

# Bond Case Briefs

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## Guidance Requested on Treatment of Charitable Contributions Costs.

Marc Gerson of Miller & Chevalier has asked the IRS to include on its 2014-2015 priority guidance list (Notice 2014-18) guidance clarifying the treatment under current law of current year acquisition costs for charitable contributions of inventory and other property under section 170(e)(3).

April 30, 2014  
Courier's Desk Internal Revenue Service  
Attn: CC:PA:LPD:PR (Notice 2014-18)  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

### **Re: Recommendation for the 2014-2015 Priority Guidance Plan Pursuant to Notice 2014-18**

To Whom It May Concern:

Pursuant to Notice 2014-18, 2014-15 I.R.B. 1 (the "Notice"), Miller & Chevalier Chartered respectfully requests that guidance in the form of a notice clarifying the treatment under current law of current year acquisition costs with respect to charitable contributions of inventory and other property under Section 170(e)(3) of the Internal Revenue Code<sup>1</sup> (as contemplated by Notice 2008-90, 2008-43 I.R.B. 1000) be included on the 2014-2015 Priority Guidance Plan under the jurisdiction of the Office of Associate Chief Counsel (Income Tax & Accounting).

#### I. Requested Guidance Pursuant to Section 170(e)(3)

Guidance in the form of a notice is requested clarifying the treatment under current law of current year acquisition costs with respect to charitable contributions of inventory and other property under Section 170(e)(3) for the benefit of the ill, the needy, or infants.<sup>2</sup> Specifically, such guidance should provide that such current year acquisition costs are treated as cost of goods sold (and, therefore, not classified and deducted as a charitable contribution) under current law. Such guidance will provide certainty that, consistent with the existing regulatory charitable contribution regime, donors of inventory and other property for the benefit of the ill, the needy, or infants will under all circumstances (i) be allowed to recover their basis in donated inventory or other property, and (ii) be able to compute the enhanced charitable contribution deduction available under Section 170(e)(3). For your consideration, (i) enclosed as Exhibit A is a draft notice providing the requested clarifying guidance, and (ii) enclosed as Exhibit B is an example demonstrating the application of such guidance.

It should be noted that the application of Section 170(e)(3) to current year acquisition costs is particularly important in the context of charitable contributions of food to satisfy the increased demand on food banks and other hunger relief agencies as a result of the current economic

situation.<sup>3</sup> In order to ensure that such contributions continue to satisfy such increased demand, it is respectfully requested that guidance with respect to the treatment of such current year acquisition costs be included on the 2014-2015 Priority Guidance Plan and then be issued in the form of a notice drafted by the Office of Associate Chief Counsel (Income Tax & Accounting) as soon as practically possible thereafter.<sup>4</sup>

## II. Discussion

Section 170(e)(1) provides the general rule that donors are permitted a deduction for charitable contributions of ordinary income and capital gain property equal to the lower of the donor's basis or the fair market value of the property at the time of donation. Treas. Reg. § 1.170A-1(c)(4) provides that under this general rule (i) current year acquisition costs (i.e., purchases) with respect to contributed property should be treated as cost of goods sold (and, therefore, not classified and deducted as a charitable contribution), and (ii) prior year acquisition costs with respect to contributed property that are included in opening inventory in the year of contribution should be "removed" from inventory and classified and deducted as a charitable contribution (the so-called "removal rule").<sup>5</sup> This longstanding regulation ensures that donors will recover current year acquisition costs through cost of goods sold without regard to the limitations imposed on charitable contributions under Section 170, primarily the taxable income limitation of Section 170(b)(2).

Section 170(e)(3) is a special incentive designed to provide an enhanced charitable deduction (the so-called "bump") with respect to donations of inventory and other property for the benefit of the ill, the needy or infants equal to the lower of (i) twice the cost basis of the contributed property, or (ii) the cost basis plus one-half of the appreciation in excess of basis. Treas. Reg. § 1.170A-4A(c)(3) provides that "[n]otwithstanding the rules of § 1.170A-1(c)(4), the donor of the property which is inventory contributed under this section must make a corresponding adjustment to cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the contributed item or the amount of basis. . . ."

