § 1366(d) apply to charitable contributions made by S corporations in taxable years beginning after December 31, 2005, and before January 1, 2008. Charitable contributions made by S corporations in taxable years beginning after December 31, 2007, barring any statutory change, are subject to the law in existence prior to these amendments. The IRS and Treasury Department are considering issuing guidance on the treatment of charitable contributions made by S corporations in taxable years beginning after December 31, 2007.

#### ANALYSIS

Under the facts of this revenue ruling, X 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 under § 170(c). The charitable contribution is treated as a separately stated item of deduction that passes through to A and is deductible in computing A's individual tax liability. Section 1.1366-1(a)(2)(iii).

Pursuant to § 1.1367-1(f), A's \$50x basis in the X stock is first increased by \$30x under § 1367(a)(1)(B) to reflect A's share of X's taxable income. A's basis in the X stock is then decreased (but not below zero) by A's pro rata share of the sum of the

adjusted basis of the contributed property (\$100x) pursuant to the flush language of § 1367(a)(2) and by A's pro rata share of X's long-term capital loss (\$25x) pursuant to § 1367(a)(2)(B). However, A's pro rata share of the aggregate amount of losses and deductions (\$125x) exceeds A's basis in the X stock of \$80x. Section 1366(d)(1), accordingly, will limit the allowable losses and deductions to A for X's 2007 tax year.

Pursuant to § 1366(d)(4), the basis limitation rule in § 1366(d)(1) does not apply to a contribution of appreciated property to the extent the shareholder's pro rata share of the contribution exceeds the shareholder's pro rata share of the adjusted basis of the contributed property. Accordingly, the basis limitation rule of § 1366(d)(1) does not apply to A's pro rata share of the amount of deductible appreciation in the contributed property (\$90x).

Under § 1.1366-2(a)(4), when a shareholder has losses or deductions in excess of the sum of the shareholder's basis in the stock plus indebtedness of the S corporation to the shareholder, the limitation on losses must be allocated pro rata to each item of loss or deduction. In the case of a charitable contribution deduction, the limitation amount allocable to such deduction is determined by reference to the shareholder's pro rata share of the contributed property's adjusted basis pursuant to § 1366(d)(4).

In applying § 1.1366-2(a)(4), the amount of the limitation allocable to a charitable contribution deduction is an amount that bears the same ratio to the § 1366(d) limitation as the shareholder's pro rata share of the contributed property's adjusted basis bears to the total of the shareholder's pro rata share of the corporation's losses and deductions

(excluding the charitable contribution deduction attributable to the shareholder's pro rata share of the fair market value of the contributed property over the contributed property's tax basis). Accordingly, the amount of the limitation allocable to A's share of X's charitable contribution deduction is determined by multiplying A's basis in the X stock (\$80x) by a fraction, the numerator of which is \$100x (the contributed property's adjusted basis) and the denominator of which is \$125x (the total of the capital loss and the contributed property's adjusted basis). Thus, \$64x is allocated to the charitable contribution deduction. The remaining \$16x is allocated to the capital loss.

Accordingly, in 2007, the amount of the charitable contribution deduction that A may claim is \$154x. This amount is comprised of A's pro rata share of the property's appreciation (\$90x) plus the amount of the loss limitation allocated to A's pro rata share of the contributed property's adjusted basis (\$64x). Under § 1367(a)(2)(B), A's basis in the X stock is 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. Pursuant to § 1366(d)(2), the disallowed portion of the charitable contribution deduction (\$36x) and the capital loss (\$9x) shall be treated as incurred by X in the succeeding taxable year with respect to A.

#### HOLDING

If an S corporation makes a charitable contribution of appreciated property during a taxable 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 (i) the shareholder's pro rata share of the fair market value of the



contributed property over the contributed property's adjusted tax basis, and (ii) the amount of the § 1366(d) loss limitation amount that is allocable to the contributed property's adjusted basis under § 1.1366-2(a)(4). Any disallowed portion of the charitable contribution retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Cynthia D. Morton of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Cynthia D. Morton at (202) 622-3060 (not a toll-free call).