Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:JAX:NAS:TL-N-5608-00
KSChaberski ID# [redacted]

date: Feb. 20, 2001

to: Engineer Harry Craig, Engineering Group 1844
Memphis, Tennessee

from: Associate Area Counsel (LMSB) Area 3 - Nashville

subject: [redacted]
EIN: [redacted]
Cycle: [redacted] **through** [redacted]
Advisory Opinion

This responds to a request by the Large & Mid-Size Business Division through Engineer Harry Craig that we provide an opinion regarding the proposed disallowance of charitable contributions claimed as deductions on the above-referenced taxpayer's federal income tax return for each of the taxable years [redacted] and [redacted].

ISSUES

1. Whether claimed charitable contribution deductions for inventory donated by a domestic corporation to various domestic charitable entities are disqualified by I.R.C. § 170(c)(2) because all of the donated inventory was, at the time of the donation, earmarked for charitable use outside the United States and any U.S. possession?

2. Whether the claimed deductions should be disallowed based on the fact that the taxpayer/donor received perceived intangible benefits (i.e. good will, positive media coverage, potential expansion of markets and "inventory control") in exchange for the donation of its inventory?

3. If the taxpayer is entitled to a deduction for any of the inventory referred to above, whether the taxpayer has properly valued the allowable deduction on each of the returns at issue?

CONCLUSIONS

1. I.R.C. § 170(c)(2) does **not** disqualify otherwise allowable deductions for charitable contributions made by a domestic corporation to another domestic charitable **corporation** based upon the fact that the donated goods are intended to be or are in fact utilized in a foreign country. However, that section does serve to disqualify any such deduction if the goods are donated to a **trust, chest, fund, or foundation** for use outside the United States or a U.S. possession. Thus, based on our review of the information provided, it appears that section 170(c)(2) does not disqualify the claimed donations with respect to inventory donated to [redacted]"), and [redacted]. Further examination is necessary to determine whether [redacted], and [redacted] are domestic charitable corporations before the Service can determine whether it must disallow the claimed deductions relating to inventory contributed to each of those entities in accordance with section 170(c)(2).

2. Since the Service has determined (and we agree) that the taxpayer possessed donative intent with respect to the donated inventory, any benefits received in return for the donations would serve to reduce the amount of the allowable donation rather than to disqualify the deduction in its entirety. The facts as developed thus far do not indicate that any such adjustment is warranted based upon the perceived intangible benefits.

3. Further examination regarding the amount claimed by the taxpayer as deductions is warranted in accordance with the discussion below.

FACTS

The above-referenced taxpayer is an international corporation which manufactures and markets [redacted] medical equipment. The Service has established that the taxpayer, which has its headquarters in [redacted], donated inventory ([redacted] and related medical/surgical equipment) during [redacted] and [redacted] to each of the entities listed in

the chart below.[1] The Service has also established that each of these organizations utilized the donated medical equipment outside the United States and U.S. possessions (primarily in "third-world countries" and/or "disaster or war-torn areas") and that, in fact, the donations were made by the taxpayer with specific knowledge and intent that the equipment would be shipped to and used in these foreign countries.[2]

The Service has also established that most, if not all, of the donated inventory/equipment was categorized by the taxpayer itself as "excess" at the time it was donated. In response to a question posed by the Service[3], the taxpayer responded that the inventory which constituted all but one of the donations had been "reserved as excess" on the taxpayer's books. The taxpayer defines excess inventory in this regard as "inventory with a 24-month supply or greater on hand." The response to the IDR also noted, with no objective substantiation, that such "excess inventory is still sold at list price without a discount."

During the course of this examination, the Service was provided by the taxpayer with a letter to the taxpayer from [redacted], soliciting donation of medical equipment and supplies for a medical mission to [redacted].[4] Said letter, dated [redacted], bears a printed (in ink) notation which appears to have been written by a high-ranking employee/officer of the taxpayer to a subordinate. The handwritten note indicates that the taxpayer "...may have some obsolete product inventory to donate". A separate handwritten notation on the same letter also appears to indicate an intent on behalf of the taxpayer to donate inventory/equipment for the purpose of gaining a tax "write off".

