

MEMORANDUM

TO Julie Emory-Johnson, Alabama Opportunity Scholarship Fund, LLC, C2 Opportunity Scholarships, LLC and Academics + Opportunity Scholarship Fund, LLC (collectively, “AOSF”)

FROM Bruce P. Ely/Brian T. Robbins

DATE January 23, 2020

SUBJECT Examples of Approved Business Purposes for Business Entities to Donate to Qualified Charities such as AOSF

In light of the recent U.S. Treasury Department proposed regulations¹ clarifying that various forms of pass-through entities (“PTEs”) may donate money or goods to tax-exempt organizations including AOSF and may both (i) deduct the donation as a trade or business expense under Internal Revenue Code (IRC) section 162 and (ii) receive an income tax credit that in turn passes through to their owners, you and several CPAs asked us to delve into the most common business purposes for such donations, which have either been suggested by the IRS or approved by the courts over the years. We are pleased to do so but will only offer some examples below, rather than an exhaustive list. Of course, every donor has unique circumstances.

As you know, previous Treasury/IRS announcements and regulations have confirmed that business entities may donate to various tax-exempt organizations and claim a Section 162 business expense [rather than a Section 170 charitable contribution deduction] while also receiving a state or local tax credit for an *entity-level tax* such as a property tax, sales tax, or excise tax.² The IRS issued Revenue Procedure 2019-12 on December 28, 2018, providing a safe harbor to C corporations and certain “specified pass-through entities” under Section 162 to that effect.

That Rev. Proc. provided only limited assurance to donors to AOSF, other Alabama SGOs, and similar organizations in several other states for which only an *income tax* credit is granted in return for the donation. PTEs operating in Alabama and those other states are not subject to state income tax but instead pass-through their net income (or loss) to their owners, who include their distributive or pro rata share of that income (or loss) in their individual income tax calculations. On December 17, 2019, Treasury issued proposed regulations³ that, among other things, clarified that a PTE could indeed donate money or goods to an exempt organization like AOSF, and if the donation had a valid business purpose, could deduct the donation as a business expense for federal income tax purposes under Section 162 while passing-through the state income tax credit generated by the donation to their owners, subject to normal limitations.

Example 2 of Proposed Reg. section 1.162-15(a)(2) states as follows:

¹ 84 Fed. Reg. 68833 (Dec. 17, 2019).

² <https://www.irs.gov/newsroom/clarification-for-business-taxpayers-payments-under-state-or-local-tax-credit-programs-may-be-deductible-as-business-expenses> (accessed January 21, 2020).

³ 84 Fed. Reg. 68833 (Dec. 17, 2019).

P, a partnership, operates a chain of supermarkets, some of which are located in state N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N... P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a \$1,000 payment to a charity.... P may treat the \$1,000 payment as an expense of carrying on a trade or business under section 162. *This result is unchanged if, under State N's tax credit program, P expects to receive a \$1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners.*" [emphasis added]

In a rare move, Assistant Treasury Secretary David Kautter and U.S. Department of Education Secretary Betsy DeVos hosted a nationwide telephone conference call the morning of Tuesday, December 17, 2019, to discuss the proposed regulations and answer questions from tax practitioners and taxpayers. According to your adviser, David Kirk of Ernst & Young LLP in Washington, D.C., who participated in the call, Secretary Kautter was "very intentional" in confirming the scope of Example 2 and the ability of PTEs to donate to exempt organizations while deducting the donation for federal income tax purposes under Section 162 and being granted a state income tax credit, even if the credit under state law passes through to the owners and can be claimed by them on their individual tax returns.

Further to that positive effort, the proposed regulations themselves state they are effective generally for payments or transfers to entities described in Section 170(c) on or after December 17, 2019. "However, a taxpayer may rely on these proposed regulations for payments.... *on or after January 1, 2018* and before the date regulations finalizing these proposed regulations are published..." [emphasis added].

In addition to the business purpose approved in Example 2 above (increasing name recognition and customer goodwill), there are several other examples that have either been approved by the IRS in a published ruling or by a federal court in a particular taxpayer's case. The following are some examples:

Donations to a city board of education under a contract that required the BOE to upgrade the quality of education in the surrounding community. The taxpayer-donor was planning to expand its plant with the hopes of hiring workers from elsewhere but was concerned that an inferior public education system would deter them from accepting employment. The taxpayer chose to expend funds to upgrade the local schools rather than close the plant and build a new plant elsewhere. The court termed that a "valid business decision." United States v. Jefferson Mills, Inc., 367 F.2d 392 (5th Cir. 1966)(note that 5th Circuit Court of Appeals decisions issued prior to 1981 are also binding on the IRS and taxpayers in the 11th Circuit, which includes Alabama, Florida and Georgia).

Donations to a non-profit organization created to assist the donor-employer's own employees with sickness and disability benefits and educational funds. The donations to the fund were made for the purpose of "improving and maintaining the morale and loyalty of its employees..." The U.S. Tax Court held the payments were deductible under Section 162 as an ordinary and necessary expense of the business. Weil Clothing Co. v. Commissioner, 13 T.C. 873 (1949).

Donations to charitable organization whose primary goal was to reduce neighborhood tension and combat community deterioration in the neighborhood in which the donor-taxpayer's office was located. The donor was a stock brokerage firm and believed that these donations would impress its customers with its community spirit and it “emphasized in its advertisements to its customers and potential customers that [its donations] would enable the customers to benefit the [charitable] organization and, thus, the community...” IRS Rev. Rul. 72-134, 1972-1 C.B. 44.

Donations of sewing machines to public schools, etc. to train students and generate future sales. The Singer Company would sell its sewing machines at a substantial discount to public schools and other charitable organizations in order to interest and train young women in machine sewing and enlarge the future potential market for its products. The court ruled that this was likely a legitimate business purpose, but unfortunately the taxpayer did not raise that argument; it instead argued only that the donations were charitable in nature and qualified under Section 170. Singer Company v. United States, 196 Ct. Cl. 90, 100-104 (1971).

Donation by a retail business to non-profit corporation for purposes of scientific research, restoration and preservation of the coastline and restoration of wildlife and the public image of the area after an offshore oil-well blowout. An unidentified retail business located in a resort area that derived a significant portion of its income from the tourist industry suffered lost business after an offshore oil-well exploded and leaked crude oil all along the area's beaches, driving tourists away. The local city council established “a special fund for the protection of local business through an oil pollution control fund.” The fund also expended monies on advertising to counteract the damaging publicity surrounding the oil spill. The IRS ruled that donation will qualify as a bona fide business expense under Section 162, but not as a charitable contribution deduction. IRS Rev. Rul. 73-113, 1973-1 C.B. 65.

We also found the following law review article useful in our research: Nancy J. Knauer, “The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity,” 44 DePaul Law Review 1 (1994).

PTE (or C corporation) donors should be reminded that in order to deduct a cash donation to AOSF, the donation must be paid or incurred in carrying on a trade or business, must be an expense, must be a “necessary” expense, and must be an “ordinary” expense. Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971)(citations omitted). The donation and the related business purpose should be contemporaneously documented in corporate or similar minutes and of course the receipt should be acknowledged by AOSF. It would also be helpful if AOSF thanked its donors in its annual report and perhaps in some form of public advertising, although any sort of public disclosure should first be approved by the donor.

Please let us know if you have any questions or require additional explanation. Thanks for the opportunity to be of service.