Halcolm Bard
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TAX AND BUSINESS ADVISOR

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Tax and Business Alert™

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Qualified Conservation Contributions

Recent legislation has enhanced the value of an existing tax-saving opportunity. As background information, taxpayers can receive a generous income tax deduction when they make a *qualified conservation contribution*. A qualified conservation contribution is the donation of a qualified real property interest (e.g., an easement) to an organization that uses it exclusively for conservation purposes. A real property interest for this purpose includes a perpetual restriction on the use of real property. The landowner does not give up ownership or control of the land; the easement only restricts what can be done on or to the land. In the typical case, a perpetual conservation easement is given to a qualified organization such as a state agency charged with preserving natural resources.

Generally, when taxpayers contribute less than their entire interest in a property, the contribution is nondeductible due to this material restriction (the partial property interest retained by the donor). However, this usually does not apply to a qualified conservation contribution. Taxpayers are also generally limited to a percentage of their adjusted gross income (AGI) as the maximum amount of charitable contributions that can be taken in a given year. This percentage limitation has traditionally been 30% of AGI for qualified conservation contributions.


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The Pension Protection Act of 2006 temporarily enhanced the value of qualified conservation contributions made in tax years beginning after December 31, 2005, and before January 1, 2008. The new law increases the maximum charitable deduction limit to 50% of AGI from 30%. In addition, excess contributions not used in the current year can be carried forward for up to 15 years instead of the normal five years.

This new enhanced charitable deduction opportunity is only available for a limited time. Please call us to discuss how you might benefit from the increased deduction limit and carryforward period for qualified conservation contributions.

New Tax Break for S Corporation Shareholders

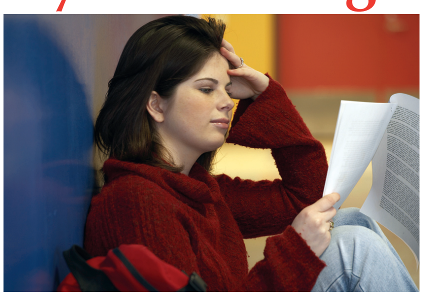
Congress has created a new tax break for charitably inclined S Corporation shareholders. The Pension Protection Act of 2006 (the Pension Act) allows these shareholders to recognize a generous contribution and, theoretically, a smaller gain and correspondingly lower tax bill when they sell their S-corp stock.

When an S-corp donates property, the IRS requires that the fair market value (FMV) of the property be used to determine the contribution amount. In this regard, it is not unusual for an S-corp to donate appreciated property, like a building, where the property's FMV exceeds its tax basis (original cost plus improvements). The tax deduction for the charitable contribution is passed through to the shareholders. Prior to the Pension Act, the shareholders were required to reduce the basis of their S-corp stock by the same amount—the FMV of the donated property. This often resulted in a higher taxable gain when their S-corp stock was sold.

During tax years beginning after December 31, 2005, and before January 1, 2008, S-corp shareholders still will be allowed a charitable deduction for their share of the property's FMV contributed by the corporation, but their stock basis will only be reduced by the contributed property's tax basis. A smaller reduction in the S-corp stock basis can result in a smaller taxable gain when the S-corp stock is sold.

Please call us to discuss this tax saving opportunity in detail.

Help Your Grandchildren Pay for College



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Contributing to a 529 plan is a great way for grandparents to help their grandchildren pay for college. It is also an effective way to remove assets from the grandparent's estate without paying the gift tax. Grandparents can contribute up to $60,000 per person to a 529 plan without incurring gift tax and still maintain control of the account. As an added feature, money in a 529 plan owned by a grandparent is not assessed by the federal financial aid formula.

New Formula for the Telephone Tax Refund

Businesses and tax-exempt organizations can request a refund of the federal long-distance telephone excise taxes they paid during the 41-month period from March 2003 through July 2006. The IRS recently announced the availability of a formula that will allow businesses and tax-exempt organizations to estimate their federal long-distance telephone excise tax refund. Using the formula eliminates the need to examine 41-months of telephone bills in detail to calculate the refund. The IRS received input from business organizations, the Small Business Administration, and representatives from the tax-exempt community to develop the refund formula.