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[1] All of the donated inventory was approved by the United States Food and Drug Administration for medical /surgical use in the United States.

[2] The examination indicates that all of the inventory for which deductions are claimed was solicited for and actually used for medical missions to [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted].

[3] The question was posed in an Information Document Request ("IDR").

[4] This letter resulted in the taxpayer's donation of inventory to the soliciting organization; that donation is one of the donations currently at issuer.

A copy of that letter is attached to the Engineering and Valuation Report for this issue as Exhibit 1.

The taxpayer claimed charitable contribution deductions under I.R.C. § 170 on its [redacted] and [redacted] federal income tax returns of double its cost for the donated inventory. The deductions at issue are as follows:

[redacted] **CONTRIBUTIONS**

Donee	Deduction Claimed	T/P's Cost
[redacted]	$ [redacted]	$ [redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted] **Totals**	$ [redacted]	$ [redacted]

[redacted] **CONTRIBUTIONS**

Donee	Deduction Claimed	T/P's Cost
[redacted]	$ [redacted]	$ [redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted] **Totals**	$ [redacted]	$ [redacted]

SUMMARY OF PROPOSED ADJUSTMENTS

Year	Per Return	Allowed	Proposed Adjustment
[redacted]	$ [redacted]	$ [redacted]	$ [redacted]
	$ [redacted]	$ [redacted]	$ [redacted]

DISCUSSION

I.R.C. § 170 provides, in pertinent part, that there shall be allowed as a deduction any charitable contribution (as defined in Section 170(c)), payment of which is made within the taxable year. A charitable contribution shall be allowed as a deduction only if verified in accordance with regulations prescribed by the Service.

Section 170(c) provides, inter alia, that for purposes of Section 170, the term "charitable contribution" means a contribution or gift to or for the use of -

> (2) A corporation, trust, or community chest, fund, or foundation -
>
> (A) created or organized in the United States, or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;
>
> (B) organized or operated exclusively for religious, charitable, scientific, literary, or educational purposes ... or for the prevention of cruelty to children or animals;
>
> (C) no part of the net earnings of which inures to the benefits of any private shareholder or individual; and
>
> (D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in ... any political campaign on behalf of (or in opposition to) any candidate for public office.

The last sentence of section 170(c)(2) specifically provides that "[a] contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified" in subparagraph (B) above (i.e. for religious, charitable, scientific , literary, educational, etc. purposes).

Ultimate Foreign Use

The Service proposes to disallow the claimed deductions in accordance with the last sentence of section 170(c)(2), which is quoted in the preceding paragraph, on the basis that the inventory was earmarked for use outside of the United States or any U. S. possession. We do not believe an adjustment on that basis is warranted.

Our research indicates that the last sentence of section 170(c)(2) represents a truly quirky and odd bit of tax law. While that last sentence does indeed serve to disqualify a deduction for a charitable contribution by a corporation to a **trust, chest, fund, or foundation** if the donation is used outside of the United States or a U.S. possession, that sentence contains no specific limitation as to deductions by a corporation for charitable contributions to a domestic charitable **corporation**. Moreover, the Service has publicly stated that it will not read any such limitation into the statute. It is in fact the published position of the Service that the statute does not preclude the deductibility of contributions to a domestic charitable corporation which uses the contributed property for a charitable purpose in a foreign country.[5] Rev. Rul. 69-80, 1969-1 C.B. 65; *See also*, Bilingual Montessori School of Paris, Inc. v. Commissioner, 75 T.C. 480 (1980). Thus, to the extent that the inventory was donated to domestic charitable corporations, the taxpayer is entitled to rely on the published position of the Service and the deduction may not be denied on the basis that the donation was earmarked for use outside of the United States.

