



June 7, 2016

Mr. Scott Dinwiddie  
Associate Chief Counsel  
Income Tax & Accounting  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Recommendations for Modifying the Rules of Section 170 Charitable Contributions of Inventory

Dear Mr. Dinwiddie:

The American Institute of CPAs (AICPA) is pleased to submit recommendations with respect to guidance under Internal Revenue Code (IRC or “Code”) sections 170(e)(1) and 170(e)(3) regarding charitable contributions of inventory.<sup>1</sup> The AICPA recognizes that the provision of guidance under section 170(e)(3) is a priority to the Internal Revenue Service (IRS) as it is listed in the Department of the Treasury 2015-2016 Priority Guidance Plan<sup>2</sup> under General Tax Issues.

The AICPA recommends revising the regulations related to charitable contributions of inventory under section 170(e)(1) to include costs and expenses which are part of the basis of contributed inventory, in cost of goods sold for the year of contribution. This rule should apply regardless of whether such costs and expenses were incurred prior to or during the year of contribution, as well as when the basis of the contributed inventory exceeds the fair market value (FMV) of the contributed inventory.

The AICPA also recommends revising the regulations related to qualified contributions of inventory under section 170(e)(3) to provide an inclusion of the basis of the contributed inventory in the cost of goods sold in the year of the contribution. Additionally, we recommend treating only the amount of the deduction in excess of the basis (“the enhanced deduction”) as a charitable contribution deduction subject to the 10 percent taxable income limitation under section 170(b)(2)(A) or the 15 percent limitation under section 170(e)(3)(C)(ii).

The AICPA is the world’s largest member association representing the accounting profession with more than 412,000 members in 144 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services

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<sup>1</sup> All references herein to “section” or “§” are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

<sup>2</sup> See April 29, 2016, Department of the Treasury “[2015-2016 Priority Guidance Plan](#),” page 16 of 43.

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to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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We appreciate your consideration of these recommendations and welcome the opportunity to discuss these items further. If you have any questions, please contact me at (801) 523-1051 or [tlewis@sisna.com](mailto:tlewis@sisna.com); or Jane Rohrs, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 370-2290, or [jrohrs@deloitte.com](mailto:jrohrs@deloitte.com); or Ogochukwu Anokwute, Lead Technical Manager-AICPA Tax Policy & Advocacy, at (202) 434-9231, or [oanokwute@aicpa.org](mailto: oanokwute@aicpa.org).

Sincerely,



Troy K. Lewis, CPA, CGMA  
Chair, AICPA Tax Executive Committee

cc: Christopher Call, Attorney-Advisor, Department of the Treasury, Office of Tax Legislative Counsel  
Ken Beck, Taxation Specialist, Department of the Treasury, Office of Tax Legislative Counsel

**AMERICAN INSTITUTE OF CPAs**

**Recommendations on Section 170 Charitable Contributions of Inventory**

**Developed by the AICPA Tax Methods and Periods Technical Resource Panel  
Section 170 Working Group**

**James Martin, Chair**

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**Jane Rohrs, Chair, AICPA Tax Methods and Periods Technical Resource Panel**

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**June 7, 2016**

## AMERICAN INSTITUTE OF CPAs

### Comments on Charitable Contributions of Inventory

#### **Background**

Section 170(b)(2)(A) provides that, in general, the total charitable contribution deduction for any taxable year shall not exceed 10 percent of a corporation's taxable income. This rule is the 10 percent taxable income limitation.

Section 170(d)(2) provides that any contribution made by a corporation that is not deductible in the year of contribution due to the 10 percent taxable income limitation under section 170(b)(2)(A) shall be deductible during the five succeeding taxable years ("five-year carryover period"), subject to additional limitations.

Section 170(e)(1)(A) provides that the charitable contribution deduction for ordinary income property (e.g., inventory) shall be reduced by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of contribution).