Clarification is necessary with respect to the treatment of current year acquisition costs with respect to charitable contributions of inventory and other property under Section 170(e)(3). Specifically, there is uncertainty regarding the scope and application of Treas. Reg. § 1.170A-4A(c)(3) and, in particular, whether current year acquisition costs with respect to charitable contributions under Section 170(e)(3) are (i) treated as cost of goods sold under the general rule of Section 170(e)(1) and Treas. Reg. § 1.170A-1(c)(4), or (ii) subject to the removal rule and classified and deducted as charitable contributions under Treas. Reg. § 1.170A-4A(c)(3).<sup>6</sup> We respectfully request that clarifying guidance in the form of a notice be issued that such costs are treated as cost of goods sold under current law and regulations, as such treatment is consistent with the intent of the existing regulatory charitable contribution regime as described above.

The regulatory development of Treas. Reg. § 1.170A-4A(c)(3) clearly supports the treatment of current year acquisition costs as cost of goods sold. Treas. Reg. § 1.170A-4A(c)(3) originally required the donor to apply the removal rule by reducing its cost of goods sold by the basis of the donated property.<sup>7</sup> The Treasury Department and the Internal Revenue Service (the "IRS"), however, recognized that this rule created a problem with respect to "underwater" inventory having a fair market value less than its basis:

- Where the basis of the contributed inventory property qualifying under section 170(e)(3) exceeds the property's fair market value, the underlying purpose of the section to encourage contributions of this type of property for the purposes specified in section 170(e)(3) may be frustrated. This is because the entire basis of the contributed property is removed from the cost of goods sold while the charitable contribution is limited to the property's fair market value. It

would be more advantageous for the taxpayer to destroy or sell the property than to contribute it for the care of the ill, the needy, or infants. A taxpayer would then be entitled to deduct its entire basis in the property as a loss deduction under section 165 or as part of the cost of goods sold as compared to a charitable contribution amount limited to the property's fair market value.

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Treas. Reg. § 1.170A-4A(c)(3) was subsequently amended by T.D. 7962 “[i]n order to remove this disincentive.”<sup>9</sup> It is important to note, however, that although not explicit in the text of T.D. 7962 or the regulation itself, it is clear that the amended regulation was directed at limiting the removal rule with respect to prior year acquisition costs<sup>10</sup> and was not intended to override the established treatment of current year acquisition costs as cost of goods sold under the general rule of Section 170(e)(1) and Treas. Reg. § 1.170A-1(c)(4). Treas. Reg. § 1.170A-4A(c)(3) by its terms applies to “property *which is inventory*.” Designation of property as “inventory” is limited to prior year acquisition costs under the existing regulatory charitable contribution regime as evidenced by Treas. Reg. § 1.170A-1(c)(4), which distinguishes between (i) “[a]ny costs and expenses pertaining to the contributed property which were incurred in taxable years preceding the year of contribution and are properly *reflected in the opening inventory* for the year of contribution” (i.e., prior year acquisition costs subject to the removal rule), and (ii) “[a]ny costs and expenses pertaining to the contributed property which are incurred in the year of contribution” (i.e., current year acquisition costs treated as cost of goods sold). Current year acquisition costs by definition are not “inventory” (i.e., they remain as part of cost of goods sold in the current year and, therefore, are never reflected in inventory) and, therefore, should not be subject to the application of Treas. Reg. § 1.170A-4A(c)(3) which as noted above is limited to “property *which is inventory*.”<sup>11</sup>

It should be noted that it is our understanding that some parties have interpreted the introductory language of the regulation (i.e., “[n]otwithstanding the rules of § 1.170A-1(c)(4)”) to disregard the established treatment of current year acquisition costs as cost of goods sold, when such language should for the reasons described above be limited to an interpretation of the application of the removal rule to prior year acquisition costs. As detailed above, the context of the amendment to Treas. Reg. § 1.170A-4A(c)(3) was clearly limited to the treatment of prior year acquisition costs and there is nothing to suggest that the established treatment of current year acquisition costs as cost of goods sold under Treas. Reg. § 1.170A-1(c)(4) was intended to be modified. This is further supported by the fact that Treas. Reg. § 1.170A-4A(c)(3) was amended without being subject to the normal notice and comment procedures and effective date limitations of the Administrative Procedure Act (the “APA”) as the Treasury Department and the IRS determined that the amendment “merely liberalize[d] the provisions of § 1.170A-4A(c)(3).”<sup>12</sup> Therefore, it was “found unnecessary to issue it with notice and public procedure under [the APA] or subject to the effective date limitation of [the APA].”<sup>13</sup> It is respectfully submitted that the amendment to Treas. Reg. § 1.170A-4A(c)(3) was not intended as a restriction on the established treatment of current year acquisition costs as cost of goods sold under Treas. Reg. § 1.170A-1(c)(4), since if it was intended as such a restriction the Treasury Department and the IRS presumably would not have viewed the amendment as a “liberalization” and, therefore, would have been compelled to follow the required APA procedures.

