
Beneficial extension of 'enhanced' deduction for charitable contributions of food inventory

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In brief

The American Taxpayer Relief Act of 2012 (ATRA) retroactively extended the Section 170(e)(3)(C) 'enhanced' deduction for qualifying charitable contributions of food inventory made by taxpayers that are not C corporations (e.g., partnerships, S corporations). This deduction had expired at the end of calendar year 2011, but the ATRA retroactively extended it through calendar year 2013, providing another opportunity for taxpayers that are not C corporations to obtain a greater benefit for their charitable contributions.

While many taxpayers will be able to take advantage of this opportunity, some taxpayers may discover that they are unable to efficiently capture the information necessary to document and support the enhanced deduction. This is most likely to occur where a taxpayer's management is highly decentralized, where a taxpayer operates a vertically-integrated group of businesses that has significant intercompany transfers of inventory, or where a taxpayer's Enterprise Resource Planning (ERP) system is inadequate.

If a taxpayer cannot efficiently capture the information necessary to document and support the enhanced deduction, the taxpayer should consider employing statistical sampling, an IRS pre-filing agreement, or both in order to streamline the process. By using statistical sampling, taxpayers often can reduce significantly the amount of information that otherwise would have to be collected and analyzed. By using an IRS pre-filing agreement, taxpayers can obtain certainty with respect to their approach to gathering such information. Successful integration of these types of programs can help taxpayers more efficiently capture the information necessary to claim the additional tax benefit associated with charitable contributions of food inventory.

In detail

The retroactive extension of the Section 170(e)(3)(C) enhanced deduction for charitable contributions of food inventory provides an opportunity for taxpayers that are not C corporations to obtain a greater benefit for their charitable

contributions (taxpayers that are C corporations are not affected by the retroactive extension of this benefit because they already were entitled to an enhanced deduction for qualifying charitable contributions of food and non-food inventory under the

broader provisions of Section 170(e)(3)). To take advantage of this opportunity, a taxpayer must be able to qualify, quantify, and appropriately document and support the deduction.

Qualifying the enhanced deduction

For purposes of Section 170(e)(3)(C), a 'qualified contribution' is a charitable contribution of food inventory to a tax-exempt charitable organization (other than a private foundation that is not an operating foundation), provided that:

- 1) 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, the needy, or infants;
- 2) the property is not transferred by the donee in exchange for money, other property, or services;
- 3) 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 (1) and (2) above; and
- 4) the property fully satisfies the requirements of the Federal Food, Drug, and Cosmetic Act (FFDCA) and related regulations on the date of transfer and for 180 days prior in cases where the donated property is subject to the FFDCA.

In addition, the donated food inventory must be 'apparently wholesome food,' meaning it meets the requirements of the Bill Emerson Good Samaritan Food Donation Act, as in effect on the date of enactment of subparagraph (C).

Quantifying the enhanced deduction

A taxpayer generally is entitled to deduct the fair market value of donated property, except where ordinary income property, such as inventory, is involved. In the case of donated inventory, the deduction typically is limited to the taxpayer's basis in the property. However, under

Section 170(e)(3)(C), charitable contributions of food inventory that are used to care for the ill, the needy, or infants may result in an enhanced deduction (subject to the 10% taxable income limitation). The enhanced deduction is equal to the taxpayer's basis in the contributed inventory, *plus half of the profit that would have been recognized if the inventory had been sold at its fair market value on the date of contribution, not to exceed two times the taxpayer's basis in the contributed inventory.* Stated differently, enhanced deductions for charitable contributions of food inventory effectively result in an incremental 'permanent' benefit.

Consider the following examples:

Example 1: X (a partnership) makes a qualified contribution of food inventory with a fair market value of \$1,000 on the date of the contribution and a basis of \$200. X's tentative deduction is \$600 (i.e., the basis of the inventory, \$200, plus half the unrealized profit in the inventory, \$400). This amount, however, is more than twice X's basis of \$200, so the deduction must be reduced by the excess, resulting in a final deduction of \$400 (i.e., \$600 tentative deduction minus \$200, the excess of the tentative amount over twice the basis, \$400).

Example 2: Y (an S corporation) makes a qualified contribution of food inventory with a fair market value of \$1,000 on the date of the contribution and a basis of \$600. Y's tentative deduction is \$800 (i.e., the basis of the inventory, \$600, plus half the unrealized profit in the inventory, \$200). Because this amount is not more than twice Y's basis of \$600, Y's final deduction is \$800.

To avoid duplicate deductions, a taxpayer that makes a qualified contribution must make a corresponding downward adjustment to its cost of goods sold

equal to the lesser of the fair market value of the contributed property or the basis of such property (Reg. Section 1.170A-4A(c)(3)).