Section 170(e)(3) provides a special rule for qualified contributions of inventory and other property described in paragraph (1) or (2) of section 1221(a) by a corporation (other than an S corporation) to a 501(c)(3) organization exempt under section 501(a) (other than a private foundation, as defined in section 509(a), that is not an operating foundation, as defined in section 4942(j)(3)), provided that:

- (i) the use of the property by the donee is related to the purpose or function constituting the basis for its exemption under section 501 and the property is to be used by the donee solely for the care of the ill, needy, or infants;
- (ii) the property is not transferred by the donee in exchange for money, other property, or services;
- (iii) the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of (i) and (ii) above; and
- (iv) in cases where the donated property is subject to regulation under the Federal Food, Drug, and Cosmetic Act of 1938,<sup>3</sup> as amended, the property must fully satisfy the applicable requirements of the Act and related regulations on the date of transfer and for 180 days prior.

Section 170(e)(3)(B) provides that the reduction under section 170(e)(1)(A) for any qualified contribution shall be no greater than the sum of:

- (i) one-half of the amount of the reduction computed under paragraph (1)(A), and
- (ii) the amount (if any) by which the charitable contribution deduction for any qualified contribution (computed by taking into account clause (i) above) exceeds twice the basis of such property.

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<sup>3</sup> 21 U.S.C. §§ 301 et seq. (2015).

Section 170(e)(3)(C)(i) provides that, in the case of a charitable contribution of food from any trade or business of the taxpayer, this paragraph shall be applied:

- (I) without regard to whether the contribution is made by a C corporation, and
- (II) only to food that is apparently wholesome food.

Section 170(e)(3)(C)(ii) provides that the aggregate amount of such contributions for any taxable year which may be taken into account under this section shall not exceed:

- (I) in the case of any taxpayer other than a C corporation, 15 percent of the taxpayer's aggregate net income for such taxable year from all trades or businesses from which such contributions were made for such year, computed without regard to this section, and
- (II) in the case of a C corporation, 15 percent of taxable income (as defined in subsection (b)(2)(D)).

Section 170(e)(3)(C)(iii)(II) provides that, in the case of any charitable contribution which is allowable after the application of clause (ii)(II), subsection (b)(2)(A) shall not apply to such contribution, but the limitation imposed by such subsection shall be reduced (but not below zero) by the aggregate amount of such contributions.

Treasury Reg. § 1.170A-1(c)(1) provides that the amount of a charitable contribution of property other than money is the FMV of the property at the time of the contribution reduced as provided for in section 170(e)(1) and Treas. Reg. § 1.170A-4(a), or section 170(e)(3) and Treas. Reg. § 1.170A-4A(c).

Treasury Reg. § 1.170A-1(c)(4) provides that 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.

Treasury Reg. § 1.170A-4(a)(1) provides that the amount of the charitable contribution for ordinary income property (i.e., the FMV of the property at the time of the contribution) shall be reduced by the amount of gain which would have been recognized as gain which is not long-term capital gain if the property had been sold by the donor at its FMV at the time of the contribution.

Treasury Reg. § 1.170A-4A(c)(1) provides that the amount of the charitable contribution for ordinary income property (i.e., the FMV of the property at the time of the contribution) shall be reduced first, by the one-half of the amount of gain which would not have been long-term capital gain if the property had been sold by the donor at its FMV on the date of contribution, and second, by the amount (if any) by which the remaining charitable contribution deduction for any qualified contribution exceeds twice the basis of such property.

Treasury Reg. § 1.170A-4A(c)(3) provides that, notwithstanding the rules of Treas. Reg. § 1.170A-1(c)(4), the donor of inventory property contributed under this section must make a corresponding adjustment (decrease) to cost of goods sold by the lessor of the FMV of the contributed item or the amount of basis determined under the donor's method of accounting for inventory for United States (U.S.) income tax purposes.