It appears on the face of the facts presented that [redacted], [redacted], [redacted], [redacted], and [redacted] are corporate entities and that otherwise

[5] We note that Rev. Rul. 63-252, which is relied upon by the Service, does not discuss "earmarked" contributions to a domestic charitable **corporation** for use overseas.

deductible contributions to these entities cannot be disallowed based upon the fact that the donations were earmarked for use abroad.[6] [redacted], and [redacted], on the other hand, may or may not be domestic charitable corporations. We thus recommend that the Service determine whether each of these organizations meets these criteria before determining whether the claimed deductions relating to donations made to any of these entities must be disallowed in accordance with the last sentence of section 170(c)(2).

"Earmarked" Contributions

The Service is also concerned in this case that the taxpayer would not have donated the equipment/inventory had it not known beforehand that the equipment was to be used overseas (i.e. in a country in which the taxpayer had no established market for the equipment). This circumstance raises the further issues of whether the donations of medical inventory constitute "earmarked" donations and, if so, whether such donations may still qualify for a deduction under section 170.[7] We conclude that the contributions in the instant case were not "earmarked" in such a way as would disqualify them from deduction under section 170. Moreover, the manner in which the donee solicited and ultimately utilized the donated equipment also does not provide a basis for disallowance of the deductions at issue.

In considering whether the donated equipment was "earmarked", the Service's Engineering and Valuation Report quotes at length from and contains a detailed discussion of Rev. Rul. 63-252, 1963-2 C.B. 101. That Revenue Ruling, along with Rev. Ruls. 66-79, 1966-1 C.B. 48 and 75-65, 1975-1 79 discusses, under varying circumstances, the concept of "earmarked" donations as well as donations which ultimately end up in a foreign country. The Service concludes that the donation of equipment by the taxpayer in the instant case parallels the facts recited in

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[6] We have not verified that any of these entities are in fact domestic charitable corporations; we recommend that the Service do so if it has not already.

[7] This discussion presumes that the taxpayer possessed donative intent; if the taxpayer maintained significant post-donative control over the equipment, there would, by definition, be no donation to begin with. See the discussion regarding essential elements of a charitable contribution deduction below.

Example (3) of Rev. Rul. 63-252 and is thus, in accordance with the conclusion of the Revenue Ruling, not deductible. As is discussed further below, we believe that the pertinent facts of the instant case differ significantly from those in Example (3) and that the conclusion of that Revenue Ruling is thus not controlling in this case. Example (3) of Rev. Rul. 63-252 is as follows:

> (3) A foreign organization entered into an agreement with a domestic organization which provides that the domestic organization will conduct a fund-raising campaign on behalf of the foreign organization. The domestic organization has previously received a ruling that contributions to it are deductible under section 170 of the Code. In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

1963-2 C.B. at 103.

In determining that the situation reflected in Example (3) does not support a charitable contribution deduction, Rev. Rul. 63-252 utilizes a substance over form analysis. The concern with "earmarked" donations of this type is that a taxpayer may turn an otherwise non-deductible payment into a deductible charitable contribution simply by funneling the payment through a domestic charitable organization. Such was the case in Thomason v. Commissioner, 2 T.C. 441 (1943), where the Tax Court held that amounts paid to a legitimate charitable organization were not deductible when the donor earmarked the funds to be used only for a specified ward of the organization (for whom the donor felt a sense of fiscal responsibility). The Thomason Court determined that the taxpayer in that case could not turn otherwise non-deductible support payments into a charitable contribution deduction simply by funneling the support payments through the charitable organization. Similarly, Rev. Rul. 63-252 recognizes that, under the circumstances presented in Example (3), the donee is contractually obligated to provide the donation to a foreign entity and is in substance acting as a mere agent for the foreign entity. With respect to the funds at issue in Example (3), the donee has no right to exercise any discretion regarding the ultimate use of the funds; its sole function is as a mere conduit between the donor and the foreign entity.