Bargain Priced Home Sales to an Adult Child

As part of an estate and gift planning strategy, a taxpayer may consider transferring ownership of a family home to an adult child. Since many residential properties have gone up substantially in value over the last few years, the tax implications of such transfers can be very significant. When a taxpayer sells a home (or any other asset) for a bargain price to a relative (or any other person), they are actually treated as making a two-pronged transaction. The first prong is considered a sale for an amount equal to the bargain sale price. Their entire basis (cost) in the transferred property is offset against the sale proceeds. The second prong is considered a gift equal to the difference between the fair market value (FMV) of the property and the bargain sale price. The following example illustrates the tax consequences for the seller.

> **Example:** Gwen, an unmarried taxpayer, sells her $600,000 home in 2007 to her unmarried adult son, Fred, for a bargain price of $350,000. Gwen is treated as selling the property to Fred for $350,000 and making a related $250,000 gift ($600,000 FMV – $350,000 sale price).
>
> Gwen's taxable gain from the sale prong equals the difference between the $350,000 sale price and her entire basis (cost) in the transferred property. For the gift prong, Gwen can use her $12,000 annual gift tax exclusion to reduce the potentially taxable gift amount to $238,000. The $238,000 gift then reduces her $1 million federal gift tax exemption dollar-for-dollar. It also reduces her separate $2 million federal estate tax exemption dollar-for-dollar.

Assuming the parent has most or all of their $1 million federal gift tax exemption available to shelter the gift prong of the bargain sale transaction, this type of transaction generally works out quite well for the parent because it removes an appreciating asset from their estate. Also, assuming the parent lives long enough to benefit from future increases in the federal estate tax exemption, the hit to that exemption will be partially or completely restored.

The sale prong of the bargain sale transaction obviously has income tax implications for the parent. The parent's capital gain is determined by subtracting his or her entire basis in the home from the sale price. Of course, if the home is the parent's principal residence, the $250,000/$500,000 federal gain exclusion privilege will usually be available to offset some or all of the gain.

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In a bargain sale scenario, the child's tax basis in the home will generally be the sale price plus the amount of any federal gift tax triggered by the transaction. When the home has appreciated significantly in value (as will often be the case), the child may be stepping into a substantial built-in taxable gain that can cause future problems. This is not a great tax outcome for the child, but complaining about the tax results of an otherwise favorable bargain sale deal seems petty.

On a more positive note, if the child uses the home as a principal residence for at least two years, the federal home-sale gain ($250,000/$500,000) exclusion privilege will become available. Also, if the child is able to arrange purchase-money mortgage financing for the purchase prong of the transaction, the mortgage interest will generally be deductible as qualified residence interest.

The bargain sale scenario can produce great tax results for the parent. However, as the analysis illustrates, it may produce less-than-great income tax results for the child if the home has appreciated significantly. Please call us to discuss home sales, gifting scenarios, or any other tax matter.

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Corporate Annual Meetings Are Important

Generally, one of the requirements for maintaining a corporation's existence (and the liability protection it affords) is that the shareholders and Board of Directors must meet at least annually. Although most people view this requirement as a necessary evil, it doesn't have to be a waste of time. For example, in addition to being a first step in making sure the corporation is respected as a separate legal entity, an annual meeting can be used as an important tool to support your company's tax positions.


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Besides the election of officers and directors, other actions that should be considered at the annual meeting include the directors approving the accrual of any bonuses and retirement plan contributions, and ratifying key actions taken by corporate officers during the year. It is common for the IRS to attack the compensation level of closely held C Corporation shareholder/officers as unreasonably high and, thereby, avoiding taxation at the corporate level. A well-drafted set of minutes outlining the officers' responsibilities, skills, and experience levels can significantly reduce the risk of an IRS challenge.

If the shareholder/employees are underpaid in the start-up years because of a lack of funds, it is also important to document this situation in the minutes for future reference when higher payments are made.

The directors should also specifically approve all loans to shareholders. Any time a corporation loans funds to a shareholder, there is a risk that the IRS will attempt to characterize all or part of the distribution as a taxable dividend. The primary documentation that a distribution is intended to be a loan rather than a dividend should be in the written loan documents, and both parties should follow through in observing the terms of the loan. However, it is also helpful if the corporate minutes document the need for the borrowing (how the funds will be used), the corporate officers' authorization of the loan, and a summary of the loan terms (interest rate, repayment schedule, loan rollover provisions, etc.).

If the corporation is accumulating a significant amount of earnings, the minutes of the meeting should *generally* spell out the reasons for the accumulation to help prevent an IRS attempt to assess the accumulated earnings tax.

These are just a few examples of why well-documented annual meetings can be an important part of a corporation's tax records. As the time for your annual meeting draws near, please call us if you have questions or concerns.

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