The final regulations retain the provision found in the proposed regulations, updating Reg. §1.162-15(a) that provides a test to determine if a payment to a charitable organization qualifies as a trade or business expense under IRC §162. The regulation provides:

> *A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see §1.170A-1(h).[2]*

Why is it important if the payment is a charitable contribution vs. a business expense? Normally a business expense deduction gets a more favorable tax treatment than a charitable contribution. Some of the benefits to having the payment reclassified can include:

- No percentage of adjusted gross income (for individuals) or taxable income (for a C corporation) limitation on the annual deduction exists for §162 expenses, while charitable contributions are subject to such restrictions;
- No need for an individual to itemize deductions to obtain a tax benefit if the deduction is under IRC §162 for a business (other than as an employee) conducted by the taxpayer or which has income flow through to the taxpayer; and
- The deduction reduces a taxpayer's adjusted gross income rather than taxable income, potentially allowing a taxpayer to receive a tax benefit that would not be available or would be reduced if the taxpayer's adjusted gross income was higher.

But note that for the payment to be treated as a trade or business expense, the business must show two things:

- A direct relationship of the payment to the taxpayer's trade or business and
- The payment was made with a reasonable expectation of a financial return commensurate with the amount of the payment or transfer.[3]

As the IRS did when the proposed regulations were issued, the IRS directs taxpayers to review the analysis in the case of *Marquis v. Commissioner*, 49 T.C. 695 (1968) to understand how to meet the tests.

We discussed the *Marquis* case when the proposed regulations were issued in January[4] and the issue remains the same—in *Marquis* the taxpayer had clearly calculated her likely additional business related to her "contributions" and stopped contributing to organizations when it became clear they wouldn't use her services.

The regulation provides the following example of applying this rule:

Example 1, Reg. §1.162-15(a)(2)(i)

A, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. A makes a $1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert supporters, including A. A's advertisement includes the URL for the website through which A sells its instruments. A reasonably expects that the advertisement will attract new customers to A's website and will help A to sell more musical instruments. A may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

In response to our article on the proposed regulations, we received a number of inquiries from advisers who had been told by charities (primarily what the IRS will refer to in the preamble as scholarship granting organizations, or SGOs) that the above regulation allowed a full deduction anytime a passthrough organization made a donation to such an entity and even that there was no requirement to show either the connection to the trade or business or demonstrate an expectation of a return in excess of the amount contributed. Such organizations often openly marketed such contributions to their organizations as work-arounds for the $10,000 limit on deductions on non-business state and local taxes under IRC §164.

Some of that was driven by an example, also contained in the final regulations, that applied this rule to a passthrough entity.

Example 2, Reg. §1.162-15(a)(2)(ii)

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 makes the final determination on which charities receive payments. 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 described in section 170(c). 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)

It continues to be the author's position that the organizations are claiming, or at least strongly implying, more than the regulation allows by its clear language—and that the example is consistent with that position. While the last paragraph indicate the deduction could be allowed even if it resulted in a income tax credit passed out to the equity holders (as is the case in some of these programs), it also provided that the partnership found a reasonable expectation that the contribution would increase goodwill and revenue significantly, a point I've not found emphasized in much of the marketing material.

As well, the IRS noted in the preamble that one commentator had "requested clarification regarding whether a business entity may deduct payments to SGOs under section 162 as ordinary and necessary business expenses incurred in carrying on a trade or business." The IRS did not provide that sort of specific clarification, rather it provided in the preamble:

> *While the Treasury Department and the IRS acknowledge these concerns, the regulations retain the clarifications to §1.162-15(a)(1) and (a)(2) regarding section 162 deductions for business payments to section 170(c) entities, as well as examples illustrating the rule. Section 1.162-15(a)(1) mirrors the language of §1.170A-1(c)(5), which has been in effect since 1970. Section 1.170A-1(c)(5) provided that if the taxpayer's payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of commensurate financial return, the payment or transfer may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. See also Marquis v. Commissioner, 49 T.C. 695 (1968). Section 1.162-15(a)(1) applies the same standard. Thus, a passthrough entity may deduct a payment under §1.162- 15(a)(1) only if the entity can demonstrate that the payment satisfies these requirements, which limits the possibility of abuse. (emphasis added)*

Some have objected that, in a case where a credit equal to 100% of the amount contributed is allowed for a contribution (something the state of Arizona, for one, does allow), the contribution would always meet the requirement of a benefit beyond the amount paid by the business. However, that view ignores the fact the regulation requires that the *taxpayer* (in this case the passthrough) have a reasonable expectation of a financial return. When the credit is passed out to the equity holders, it is they and not the passthrough taxpayer, that would receive any return.

As well, that analysis also ignores the requirement that payment bear a *direct* relationship to the taxpayer's trade or business. Without a substantial benefit aside from the indirect payment of personal income taxes of the equity holder(s), it would appear very difficult to articulate a reasonable direct relationship. Such a transaction appears also to pose issues of lacking economic substance as that term is defined at IRC §7701(o).