Though the donee in Example (3) is a qualified domestic charitable organization (which fact is ordinarily sufficient to justify a claimed deduction), Rev. Rul. 63-252 recognizes that certain transactions require further scrutiny before a deduction may be allowed. Since under those facts the domestic entity is acting as a mere conduit in funneling funds to a foreign entity, the Service must look to the substance of the transaction, rather than simply relying on the form. The funds donated in Example (3) are, by the very terms of the solicitation and donation, "earmarked" for immediate transfer to the foreign entity; the domestic entity has no control or discretion over these funds. Despite the insertion of the domestic entity into the stream of this transaction, the true substance of the contribution is that the donation is made directly from the donor (who claims the deduction) directly to the foreign organization.[8]

I.R.C. § 170(c)(2)(A) requires that a deduction is allowed only for contributions to an organization formed within the United States or in a U.S. possession. Rev. Rul. 63-252 thus concludes that the contribution in Example (3) is not deductible. In so concluding, the Revenue Ruling recognizes that the requirements of section 170(c)(2)(A) would be effectively nullified if contributions which were "inevitably committed" to go to a foreign organization were found to be deductible simply because, in the course of transmittal to the foreign organization, they came to rest momentarily in the hands of a qualifying domestic organization. 1963-2 C.B. at 103.

The fact that a contribution is "earmarked" for a particular use does not, however, in and of itself preclude a deduction under section 170. Rather, "earmarked" donations are subjected to further scrutiny; once it is determined that the contribution was "earmarked", the critical step is to determine the true substance of the transaction. It is the **substance** of the transaction, not the fact that a donation is "earmarked", which ultimately determines whether a deduction is warranted.[9] Rev. Proc. 63-252

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[8] It must be remembered that the domestic charitable organization solicited the funds under this premise; the donor was at all times aware that the funds were to be transmitted directly to the foreign entity.

[9] A donation to a qualifying homeless shelter with the understanding that the donation will be used solely to provide "Thanksgiving Dinners" to those served by the shelter is a common example of an "earmarked" donation which is properly deductible.

also does not stand for the proposition that donations to be used in specified areas are not deductible, or even that donations to be utilized in a foreign country are not deductible.

Rev. Rul. 66-79 examined contributions made to a domestic charitable organization which were solicited for a specific project of a foreign charitable organization. Under at least one definition, this would seem to have been an "earmarked" donation. However, Rev. Rul. 66-79 indicates that "earmarked" donations as that term is used in Rev. Rul. 63-252 are those donations over which the **donee** has no discretion or control, such as the directed donations in Thomason, 2 T.C. 41 or the contractual obligation to turn donations over to a certain entity as reflected in the facts of Example (2).

The proper test, according to Rev. Rul. 66-79, is whether the domestic donee has full control of the donated assets, and discretion as to their use, so as to ensure that they will be used to carry out its functions and purposes. Rev. Rul. 66-79 concludes that, since the domestic donee had reviewed and approved the foreign project as being in furtherance of its own exempt purposes and that it maintained control and discretion over the use of the contributions, deduction of amounts contributed is appropriate under section 170. The fact that the contributions were specifically solicited for use overseas did not preclude deductibility as long as the donee's decision to turn the funds over to the foreign entity was made willingly and in furtherance of its exempt purpose. The substance of the donative transaction under these facts was determined to be in furtherance of the exempt purpose of the donee.

Rev. Rul. 75-65 expanded the holding of Rev. Rul. 66-79 another step. Rev. Rul. 75-65 addressed the propriety of claimed deductions for contributions to a domestic charitable organization which was formed for the express purpose of dealing with problems of plant and wildlife ecology in a specified foreign country through programs that include grants to foreign organizations. Though this organization was formed in the United States, it had no charitable purpose within the United States or any U.S. possession and used none of the funds which it solicited for domestic charitable purposes. Rev. Rul. 75-65 concludes that, as long as the domestic donee organization has reviewed and approved the foreign projects as being in furtherance of its own exempt purposes and maintains control and discretion as to the use of the contributions, contributions to the donee are deductible under section 170. Once again, the fact that the contributions were specifically solicited for use overseas does

not, in and of itself, preclude deduction of amounts contributed.

