

Firm Makes Recommendation for Treatment of Charitable Contributions of Inventory Property

Date: Jan. 22, 2009

Summary by **taxanalysts**[®]

James Atkinson, Marc Gerson, and Phillip Mann of Miller & Chevalier, Washington, have supplemented prior comments on the treatment of charitable contributions of inventory property under section 170(e)(3) (Notice 2008-90), suggesting a two-step method that would promote fairness while accomplishing the policy goal underlying the rules generally applicable to inventory donations.

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January 22, 2009

CC:PA:LPD:PR (Notice 2008-90)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20044

Re: Comments on Notice 2008-90

Dear Sir or Madam:

Pursuant to Section 4 of Notice 2008-90, 2008-43 I.R.B. 1000 (the "Notice"), we respectfully submit the following comments regarding the treatment of charitable contributions of inventory property under section 170(e)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). We appreciate the opportunity to comment on the Notice and would welcome the opportunity to meet with the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") to discuss these comments in greater detail or to answer any questions that you may have.

As an initial matter, we would like to take this opportunity to commend and thank Treasury and the IRS for the timely response to the concerns that we raised in our May 2, 2008 submission (the "Prior Submission"), regarding the unintended result under the current charitable contribution regulations with respect to

donations to food banks and other hunger relief agencies.¹ We sincerely appreciate the manner in which both Treasury and the IRS responded to ensure that needed food bank donations would continue unabated in 2008 and beyond. In light of the severe economic conditions facing the nation, the continuation of these donations is particularly important.

As we detailed in our Prior Submission and discussed with Treasury, the apparent disconnect between the intended and actual applications of section 170(e)(3) is best addressed through a two-step process. The Notice accomplishes the first critical step, namely the timely issuance of interim guidance allowing taxpayers to choose whether to apply the general rules applicable to inventory property under section 170(e)(1) of the Code or instead to apply the special rules under section 170(e)(3). See Section 2 of Notice 2008-90 ("the Service will not challenge a taxpayer's computation of the deductible amount and the required adjustment to cost of goods sold under either (1) [section] 170(e)(3). . . , or (2) [section] 170(e)(1). . ."). As we discussed more fully in the Prior Submission, the special incentive offered by section 170(e)(3) can in certain circumstances actually penalize rather than reward the donor. By requiring donors of qualified contributions (as that term is defined in section 170(e)(3)(A)) to recover the costs of the property only through the mechanics of section 170, donors that are unable to utilize a charitable deduction by reason of the taxable income limitations of section 170(b)(2) (and who are unwilling to avoid the section 170 limitations altogether through a "non-charitable" disposition of the food) may face the loss of their entire basis in the donated property. In those circumstances, the donors whom Congress intended to reward are perversely placed in a worse position than those ineligible for the enhanced deduction.

The Notice effectively addresses this unintended result by allowing taxpayers to apply the general rules of section 170(e)(1) to inventory donations otherwise eligible for the purportedly more beneficial treatment of section 170(e)(3). By applying the general rules rather than those of section 170(e)(3), the taxpayer may treat the current-year acquisition costs of donated food as costs of goods sold ("COGS") recoverable in full under its inventory method of accounting, and exclude those costs from the operation of section 170. Thus, the Notice allows food donors to recover most (or all) of the tax basis of donated food, but at the cost of forfeiting the enhanced deduction designed as an incentive to the donation of food inventory for the benefit of the ill, needy, or infants. As an interim measure, the approach of the Notice provides a much needed (and much appreciated) patch to the inherent flaw in the current regulations, and meets the goal of the first of the two steps that we discussed in the Prior Submission.

The Notice also announces the intention of Treasury and the IRS to proceed to the second phase of this overall effort, conforming the operation of the Treasury regulations issued under section 170(e) with the Congressional purpose underlying the enhanced deduction of section 170(e)(3). We discussed the

legislative development and intended purposes of section 170(e)(3) in our Prior Submission and do not repeat that discussion here. In brief, however, section 170(e)(3) was designed to provide an additional incentive to donors of certain types of inventory property (such as food) for the benefit of the ill, the needy, or infants. This incentive was designed as an enhanced deduction (a so-called "bump") in excess of the charitable deduction to which taxpayers were already entitled for the donation of inventory property under section 170(e)(1). By offering this additional bump, taxpayers were assured of recovering not only their cost basis in the donated property (as under the general rule of section 170(e)(1)), but an additional increment as well. This additional increment -- the bump -- is a function of the taxpayer's cost basis in the donated inventory, such that the donor's charitable deduction equals either (i) twice the amount of the cost basis, or (ii) the cost basis plus one-half of the appreciation in excess of basis.

