

ACHIEVING TRIPLE BOTTOM LINE RESULTS

CREATIVE SOLUTIONS FOR RETAIL PRODUCT RETURNS, OVERSTOCK, OR DAMAGED GOODS



By Gary Schuler Founder/CEO

BACKGROUND

Throughout the United States non-durable goods industries there is excess capacity and inventory driven by liberal return policies, inaccurate forecasting, lack of demand, or obsolescence. This excess product is destroyed or discarded if it cannot be channeled through the traditional methods of restocking the product or sold to 3rd party liquidators.

According to the *National Retail Federation*, apparel retailers experience an average return rate of 10% of retail sales and E-Commerce companies average of 15% of retail sales. Retail product returns are up 66% over the past 5 years to an estimated \$400 billion.

What happens to these products?

In a survey conducted by the retail industry the average disposition practices included:

- Resell the product (to a 3rd party liquidator) - 37.93%
- Landfill - 29.31%
- Re-stock - 24.14%
- Donate - 8.62%

Liberal returns policies are adding to landfill tonnage at an alarming rate. A recent New York Times article quoted that “... *as much as two million tons or returned merchandise – much of it undamaged – are landfilled each year.*”

ENVIRONMENTAL SUSTAINABILITY – UTOPIA VERSUS REALITY

One little known fact is that the many retailers sell their returned or excess inventory to 3rd party liquidators which then “re-sell” these products on the secondary market. If the 3rd party liquidators cannot immediately re-sell these products on the secondary market, they often end up being landfilled. Retailers should be concerned about this practice. Proposed environmental “*cradle to grave*” legislation may eventually force retailers to alter their existing disposition practices which will most likely significantly increase operational cost.

SOLUTION: INCREASE MARGINS AND REDUCE LANDFILL COSTS BY UTILIZING NON-PROFIT ORGANIZATIONS

A *Triple Bottom Line* solution (Economical, Social, and Environmental) may be available to both the retailer *and* 3rd party liquidators. Utilizing non-profit organizations can offer measurable cost savings by allowing companies to take up to 200% of the product cost as a tax deduction.

Under the Internal Revenue Code (IRC), donations of appreciated ordinary income property are deductible when contributed by corporations to charitable organizations. The *U.S. Master Tax Guide (2014)*, 930.*Charitable Contributions of Inventory* code allows qualified businesses an enhanced tax deduction for one half of the difference between the cost to produce the product and the full market value of the donated product.

Sample Calculation

Take the sum of one-half of the unrealized appreciation (market value minus cost = appreciation) plus the taxpayer’s cost, but not in excess of twice the cost.

Example:

Selling Price	\$4.00
Cost	\$1.00
Gross Profit	\$3.00
One-half of Gross Profit	\$1.50

The maximum deduction can never exceed two times the cost (\$2.00). The total charitable deduction is now \$2.00 versus only deducting \$1.00 for the product cost.

To expand this example, let's assume a retailer has 80,000 returned garments with a Fair Market Value of \$45.00 and a cost basis of \$12.00. The added additional tax deduction would be \$960,000. At a 35% corporate tax rate, the net effect would be a \$336,000 savings to the company.

<u>Extended FMV</u>	<u>Extended Cost</u>	<u>Difference</u>	<u>Added Tax Deduction</u>
\$3,600,000	\$960,000	\$2,640,000	\$960,000

A company would have to obtain \$6.46/per garment in liquidation in order to justify NOT donating the product.

The "cash" value per item value from the added deduction would be \$4.20/per unit. Based on the current liquidation value of \$ 0.25 to \$ 0.95 per garment, corporations are in effect, "leaving money on the table." In other words, a company just "sold" \$4.20 for \$0.25!

3rd party liquidators can also benefit from this provision. If the documentation for historical secondary fair market value has an established, up to 200% of the cost basis can be taken as a possible tax deduction by donating the product. That would enable the 3rd party liquidator who paid \$0.35 per pound to potentially take \$0.70 per pound as a tax deduction which offers a far greater return than the landfill expense.

These missed tax benefits go unrealized for one or more of the following reasons:

Lack of knowledge of IRS guidelines

CFO's, VP of Corporate Tax, and the Director of Corporate Tax in larger retail companies may not have a working knowledge of the specifics of tax incentives for donating excess product to non-profit organizations that is behind the latest IRS 170e3 provision. Companies are likely to be "risk adverse" to taking these added tax benefits even though these added benefits are available.

Branding Concerns

Fear of protecting the company's brand or image is also a contributing factor for avoiding donating returned products. Corporations sometimes assume that the donated product would be re-sold in one of the national retail modeled non-profit thrift stores. Donated branded product may conflict with agreements and protocol in the retail channels.

Out-Dated Corporate Returns Policies

Limited evaluation is directed to determine the optimal disposition methods for returns, manufacturing overruns, and/or defective packaging or products. A

simple walk-through of a company's distribution centers, manufacturing facilities, and retail store locations will often yield variations in this product disposition process. A formal financial evaluation may yield immediate cost savings.

Historically, non-profit organizations have failed to understand the possible negative impact that donating large amounts of product has on a company. Non-profit organizations have not been proactive in finding solutions to the following concerns:

- ***Product Branding Removal*** – Consumable products like soap, lotion, food, etc., can qualify for enhanced tax deductions although existing packaging may need to be removed or modified. Brand removal services or product recycling may be required for a company to consider donating certain products.
- ***The practice of “re-selling” product*** – Sadly, not all the donated products go directly towards humanitarian efforts. Non-profit organizations often sell the donated product to pay for their expenses. Certain products may only be used for humanitarian aid outside of the U.S. limiting the number of available non-profit organizations that can manage international shipping.
- ***Time and Labor*** – Most manufacturing, distribution centers, 3rd party logistics companies, and individual retail locations have restrictive hourly labor budgets. Logistics and operational consideration need to be addressed which limit added expense.
- ***Liability and End Destination for Product*** – Corporate attorneys who are responsible for mitigating risk and limiting the company's liability may be reluctant to consider donating products to a charity.

EXECUTIVE SUMMARY

In summary, non-profit organizations can be used as viable solutions for product *recycle, repurpose, or re-manufacturing* which can eliminate products from going into the landfill provided the necessary financial paperwork is managed and audit traceable. In addition, managing the branding and operational issues with the non-profit organizations is critical in order to ensure the eventual use of the donated product is consistent with legal and ethical standards.

GTF provides a managed solution which captures the necessary financial data and coordinates the logistical and operational process with the selected 501c3 non-profit organizations. The managed solution provided by **GTF** can be structured at “no-cost”

by working on a contingent arrangement absorbing all the necessary logistics and administrative cost.

There are many upside benefits including cost savings, landfill reduction, and brand control. Added benefits include the environmental and social implications. The upfront work in establishing the necessary processes and controls will have an immediate ROI which can pay dividends for years.

FOR MORE INFORMATION, CONTACT: GARY SCHULER

SCHULERG@SOLUTIONGTF.COM