Notice 2008-90<sup>4</sup> indicates that the IRS and the United States Department of the Treasury ("Treasury") are aware that some taxpayers making qualified contributions may, because of the income limitation of section 170(b)(2), prefer to apply the provisions of section 170(e)(1) and Treas. Reg. § 1.170A-1(c) rather than the provisions of section 170(e)(3) and Treas. Reg. § 1.170A-4A(c).

Therefore, for a particular qualified contribution of inventory property under section 170(e)(3) that otherwise satisfies the requirements of section 170 and the relevant regulations, the IRS 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) and Treas. Reg. § 1.170A-4A(c), or (2) section 170(e)(1) and Treas. Reg. § 1.170A-1(c).

## **A. Contributions from Opening Inventory**

### *Analysis*

The current regulations for charitable contributions of inventory under section 170(e)(1) provide that any costs and expenses pertaining to the contributed property, that were incurred in taxable years preceding the year of contribution, and are properly reflected in the opening inventory (i.e., costs and expenses included in the basis of opening inventory) for the year of contribution, must be removed from inventory and not included in the cost of goods sold in the year of contribution. However, any costs and expenses related to the contributed property that are incurred in the year of contribution and are, under the method of accounting used, properly reflected in the cost of goods sold in the year of contribution, must be included in the cost of goods sold for such year.

Thus, under these rules, the donor must treat the basis of items contributed from opening inventory as a charitable contribution deduction but does not treat the basis of items contributed from inventory purchased or produced during the year of contribution as a charitable contribution deduction. Consequently, the basis of items contributed from opening inventory is subject to the 10 percent taxable income limitation under section 170(b)(2)(A), but the basis of items contributed from inventory purchased or produced during the year of contribution is not subject to the 10 percent taxable income limitation under section 170(b)(2)(A).

### ***Example 1 – Application of Treas. Reg. § 1.170A-1(c)(4)***

Taxpayer A donates items with a basis of \$1,000 from opening inventory. Taxpayer B donates items with a basis of \$1,000 from inventory purchased during the year. The donations made by Taxpayer A and Taxpayer B are qualified charitable contributions of inventory under section 170(e)(1). Taxpayer A and Taxpayer B each had taxable income of \$3,000 before

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<sup>4</sup> 2008-2 C.B. 1000.

taking into account the charitable contributions. Pursuant to Treas. Reg. § 1.170A-1(c)(4), Taxpayer A must treat the basis of items contributed from opening inventory as a charitable contribution deduction, subject to the 10 percent taxable income limitation under section 170(b)(2)(A), and Taxpayer B must treat the basis of items contributed from inventory purchased during the year as cost of goods sold.

Thus, under the present regulations, Taxpayer A will have cost of goods sold of \$0, a charitable contribution deduction of \$300, post-contribution taxable income of \$2,700, and a carry forward charitable contribution deduction of \$700. In contrast, Taxpayer B will have cost of goods sold of \$1,000, a charitable contribution deduction of \$0, post-contribution taxable income of \$2,000, and a carry forward charitable contribution deduction of \$0.

	Taxpayer A Items Contributed from Opening Inventory	Taxpayer B Items Contributed from Current Purchases
Pre-contribution taxable income	\$3,000	\$3,000
Cost of goods sold	\$ 0	\$1,000
Taxable income subject to 10% limit	\$3,000	\$2,000
10% taxable income limit	\$ 300	\$ 200
Current year charitable deduction	\$ 300	\$ 0
Post-contribution taxable income	\$2,700	\$2,000
Carry forward charitable deduction	\$ 700	\$ 0

Requiring different treatments for items contributed from opening inventory versus items contributed from inventory purchased or produced during the year of contribution is unwarranted and imposes a significant recordkeeping burden on donors.