Because the amount of the bump is directly proportionate to the amount of the taxpayer's cost basis in the donated property, the drafters of the Treasury regulations implementing section 170(e)(3) not unreasonably decoupled this computation from the general rules applicable to donations of inventory property. Under the general rule, current-year acquisition costs are recovered as COGS and are not included in computing the taxpayer's charitable deduction under section 170. Treas. Reg. § 1.170A-1(c)(4). Taking this same approach for purposes of section 170(e)(3), however, could dramatically reduce or even eliminate the cost basis used in computing the bump. In order to maximize the benefit available under section 170(e)(3), the drafters of the regulations provided that all costs -- including current-year acquisition costs -- are to be recovered through section 170 rather than through COGS. Treas. Reg. § 1.170A-4A(c)(3). The unintended consequence of that effort is to permanently deprive the taxpayer of the ability to recover some or all of its cost basis of acquiring the donated property where the taxable income limitation of section 170(b)(2) prevents it from deducting the full amount of the charitable contribution either during the year of the contribution or during the five-year carry-forward period provided by section 170(d).

Three fundamental principles should guide Treasury and the IRS in rationalizing the current regulations under section 170 with the intended operation of section 170(e)(3). First, taxpayers should always be allowed to recover their cost basis in donated inventory. Second, where the inventory is donated for the benefit of the ill, needy, or infants, the taxpayer should be entitled to an additional deduction by reason of section 170(e)(3), measured by reference to the property's cost basis and appreciated value. Third, these two principles are not mutually exclusive and, therefore, can be applied concurrently.

We believe that each of these fundamental principles can be satisfied readily through a "bifurcation" model. First, all taxpayers should be entitled to recover their cost basis in any donated inventory by treating those costs as COGS for purposes of their inventory method of accounting. In this regard, we see little

policy or technical basis for distinguishing between current-year and prior-year acquisition costs, so long as those costs can be identified. Second, donors should compute the initial amount of the enhanced deduction to which they are otherwise entitled under section 170(e)(3) using the entire cost basis in the donated property, without reduction for the amount to be recovered as COGS. This tentative amount would then be reduced by the donated inventory's cost basis (i.e., the amount recovered as COGS). These two steps would allow the donor of a qualified contribution to recover its COGS in all events, and to remain eligible for a charitable deduction equal to the increment in excess of COGS, as determined under section 170(e)(3). This incremental amount (but not the amount treated as COGS) would be subject to the net income limitation of section 170(b)(2) and any other provisions or restrictions applicable to charitable contributions. We have enclosed examples demonstrating this bifurcation model for your consideration.

This bifurcation model accomplishes the policy goals underlying the rules generally applicable to inventory donations as well as the special incentives for donations for the ill, needy, or infants. As with donations of inventory generally, qualifying contributions would entitle the donor to recover its cost basis in all events, satisfying the Constitutional imperative of taxing only income rather than gross receipts. By allowing a further deduction under section 170(e)(3) equal to the "bump" in excess of COGS, the Congressional intent of rewarding qualifying contributions through an additional deduction in excess of that to which the donor would otherwise be entitled also is satisfied. As the enclosed examples demonstrate, this bifurcation approach also would be consistent with the basic operational rules of both charitable deductions and dispositions of inventory. The computation is straightforward, readily reviewable by the IRS, and would result in relatively little if any additional recordkeeping burden for donors.²

Because this approach fulfills the Congressional purpose underlying the original enactment of section 170(e)(3) more effectively than do the existing Treasury regulations, we believe the regulations being contemplated by Treasury and the IRS should be applicable retroactively, at the taxpayer's election. Section 7805(b)(7) invests the Treasury and IRS with ample authority to provide for such retroactive election. Regardless of the effective date of the contemplated regulations, however, they should at a minimum reaffirm taxpayers' continuing ability to apply the approach of the Notice, at least for years prior to the effective date of the regulations.

Again, we commend and thank Treasury and the IRS for your actions to date in responding to the circumstances outlined in our Prior Submission. Particularly in light of the severe economic conditions with which the government continues to grapple, your focus upon, and effective resolution of, our articulated concerns is sincerely appreciated. We look forward to working with Treasury and the IRS in your further consideration of this area.