The substance of the donations in the instant case is as follows: the taxpayer was approached by various domestic charitable organizations and asked to donate to specific overseas missions which the donee had chartered. The taxpayer had no say in where these missions would be performed; its sole choice was to donate or not to each such mission when contacted by the donee. The missions were conducted as planned for charitable purposes within the meaning of section 170(c)(2)(B) and fell squarely within the qualified charitable purposes of each of the donee organizations. All of the other requirements of section 170(c)(2) appear to have been met. Moreover, the domestic charitable corporations to whom the taxpayer in the instant case donated equipment were not "shells", formed to collect domestic donations for a foreign charity. Rather, the domestic organizations to which the taxpayer in the instant case donated medical equipment sought donations from the taxpayer **for their own use** in furthering their charitable purposes in foreign countries.[10] Moreover, unlike the facts set forth in Example (3), the donations to were not "earmarked" for any particular foreign organization; once the donation was made, the **donee controlled the use of the donated equipment**.

Based upon all of the facts of the instant case, we cannot conclude that the taxpayer's donation of medical equipment was improperly "earmarked" so as to preclude deduction therefore under section 170. Rather, the contributions were made to qualified charitable corporations which in turn themselves utilized the equipment overseas in accordance with the charitable purpose for which they were formed. The sole control which the taxpayer exerted over these donations was to either donate the equipment or not, as it saw fit. This choice, which precedes every charitable contribution, simply does not constitute improper "earmarking" of the donations. The fact that the donated equipment was actually used overseas also does not preclude the deductions under these circumstances. *See*, Bilingual Montessori School of Paris, Inc. v. Commissioner, 75 T.C. 480 (1980).

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[10] As is noted above, the known donees in the instant case are domestic **corporations**; the claimed deductions are thus not automatically precluded by the last sentence of section 170(c)(2).

Other Requirements

I.R.C. § 170 contains many other requirements which must be met before it can be determined that a corporation is entitled to a deduction from taxable income on a return. Thus, before the Service reaches the issue of whether a claimed deduction must be disallowed in accordance with section 170(c)(2), each claimed deduction must meet all other requirements of section 170 and the regulations promulgated thereunder. We have no independent means of verifying that each of these elements has been met by the taxpayer with respect to the claimed deductions here at issue. Moreover, since the Service determined that a deduction for these contributions was, in any event, specifically precluded by the last sentence of section 170(c)(2), the Service may not have verified that each of these other elements has been met with respect to each of the claimed deductions. Thus, we recommend that a determination be made whether, with respect to each of the claimed deductions at issue, the taxpayer has met each of the following elements:

(1) A contribution or gift has been made;

(2) to or for the use of a corporation, trust, or community chest, fund or foundation;

(3) which was created or organized in the United States or in any possession thereof, or under the law of the United States, any state or territory, the District of Columbia, or any possession of the United States;

(4) which was organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

(5) that no part of the net earnings of the donee inures to the benefit of any private shareholder or individual; and

(6) that no substantial part of the activities of the donee is carrying on propaganda or otherwise attempting to influence legislation.

Please note that this analysis requires investigation into the business structure and various other aspects of each of the donee entities, which investigation is also necessary to determine whether these entities qualify under the last sentence

of section 170(c)(2). In addition, special rules and limitations apply to all claimed charitable contribution deductions. *See, e.g.*, I.R.C. § 170(b), which reflects percentage limitations on charitable contribution deductions, and section 170(b)(2) which provides specific limitations on deductions claimed by corporations.

In order to establish the first element listed above, (i.e. that a "contribution or gift" has been made), a taxpayer must show an irrevocable transfer of ownership of property without any expectation of a *quid pro quo* to be received from the donee. Hernandez v. Commissioner, 490 U.S. 680 (1989). The only intent required on the part of the donor is a "clear and unmistakable" intention to transfer, "absolutely and unmistakably", current title, control and ownership of the gift property. Goldstein v. Commissioner, 89 T.C. 535, 542 (1987).