### ***Recommendation***

The AICPA recommends revising the regulations to state that the cost of goods sold for such year should include the costs and expenses which are part of the basis of the contributed inventory that is, under the method of accounting used, properly reflected in the cost of goods sold for the year of contribution. As a result, a donor making charitable contributions of inventory under section 170(e)(1) would include the basis of the contributed inventory in cost of goods sold, regardless of whether the items are contributed from opening inventory or from inventory that was purchased or produced during the year of contribution. Thus, in Example 1 above, Taxpayer A would have the same cost of goods sold, charitable contribution deduction, post-contribution taxable income, and carry forward charitable contribution deduction as Taxpayer B.

## **B. Basis of Contributed Inventory Exceeds FMV**

### ***Analysis***

In general, the basis of inventory that is sold, scrapped, or otherwise disposed of by a taxpayer in a trade or business is included in cost of goods sold, as determined under the taxpayer's method of accounting for inventory. When a charitable contribution is made, the amount of the charitable contribution is limited to the FMV of the property that was contributed.

Specifically, section 1.170A-1(c)(1) provides that the amount of a charitable contribution is the FMV of the property at the time of the contribution, reduced as provided in sections 170(e)(1) and 1.170A-4(a) or sections 170(e)(3) and 1.170A-4A. This general rule applies even where the donor's basis exceeds the FMV of the property that was donated. The Tax Court has held that deduction of an unrealized loss on a charitable contribution of property is not a deductible loss under section 165 for an individual taxpayer.<sup>5</sup>

The FMV limitation for charitable contributions of property creates uncertainty for a taxpayer donating inventory where the FMV is below the taxpayer's cost basis in the inventory as computed under sections 471 and 263A. If the taxpayer simply scraps the inventory, it is clear that the taxpayer would be permitted to deduct the cost of the inventory through cost of goods sold under the taxpayer's method of accounting. If the taxpayer chooses instead to donate the inventory to a charity, it is unclear whether the FMV limitation on charitable contributions of property precludes the taxpayer from deducting its full cost basis in the inventory through either cost of goods sold or as a loss under section 165(a).

In the case of contributions of food inventory made in taxable years beginning after December 31, 2015, section 170(e)(3)(C)(iv) provides that the FMV of apparently wholesome food which cannot or will not be sold solely by reason of internal standards of the taxpayer, lack of market, or similar circumstances, or by reason of being produced by the taxpayer exclusively for the purposes of transferring the food to a charitable organization, is determined by reference to the selling price at which the same or similar food items are sold without regard to the internal standards or lack of market. This provision alleviates the issue described above for food inventory, presuming that the taxpayer's normal selling price of the food inventory exceeds the cost of the inventory.

### ***Recommendation***

The AICPA recommends revising the regulations to clarify that a taxpayer is entitled to deduct its cost basis of contributed inventory through cost of goods sold even when the cost basis of the contributed inventory exceeds the FMV of the contributed inventory. It is not ideal for a taxpayer to face the potential risk of being unable to recover its basis in inventory because it donated the inventory to a charity rather than scrapping the inventory.

## **C. The Enhanced Deduction**

### ***Analysis***

Under section 170(e)(3), a corporation making a qualified charitable contribution of inventory may claim a deduction equal to the FMV of the inventory, reduced by one-half of the gain which would not have been long-term capital gain (i.e., ordinary income) if the property contributed had been sold by the corporation at its FMV at the time of contribution. However, the total charitable contribution deduction may not exceed twice the basis of the contributed property. In other words, if the FMV of the contributed inventory at the time of the contribution exceeds the basis of such inventory, the amount of the charitable contribution deduction is equal to the basis of the inventory plus 50 percent of the ordinary income that

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<sup>5</sup> Withers v. Commissioner, 69 T.C. 900 (1978).



would have been realized if the inventory had been sold at its FMV at the time of contribution, not to exceed twice the basis of the inventory. The amount of the charitable contribution deduction in excess of basis is commonly referred to as “the enhanced deduction.”