Despite the fact that the context of the amendment to Treas. Reg. § 1.170A-4A(c)(3) suggests that the removal rule provided by that regulation be limited to prior year acquisition costs, the fact that there is not an explicit reference to such prior year acquisition costs has created uncertainty as to the treatment of current year acquisition costs. In response to taxpayer concerns regarding this uncertainty,<sup>14</sup> the Office of Associate Chief Counsel (Income Tax & Accounting) issued Notice 2008-90, which allowed taxpayers to treat current year acquisition costs as cost of goods sold in certain circumstances.<sup>15</sup> The notice itself, however, announced a larger study of the treatment of charitable

contributions under Section 170(e)(3) and contemplated the issuance of future guidance.<sup>16</sup> Consistent with the underlying intent of this study, it is respectfully submitted that such future guidance be included on the 2014-2015 Priority Guidance Plan and ultimately be issued by the Office of Associate Chief Counsel (Income Tax & Accounting) to provide comprehensive clarification that current year acquisition costs are treated as cost of goods sold under current law in all circumstances.

### III. Appropriateness of Inclusion of Requested Guidance on the 2014-2015 Priority Guidance Plan

Pursuant to the Notice, the Treasury Department and the IRS consider the following in reviewing recommendations and selecting projects for inclusion on the 2014-2015 Priority Guidance Plan: (i) whether the recommended guidance resolves significant issues relevant to many taxpayers; (ii) whether the recommended guidance promotes sound tax administration; (iii) whether the recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance; (iv) whether the recommended guidance involves regulations that are outmoded, ineffective, insufficient, or excessively burdensome and that should be modified, streamlined, expanded, or repealed; (v) whether the IRS can administer the recommended guidance on a uniform basis; and (vi) whether the recommended guidance reduces controversy and lessens the burden on taxpayers or the IRS.

It is respectfully submitted that the recommended guidance satisfies each of these criteria. With respect to the first criteria, the recommended guidance resolves significant issues relevant to many taxpayers. Specifically, the treatment of current year acquisition costs under Section 170(e)(3) impacts the wide number of donors and recipients of charitable contributions of inventory and other property for the benefit of the ill, the needy, or infants. This is particularly true with respect to donors of food (including grocery stores, food manufacturers and others), as well as food banks and other hunger relief agencies that are the recipients of such donations.<sup>17</sup> Uncertainty regarding the treatment of current year acquisition costs has caused such donors to consider suspending or eliminating long-standing charitable donation programs. In this regard, such uncertainty has caused such donors to consider destroying or otherwise disposing of inventory and other property (and claiming a loss deduction) rather than donating it in order to ensure that they recover the basis of such property without being subject to the taxable income limitation of Section 170(b)(2).<sup>18</sup>

With respect to the fourth criteria, the recommended guidance involves regulations that are ineffective because, as discussed above, such guidance would address the uncertainty regarding the scope and application of Treas. Reg. § 1.170A-4A(c)(3)<sup>19</sup> and, in particular, whether current year acquisition costs with respect to charitable contributions under Section 170(e)(3) are (i) treated as costs of goods sold under the general rule of Section 170(e)(1) and Treas. Reg. § 1.170A-1(c)(4), or (ii) subject to the removal rule and classified and deducted as charitable contributions under Treas. Reg. § 1.170A-4A(c)(3).

With respect to the remaining criteria, the recommended guidance would (i) promote sound tax administration, (ii) be drafted in a manner that will enable taxpayers to easily understand and apply it, (iii) be administered by the IRS on a uniform basis, and (iv) reduce controversy and lessens the burden on taxpayers or the IRS. As evidenced by the draft notice enclosed as Exhibit A and the example demonstrating the application of that draft notice enclosed as Exhibit B, the recommended guidance allows for the simple classification of acquisition costs and the straightforward calculation of the Section 170(e)(3) enhanced deduction. Such classification and calculation is (i) easily applied by taxpayers and easily administered and reviewed by the IRS,<sup>20</sup> and (ii) would result in relatively little if any additional recordkeeping or compliance burden for taxpayers.