Obstacles to claiming the enhanced deduction

Some taxpayers donate significant amounts of food inventory to tax-exempt charitable organizations, but they are unable to capture efficiently the information necessary to document and support the enhanced deduction. In some instances, it is the tax-exempt organization's inability to furnish needed donee information that prevents the taxpayer from claiming the enhanced deduction, but more often it is the taxpayer's own inability to produce needed donor information (e.g., specific items donated, fair market value, tax basis) that prevents it from claiming the deduction. This is most common where a taxpayer's business operations are in multiple locations, where a taxpayer's management is highly decentralized, where a taxpayer operates a vertically-integrated group of businesses that has significant intercompany transfers of inventory, or where a taxpayer's ERP system is inadequate. Many grocery stores, restaurants, coffee shops, bakeries, food processing plants, and similar businesses are plagued by these types of issues.

For example, many grocery stores regularly donate large amounts of food inventory to tax-exempt organizations, but the local store managers often are unaware that there may be an additional tax benefit associated with those donations. Even where store managers are aware of the additional benefit, they may not be familiar with the type of information needed to document and support such a benefit, or they may not have the local resources to capture the information, especially where there are no automated systems and

controls in place. As a result, some taxpayers attempt to back into the benefit at the end of the year, using broad product categorizations, estimates based on weight, and cost or profit margin averages to document and support the enhanced deduction, which could lead to controversy with the IRS upon examination. More often, taxpayers simply include the basis of donated property in cost of goods sold through a 'shrink' adjustment when the physical inventory count is performed, instead of claiming an enhanced deduction by capturing the needed information in real time, on an item-by-item basis.

Overcoming obstacles to claiming the enhanced deduction

A taxpayer facing obstacles like those outlined above ideally would implement new policies and procedures, and upgrade its ERP systems or develop software designed to document qualified contributions of food inventory. Unfortunately, this type of solution may prove to be extremely time-consuming, and very costly to implement, especially where a taxpayer's business operations are in multiple locations. In addition, it may not be prudent to develop a more rigorous ERP system or develop software to capture qualified contributions of food inventory, given that there is uncertainty regarding whether Section 170(e)(3)(C) will be extended beyond 2013. Alternatively, a taxpayer may be able to reduce the amount of information that would otherwise need to be collected and analyzed through the use of statistical sampling (i.e., reliance on a subset of data that is representative of the larger data set).

In Rev. Proc. 2011-42, the IRS established guidelines regarding the use of statistical sampling to support taxpayer positions reflected on returns. These guidelines include factors to consider in determining whether the use of statistical sampling

is appropriate, like the time and expense required to analyze data and whether other books and records exist that may have greater probative value. Based on these guidelines, if a company regularly donates large amounts of food inventory to tax-exempt organizations, and is unable to efficiently capture the information necessary to document and support an enhanced deduction, the use of statistical sampling may be permitted, assuming the applicable procedural requirements are followed.

Although not required, a taxpayer thinking about the use of statistical sampling also may want to consider entering into a pre-filing agreement with the IRS, pursuant to Rev. Proc. 2009-14. In this context, a pre-filing agreement would allow a taxpayer to obtain certainty with respect to its approach to gathering information needed to calculate the enhanced deduction (it may also provide a way to reduce uncertainties associated with valuation issues). More specifically, it would allow the taxpayer and the IRS to co-develop this approach. Whether a taxpayer should request a pre-filing agreement will depend largely on the type of information that is available to the taxpayer, how easily that information can be obtained, and the extent to which the taxpayer has the resources to undergo an examination (because the use of a pre-filing agreement means that the issue will be examined). The IRS also imposes a \$50,000 user fee when participating in a pre-filing agreement. Accordingly, some taxpayers will prefer to use a pre-filing agreement, but others will not.

Other ancillary planning and compliance matters

In addition to considering the use of statistical sampling and a pre-filing agreement, taxpayers may want to consider the following interrelated planning and compliance matters

relating to charitable contributions of food inventory:

- Timing of contributions to be made
- Mix of cash and product to be contributed
- Type of product to be contributed
- Identification of qualified charitable organizations
- Evaluation of processes and controls around charitable contributions
- Collection of data related to contributions (e.g., fair market value, tax basis)
- Calculation of the enhanced deduction
- Completion of Form 8283, *Noncash Charitable Contribution*
- Analysis of potential taxable income limitation, and tracking of any charitable contribution carryforwards
- Review of available tax return related elections
- Support upon IRS examination

The takeaway

Taxpayers that regularly donate excess food inventory should determine whether they are taking advantage of the enhanced deduction under Section 170(e)(3)(C). If taxpayers are not taking advantage of the enhanced deduction (or are not properly doing so) because of an inability to efficiently capture the information necessary to document and support the deduction, they should consider using statistical sampling in conjunction with a pre-filing agreement in order to streamline the process. Doing so could result in an incremental permanent benefit in the form of a

lower tax liability and effective tax rate, as well as a better position upon IRS examination.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC Private Company Services representative, or one of the subject matter professionals listed below:

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