The regulations for qualified charitable contributions of inventory under section 170(e)(3) presently provide that the donor must treat the basis of the contributed inventory plus the enhanced deduction (or, if less than the basis, the FMV of the contributed inventory) as a charitable contribution deduction. In addition, the donor must decrease the cost of goods sold by the lesser of the FMV of the contributed item or the basis of the contributed item, determined under the donor’s method of accounting for inventory for U.S. income tax purposes. Thus, when the FMV of the contributed item exceeds the basis of the contributed item, both the basis and the enhanced deduction are subject to the 10 percent taxable income limitation under section 170(b)(2)(A) or the 15 percent limitation under section 170(e)(3)(C)(ii).

As a result of these rules, donors are unable to recover the basis of contributed inventory in the year of the contribution whenever the 10 percent taxable income limitation under section 170(b)(2)(A) or the 15 percent limitation under section 170(e)(3)(C)(ii) applies. Therefore, even though section 170(e)(3) was enacted to promote charitable contributions of inventory, the present regulations actually discourage such contributions. For example, a donor subject to the 10 percent taxable income limitation may opt to dispose of the inventory instead of contributing the inventory to charity in order to recover the basis through the cost of goods sold in the year of contribution and avoid the five-year carryover period under section 170(d)(2).

In fact, this is a frequent issue for retail grocer corporations that make significant contributions of inventory to qualified charitable organizations that operate food banks and pantries. Due to the volume of inventory donations and the requirement in the present regulations to treat the basis of the inventory and the enhanced deduction as a charitable contribution deduction, many retail grocer corporations are subject to the 10 percent taxable income limitation for more than five consecutive years.<sup>6</sup> These retail grocer corporations are unable to recover the basis of the contributed inventory during the year of contribution or during the five-year carryover period. Thus, instead of donating inventory, retail grocer corporations in this situation may choose to throw the inventory in the garbage in order to recover the basis through cost of goods sold and obtain an immediate reduction in taxable income.

The IRS recognized this deterrent effect of the present regulations and issued Notice 2008-90, giving donors the option to either claim the enhanced deduction under sections 170(e)(3) and 1.170A-4A(c), or apply the rules under sections 170(e)(1) and 1.170A-1(c). Thus, if a donor making a qualified charitable contribution of inventory under section 170(e)(3) is subject to the 10 percent taxable income limitation, the donor could elect to apply the rules under section

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<sup>6</sup> Section 170(e)(3)(C)(ii) provides an increased 15 percent taxable income limitation for food inventory, including food inventory donated by corporations. However, most retail grocer corporations also make cash and/or non-food donations, which are subject to the 10 percent taxable income limitation. The 10 percent taxable income limitation must be reduced (but not below zero) by the aggregate amount of food inventory donations subject to the 15 percent taxable income limitation. Therefore, retail grocer corporations that want to take a charitable contribution deduction for cash and/or non-food donations must limit the deduction for food inventory donations to less than 10 percent of taxable income and are unable to use the 15 percent taxable income limitation for food inventory donations.

170(e)(1) instead, allowing the donor to recover the basis of the contributed inventory through the cost of goods sold in the year of contribution.

However, as noted above, this election does not resolve the problem if the contributed items are from opening inventory. Furthermore, a donor electing to apply the rules under section 170(e)(1) would forfeit the enhanced deduction, so this option removes the incentive designed by Congress to encourage charitable contributions of inventory when it enacted section 170(e)(3).

### ***Recommendation***

The AICPA recommends revising the regulations to state that, for qualified contributions of inventory under section 170(e)(3), the basis of the contributed inventory, which is, under the method of accounting used, properly reflected in the cost of goods sold for the year of contribution, shall be included in the cost of goods sold for such year. In addition, the charitable contribution deduction would only include the amount of the deduction in excess of the basis (the enhanced deduction). As a result, a donor making charitable contributions of inventory under section 170(e)(3) would include the basis of the contributed inventory in the cost of goods sold, and treat only the enhanced deduction as a charitable contribution deduction subject to the 10 percent taxable income limitation under section 170(b)(2)(A).