Thank you in advance for your consideration of this request. We appreciate the opportunity to submit this request and would welcome the opportunity to meet with the Treasury Department and the IRS to discuss it in greater detail or to answer any questions that you may have.

- Respectfully submitted,
- Marc J. Gerson
- Miller & Chevalier Chartered
- Washington, DC

Enclosures

cc:

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**\*\*\*\*Exhibit A**  
**Draft Notice**

Part III — Administrative, Procedural, and Miscellaneous Charitable Contributions of Inventory And Other Property Under § 170(e)(3)

Notice 2014-[XX]

**SECTION 1. OVERVIEW**

This notice provides guidance clarifying the treatment under current law of current year acquisition costs with respect to charitable contributions of inventory and other property that constitute qualified contributions as defined in Section 170(e)(3) of the Internal Revenue Code.

**SECTION 2. GUIDANCE UNDER SECTION 170(e)(3)**

For a particular qualified contribution of inventory and other property under § 170(e)(3) that otherwise satisfies the requirements of § 170 and the relevant regulations, any costs and expenses pertaining to the contributed property which are incurred in the year of contribution and would, under the method of accounting used, be properly reflected in the cost of goods sold for such year (“current year acquisition costs”) are to be treated as part of the cost of goods sold for such year.

**SECTION 3. RELIANCE ON NOTICE**

Taxpayers may rely on this notice unless and until further guidance is issued.

## SECTION 4. DRAFTING INFORMATION

The principal author of this notice is [insert] of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice contact [insert] at [insert] (not a toll free call).

### **Exhibit B** **Example**

Corporation X has taxable income of \$2,000 for 2014. Corporation X makes a charitable contribution of food to a local food bank in 2014. The contribution is a "qualified contribution" under Section 170(e)(3)(A). The food was purchased during 2014 and had a basis of \$100 and a fair market value of \$150 on the date of contribution. The amount and classification of the resulting deductions for 2014 are as follows: Portion of deduction classified and allowed as cost of goods sold ("COGS")

Cost basis	\$100
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Portion of deduction classified as charitable contribution

Fair market value of contributed property	\$150
Reduction for 50% of profit (\$150 - \$100)	(\$25)
Net	\$125

Twice cost basis of contributed property	\$200
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Lower of net (computed above) or twice cost basis	\$125
Portion of deduction classified and allowed as COGS	(\$100)
Net Section 170(e)(3) "bump"	\$25

Application of Section 170(b) taxable income limitation

Total 2014 charitable contribution	\$25
Taxable income limitation (10% of \$2,000)	\$200
Charitable contribution deduction in 2014	\$25

Total cost recovery in 2014

Portion of deduction classified and allowed as COGS	\$100
Charitable contribution deduction in 2014	\$25

### **FOOTNOTES**

<sup>1</sup> All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder, unless otherwise specified.<sup>2</sup> Because such guidance would clarify the treatment of current year acquisition costs under current law, such guidance should be applicable retroactively.

<sup>3</sup> Increased demand on food banks and other hunger relief agencies, and the increased efforts of donors of food to satisfy such demand, has been widely reported. *See, e.g.,* Nixon, "Food Banks Anticipate Impact of Cuts to Food Stamps, New York Times (Jan, 22, 2014); Bello, "Food Stamp Cuts Create High Demand For Food Bank Supplies," USA Today (Nov. 4, 2013). *See also* Feeding America, 2013 Annual Report (noting that the Feeding America nationwide network of member food banks provided 3.2 billion meals to 37 million people in the United States in a single year).

<sup>4</sup> As discussed in greater detail herein, the requested guidance with respect to the treatment of

current year acquisition costs may be issued in a manner that is consistent with the existing regulatory charitable contribution regime (i.e., such that no modification of the existing regulations would be required). Therefore, it is respectfully requested that guidance be issued in the form of a notice such that it may be issued in an expedited fashion. To the extent that the Treasury Department and the Internal Revenue Service are considering the issuance of broader guidance under Section 170(e)(3) that would in fact require a modification to the existing regulations, it is respectfully requested that the requested guidance with respect to the treatment of current year acquisition costs be issued in the form of a notice in advance of such regulations for the compelling socioeconomic circumstances discussed above.