Respectfully submitted,

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Enclosures

cc:
Eric San Juan, Esq., U.S. Treasury Department
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Example 1: Donation of Food Inventory Only

Corporation X has taxable income of \$1,000 for 2008. Corporation X makes a charitable contribution of food inventory to a local food bank in 2008. The contribution is a "qualified contribution" under section 170(e)(3)(A). The food inventory was purchased during 2008, and has a basis of \$100 and a fair market value of \$150 on the date of contribution. The amount and classification of the donation is as follows:

Current Application of Treas. Reg. § 1.170A-4A

Fair market value of contributed property	\$150
Reduction for 50% of profit	(\$25)
Portion of deduction allowed as:	
COGS	\$0
Charitable contribution	\$125
Comparison to twice tax basis	\$125 v. \$200
Total "qualifying contribution" (before 10% limitation)	\$125
Taxable income limitation (10% of \$1,000)	\$100
Total cost recovery in 2008	\$100

Charitable deduction carry-forward	\$25
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Application of Proposed Bifurcation Model

Cost basis of contributed inventory	\$100
Amount treated as 2008 COGS	\$100
Qualifying Contribution	
Application of section 170(e)(3) (as above)	\$125
Subtraction of allowable COGS	(\$100)
Net section 170(e)(3) "bump"	\$25
Total cost recovery in 2008 (COGS plus bump)	\$125

Example 2: Donation of Food Inventory and Other Property

Corporation X has taxable income of \$1,000 for 2008. Corporation X makes a charitable contribution of food inventory to a local food bank in 2008. The contribution is a "qualified contribution" under section 170(e)(3)(A). The food inventory was purchased during 2008, and has a basis of \$100 and a fair market value of \$150 on the date of contribution. In addition, Corporation X contributes \$100 cash to qualifying charitable organizations. The amount and classification of the donation is as follows:

Current Application of Treas. Reg. 8 1.170A-4A

Fair market value of contributed inventory	\$150
Reduction for 50% of profit	(\$25)
Portion of deduction allowed as	
COGS	\$0
Charitable contribution	\$125
Comparison to twice tax basis	\$125 v. \$200
Total "qualifying contribution" (before 10% limitation)	\$125
Other charitable contributions	\$100
Total 2008 charitable contributions	\$225
Taxable income limitation (10% of \$ 1,000)	\$100
Total cost recovery in 2008	\$100
Charitable deduction carry-forward	\$125

Application of Proposed Bifurcation Model

Cost basis of contributed inventory	\$100
Amount treated as 2008 COGS	\$100
Qualifying Contribution	
Application of section 170(e)(3) (as above)	\$125
Subtraction of allowable COGS	(\$100)
Net section 170(e)(3) "bump"	\$25
Other charitable contributions	\$100
Total 2008 charitable contributions	\$125
Taxable income limitation (10% of \$ 1,000)	\$100
Total cost recovery in 2008	
(COGS plus \$100 charitable contribution)	\$200
Charitable deduction carry-forward	\$25

FOOTNOTES

¹ A copy of the Prior Submission is enclosed for your convenience. See also "Attorneys Alert Treasury to Unintended Consequences of Existing Charitable Contribution Regs," 2008 TNT 94-19 (May 2, 2008).

² Our discussions to date, and our comments herein, are limited to charitable donations of inventory under section 170(e)(3). Sections 170(e)(4) and (e)(6) provide enhanced deductions with respect to (i) contributions of scientific property used for research, and (ii) contributions of computer technology and equipment for educational purposes, respectively. Each of these provisions looks to the computational mechanics of section 170(e)(3) for purposes of determining the charitable deduction to which a qualifying donor may be entitled under these provisions. See I.R.C. §§ 170(e)(4)(A), 170(e)(6)(A) (both referencing I.R.C. § 170(e)(3)(B)). Despite their incorporation of the computational standards of section 170(e)(3), these provisions were added to the Code several years after the enactment of section 170(e)(3), and were designed to apply to unique industries and patterns of giving. See Section 222(a) of the Economic Recovery Tax Act of 1981, P.L. 97-34 (adding section 170(e)(4)); Section 224(a) of the Taxpayer Relief Act of 1997, P.L. 105-34 (adding section 170(e)(6)). For that reason, while Treasury and the IRS may determine that it is entirely appropriate to apply our proposed bifurcation model in the context of sections 170(e)(4) and (e)(6) as well, our focus to date has been entirely upon contributions of inventory

eligible for the enhanced deduction of section 170(e)(3). As such, we respectfully reserve any comment and take no position with respect to whether your reconsideration of the interaction of section 170(e)(3) with the general rules applicable to inventory donations under section 170(e)(1) should include other provisions as well, or whether instead it should be limited to qualified contributions as defined in section 170(e)(3)(A).

END OF FOOTNOTES

Tax Analysts Information

Code Section: Section 170 -- Charitable Deduction

Jurisdiction: United States

Subject Area: Charitable giving

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Cross Reference: For Notice 2008-90, 2008-43 IRB 1000, see *Doc 2008-21199* [[PDF](#)] or

2008 TNT 194-9 .

For the firm's earlier correspondence to Treasury, see *Doc 2008-10525* [[PDF](#)] or *2008 TNT 94-19* .