### ***Example 2 – AICPA Proposal***

Taxpayer C donates inventory with a basis of \$1,000 and a FMV of \$1,400. The donation is a qualified charitable contribution of inventory eligible for the enhanced deduction under section 170(e)(3). Taxpayer C had taxable income of \$3,000, before taking into account the charitable contribution.

Pursuant to section 1.170A-4A(c), Taxpayer C must treat the basis of the donated inventory and the enhanced deduction as a charitable contribution deduction, subject to the 10 percent taxable income limitation under section 170(b)(2)(A), and must exclude the basis of the donated inventory from cost of goods sold. Thus, under the present regulations, Taxpayer C has cost of goods sold of \$0 and a charitable contribution deduction (prior to the 10 percent taxable income limitation) of \$1,200 ( $\$1,400 - \$1,000 = \$400 / 2 = \$200 + \$1,000$ ), which is equal to the basis of \$1,000 plus the enhanced deduction of \$200. Due to the 10 percent taxable income limitation, Taxpayer C has a charitable contribution deduction of \$300, post-contribution taxable income of \$2,700, and a carry forward charitable contribution deduction of \$900.

Under the AICPA proposal, Taxpayer C would include the basis of the donated inventory in cost of goods sold and would treat only the enhanced deduction as a charitable contribution deduction subject to the 10 percent taxable income limitation under section 170(b)(2)(A). Thus, under the AICPA proposal, Taxpayer C would have cost of goods sold of \$1,000 and a charitable contribution deduction (prior to the 10 percent taxable income limitation) of \$200. After applying the 10 percent taxable income limitation, Taxpayer C would have a charitable contribution deduction of \$200, post-contribution taxable income of \$1,800, and a carry forward charitable contribution deduction of \$0.

	Present Regulations	AICPA Proposal
Pre-contribution taxable income	\$3,000	\$3,000
COGS	\$ 0	\$1,000
Taxable income subject to 10% limit	\$3,000	\$2,000
10% taxable income limit	\$ 300	\$ 200
Current year charitable deduction	\$ 300	\$ 200
Post-contribution taxable income	\$2,700	\$1,800
Carry forward charitable deduction	\$ 900	\$ 0

## **Conclusion**

The AICPA believes that the present regulations under section 170(e)(1) provide inequitable treatment for items contributed from opening inventory versus items contributed from inventory purchased or produced during the year of contribution. The regulations also impose a significant recordkeeping burden on donors. The AICPA suggests revising the regulations to provide that a donor making charitable contributions of inventory under section 170(e)(1) should include the basis of the contributed inventory in the cost of goods sold for the year of contribution, regardless of whether the items are contributed from opening inventory or from inventory that was purchased or produced during the year of contribution. In addition, the AICPA suggests adding clarifying language to the regulations stating that the cost basis of contributed inventory is included in cost of goods sold even when the FMV of the contributed inventory is less than the cost of the contributed inventory.

The AICPA also believes that the present regulations under section 170(e)(3) may, contrary to congressional intent, discourage charitable contributions of inventory by requiring donors to treat the basis of the contributed inventory as a charitable contribution deduction subject to the 10 percent taxable income limitation under section 170(b)(2)(A) or the 15 percent limitation under section 170(e)(3)(C)(ii). This issue is resolvable by revising the regulations to provide that a donor making qualified charitable contributions of inventory under section 170(e)(3) should include the basis of the contributed inventory in the cost of goods sold for the year of contribution and only the enhanced deduction (if any) is treated as a charitable contribution deduction subject to the 10 percent taxable income limitation under section 170(b)(2)(A) or the 15 percent limitation under section 170(e)(3)(C)(ii).

The AICPA believes that our recommendations provide clear, simple solutions that enhance the tax policy goal of encouraging charitable contributions of inventory.