

**MUCH BETTER INCOME TAX DEDUCTION RULES FOR S CORPORATIONS
THAT DONATE CONSERVATION EASEMENTS – DÉJÀ VU, etc.**

By

Stephen J. Small, Esq.

12/30/2010

Once again, a congressional “fix” of what can best be called an anomaly in the tax code helps ease the way for more important conservation easement donations in 2010 and 2011. Most landowners will not be impacted by this provision at all, but for S corporation landowners this is very good news. Of course, this is in addition to the other tax benefits of conservation easement donations, covered in great detail at www.lta.org/tax-rules.

BACKGROUND

The provision and the tax rules are technical but very important. For decades, the tax rule has been that when an S corporation made a charitable contribution, the contribution flowed through to the shareholders of the S corporation, but only to the extent they had “basis” in their S corporation stock. “Basis” is really a tax concept; often it means the same thing as “cost,” but sometimes “cost” and “basis” are different. Let’s take a simple example.

Assume that in 1990 Mary set up an S corporation, and contributed to the S corporation \$300,000 in cash. Mary is the sole shareholder of the S corporation. The S corporation then used that money to purchase a ranch, for \$300,000. On these facts, Mary's basis in her S corporation stock is \$300,000.

Assume that in 2005, Mary decided to have the S corporation donate a conservation easement on the ranch; assume at that time the value of the ranch was \$2,000,000, and that a conservation easement on the ranch was valued at \$1,000,000. But part way through the conservation easement project, Mary was informed that because of the S corporation deduction limitation rules, only \$300,000 of the \$1,000,000 easement donation would "flow through" the S corporation so she could use that on her own individual income tax return. In other words, \$700,000 of the donation was "trapped" at the S corporation level.

Trust me on this. We have encountered many of these situations over the years, and there has been no simple or inexpensive way out of this fix. The stock-basis-limitation rule for donations by S corporations absolutely has killed a number of very important conservation easement donations. And this is not anecdotal; I have first-hand knowledge of many such donations that did not happen because of the basis-limitation rule.

As an aside, but an important clarification, note that the rule is different when a partnership, or limited liability company, donates a conservation easement. In those cases, the deduction flows through to the partners of the partnership, or the members of the limited liability company, without regard to any "basis" issues.

THE NEW RULE

In any case, in 2009 Congress changed this rule to modify the basis-limitation rule in a manner that facilitated conservation easement donations by S corporations, but that “fix” expired at the end of 2009. To make a long story short, along with a package of other provisions in the recent legislation extending the individual income tax cuts to all (including the enhanced easement donation incentives), Congress extended the S corporation deduction “fix” for donations made by S corporations in 2010 and 2011. What this means is that in almost every case when an S corporation makes a charitable contribution, that contribution will flow through to the shareholder or shareholders regardless of their stock basis.

I say “in almost every case” because the new rule does not simply say that the deduction flows through without regard to basis, so there could be some particular situations in which the full donation does not flow through. As one example (but without going through this entire exercise), it appears that the entire deduction will not flow through to shareholders if the *basis of the donated asset is greater than the shareholders’ stock basis*. This might happen, for example, if an S corporation owned a ranch or a farm and depreciation and/or operating losses over time had lowered stock basis. *Donors must check with their own advisors about the impact of this tax rule change.*

The new deduction rules apply for donations made in 2010 and 2011. In other words, like the new increased income tax incentives for all conservation easement donations, the new S corporation deduction rules are not permanent.

OBSERVATIONS

This is not the place for a technical discussion of the rule, so here are four final observations.

First, suffice it to say that in almost every case easement donations by S corporations will flow through to the shareholders, with the same tax result as if the donation had been made by a partnership, or even by the shareholders individually.

Second, and this cannot be overemphasized, owners of S corporations must check with their own tax advisors to see how these new rules work in their own individual cases.

Third, it is absolutely clear that with the new enhanced income tax incentives for conservation easement donations, in effect for donations in 2010 and 2011, a conservation easement donation that flows through an S corporation to its shareholders can be used by each shareholder up to 50% of his or her adjusted gross income for the year, with a fifteen-year carryforward. If the shareholder is a “qualified farmer or rancher” under the new incentives, the shareholder can take the deduction up to 100% of adjusted gross income with a fifteen-year carryforward!!

Fourth, bottom line, the income tax incentives for conservation easement donations by S corporations have never been greater!!!

I know of a number of very important easement donations that have been on hold pending this “fix.” It looks like 2011 will be a very good year indeed for conservation easement donations.