<sup>5</sup> Treas. Reg. § 1.170A-1(c)(4) (“Any costs and expenses pertaining to the contributed property which were incurred in taxable years preceding the year of contribution and are properly reflected in the opening inventory for the year of contribution must be removed from inventory and are not a part of the cost of goods sold for purposes of determining gross income for the year of contribution. Any costs and expenses pertaining to the contributed property which are incurred in the year of contribution and would, under the method of accounting used, be properly reflected in the cost of goods sold for such year are to be treated as part of the cost of goods sold for such year.”).

<sup>6</sup> See American Institute of Certified Public Accountants, Compendium of Legislative Proposals — Simplification and Technical Proposals, at 74-76 (Feb. 19, 2014) (the “AICPA Legislative Proposals”). Although the AICPA Legislative Proposals suggest that such uncertainty may be resolved through legislation amending Section 170(e)(3), it is respectfully submitted that because the classification of current year acquisition costs is addressed through the existing regulatory charitable contribution regime as described above, such uncertainty may be clarified through the guidance requested in this submission.

<sup>7</sup> Former Treas. Reg. § 1.170A-4A(c)(3), T.D. 7807, 1983-2 C.B. 41, 45 (“The donor of property which is inventory contributed under this section must make a corresponding adjustment to cost of goods sold by decreasing the cost of goods sold by the amount of basis. . .”).

<sup>8</sup> T.D. 7962, 1984-2 C.B. 57.

<sup>9</sup> *Id.*

<sup>10</sup> The Treasury Department and the IRS could, of course, amend the regulation with respect to the treatment of prior year acquisition costs. Such an amendment, however, is beyond the scope of the requested guidance contained herein.


<sup>11</sup> Furthermore, as noted above, Treas. Reg. § 1.170A-4A(c)(3) was amended to address situations involving “underwater” inventory that has decreased in value. T.D. 7962, 1984-2 C.B. 57. Such “underwater” inventory situations are most prevalent with respect to prior year acquisition costs as opposed to current year acquisition costs given the greater opportunity for valuation disparities to occur with respect to prior year acquisition costs. See also Treas. Reg. § 1.170A-4A(c)(4) Ex. 1 (500% increase in fair market value of donated property suggests property was included in beginning of year inventory as prior year acquisition costs).

<sup>12</sup> 1984-2 C.B. 57.

<sup>13</sup> *Id.*

<sup>14</sup> See “Attorneys Alert Treasury to Unintended Consequences of Existing Charitable Contribution Regs,” 2008 TNT 94-19 (May 2, 2008) (the “2008 Treasury Submission”).



<sup>15</sup> Notice 2008-90 at Section 2. *See also* “Firm Makes Recommendation for Treatment of Charitable Contributions of Inventory Property,” 2009 TNT 17-21 (Jan. 22, 2009) (the “2009 Treasury Submission”). 

<sup>16</sup> Notice 2008-90 at Sections 1, 4.

<sup>17</sup> *See* Footnote 3 and accompanying text

<sup>18</sup> *See* 2008 Treasury Submission. As a result of this uncertainty, the Treasury Department and the IRS issued Notice 2008-90, which allows taxpayers in certain circumstances to recover their tax basis in donated inventory and other property as cost of goods sold. *See* 2009 Treasury Submission.

<sup>19</sup> As noted above, such uncertainty is caused, in particular, by the introductory language of that regulation (i.e., “[n]otwithstanding the rules of § 1.170A-1(c)(4)”).

<sup>20</sup> Furthermore, the promulgation of the recommended guidance would not prevent the IRS from challenging other issues with respect to the Section 170(e)(3) enhanced deduction. *See* CCA 201012061 (Nov. 10, 2009) (Notice 2008-90 does not prevent IRS from challenging other issues under Section 170(e)(3)). In addition, the IRS’s ability to administer the recommended guidance would be enhanced if, consistent with the 2009 Treasury Submission, such guidance was limited to Section 170(e)(3) contributions of inventory and other property and not expanded to apply to Section 170(e)(4) contributions of scientific property used for research and Section 170(e)(5) contributions of computer technology and equipment for educational purposes, despite the cross reference in those sections to Section 170(e)(3). *See* 2009 Treasury Submission.

#### **END OF FOOTNOTES**