Unlike the determination regarding whether property received can be excluded from income by the recipient (which requires that the gift be made with "detached and disinterested generosity"[11]), a generous and/or altruistic donative intent is not required to support a claimed charitable contribution deduction. Rather, a contribution "may be motivated by the basest and most selfish of purposes as long as the donor does not reasonably anticipate benefit from the donee in return." Weitz v. Commissioner, T.C. Memo. 1989-99. The "charity" in a charitable contribution is to be found in the purposes and works of the recipient, not in the subjective intent of the donor. Foster v. Commissioner, T.C. Memo. 1990-345. Moreover, deduction for a donation is not disqualified even though the taxpayer's primary motive for the donation is to realize a tax benefit. Mount Mercy Associates v. Commissioner, T.C. Memo. 1994-83.

Once a taxpayer establishes that the required transfer of ownership has occurred, the donor's receipt of some consideration in exchange for the transfer does not result in complete elimination of the deduction; rather, the amount of the allowable deduction is then limited to the extent to which the fair market value of the gift exceeds the fair market value of the consideration received in return. Hope v. United States, 23 Cl. Ct. 776 (1991). Thus, to the extent that the Service determines that the taxpayer received some benefit(s) from the donees in return for the donations here at issue, determination of the fair market value of the benefits received is necessary.

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[11] Commissioner v. Duberstein, 363 U.S. 278, 285 (1960)

As with the determination of the fair market value of the property donated, valuation of any benefits received in return for the donation may be determined in several different ways, including cost or selling price, selling price of comparable items, replacement cost, and/or expert valuation opinions. *See, e.g.*, United States v. American Bar Endowment, 477 U.S. 105 (1986). While the Service has in this case identified several intangible "benefits" which may have been realized by the taxpayer in exchange for the donations of inventory, we are not aware that any value has been placed on any such benefits for purposes of determining the proper amount of the deduction. We note in this regard that valuation is a factual question and that general intangible "benefits" received in exchange for a donation to charity (such as general goodwill or "free advertising") may be quite difficult to value. Should you desire any specific advice regarding this type of valuation, please contact the undersigned.

If a corporation donates inventory (defined as property held primarily for sale to customers) to a qualified charitable organization, the corporation is entitled to deduct, in addition to its basis in such inventory, up to one-half of the appreciation of the property in the hands of the donor. I.R.C. § 170(e)(3). To qualify for this special treatment, the following conditions must be satisfied:

(1) The donee must use the property in a use related to its exempt purpose and solely for the care of the ill, the needy, or infants;

(2) the donee must not transfer the property in exchange for money, other property or services;

(3) the donor must receive a statement from the donee representing that the donee's use and disposition of the property will comply with (1) and (2) above; and

(4) any property that is subject to regulation under the Federal Food, Drug and Cosmetic Act must satisfy all applicable requirements under the Act and regulations on the date of transfer and for 180 days before that date.

I.R.C. § 170(e)(3)(A); Treas. Reg. § 1.170A-4A(b)(1).

If all of the above conditions are satisfied, the corporate donor is entitled to claim a deduction for the sum of the adjusted basis of the property and one-half of the unrealized

appreciation. The maximum amount of the deduction allowed pursuant to these rules is twice the taxpayer's basis in the inventory. I.R.C. § 170(e)(3)(b); *see also* Rev. Rul. 85-8, 1985-1 C.B. 59.

In the instant case, the taxpayer has claimed the maximum deduction allowable (two times basis) for each of the contributions here at issue. We believe that the Service should determine that each of the above requirements has been met with respect to each of these donations. If so, a determination must then be made as to the unrealized appreciation of the donated inventory to determine whether the taxpayer is in fact entitled to claim the maximum allowable deduction for each of these donations.

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse effect on privileges, including the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

Please contact the undersigned at (615) 250-5598 if you have any questions on the above or if you would like to discuss this issue or any aspect of this case further. Please also contact the undersigned if you seek advice regarding recommendations on how to proceed with respect to any of the issues discussed above.

BENJAMIN A. de LUNA
ASSOCIATE AREA COUNSEL (LMSB)
AREA 3

By: /s/ Kirk S Chaberski
KIRK S. CHABERSKI
Senior Attorney (LMSB)