

**COORDINATED ISSUE  
FOOD INDUSTRY  
CONTRIBUTIONS OF FOOD INVENTORY TO  
CHARITABLE ORGANIZATION**

**A. GENERAL PROVISIONS**

**FACTS**

Company Z, a food processor, finds that it has a quantity of surplus food on hand that is unsaleable for various reasons, such as: expiration of shelf life, misprinting, improper weights, overruns, new products withdrawn from test markets, damaged shipping containers, incorrect dating, etc. Rather than destroy these products and take a complete loss, it ships them to a local charitable organization that distributes goods to the needy. Company Z then takes a contribution deduction on its tax return. The amount of the deduction taken is equal to the basis of the property, plus one-half of the property's appreciated value.

**QUESTION**

Is Company Z entitled to this deduction?

**LAW**

Internal Revenue Code section 170(e)(3) and Regulation section 1.170A-4A specify what a qualified contribution of inventory and other property consists of and also specify the amount to be deducted.

The Code section and Regulations define a qualified contribution as one in which:

1. The property is to be donated to an organization qualifying under section 501 and to be used solely for the care of the ill, the needy or infants.
2. The property is not to be transferred by the donee in exchange for money, 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.

4. In the case where property is subject to the regulations under the Federal Food, Drug and Cosmetic Act, as amended, such property must fully satisfy the applicable requirements of such Act and regulations on the date of transfer and for one hundred and eighty (180) days prior.

The deduction allowed to be taken is equal to the basis for the property, plus one-half of the property's appreciated value. However, in no event may the deduction exceed twice the property's basis.

Revenue Ruling 85-8, 1985-1 C.B. 59, clarifying and superseding Rev. Rul. 83-29, 1983-1 C.B. 65, states that when a corporation donates products to a charitable organization shortly before their expiration date, the amount allowable as a charitable contribution deduction is equal to the unrealized appreciation, not to exceed twice the taxpayer's basis in such property. Final regulations were issued June 19, 1984, relating to charitable contributions of inventory qualifying under section 170(e)(3) of the Code. These regulations are retroactive to contributions made after October 4, 1976, in taxable years ending after that date.

Regulation section 1.170A-1(c)(1) provides that the amount of qualified charitable contributions of property is equal to the property's fair market value reduced as provided in Code section 170(e)(1) (one-half the appreciated value). Regulation section 1.170A-4A (c)(3) requires the donor of inventory qualifying under section 1.170(e)(3) to decrease the cost of goods sold by the amount of basis of the inventory property.

A problem arose where the basis of the contributed property exceeded the fair market value. The entire basis of this contributed property is removed from cost of goods sold, while the charitable contribution is limited to the property's fair market value. It would be more advantageous for the taxpayer to destroy the property rather than contribute it, if the cost exceeded the value. This was not the intent of the statute. The final regulations provide that the taxpayer's cost of goods sold will be reduced by the lesser of the fair market value or the basis of the contributed property. So, the reduction in cost of goods sold can never be more than the charitable contribution amount. The Regulation states:

**1.170A-4A(c)(3) Adjustment to Cost of Goods Sold.**

Notwithstanding the rules of 1.170A-1(c)(4), the donor of the property which is inventory contributed under this section must make corresponding adjustment to cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the contributed item or the amount of basis determined under paragraph (c) (2) of this section.

## **CONCLUSION**

The following items have to be taken into consideration in determining whether or not a deduction is allowed to Company Z.

1. Was the organization that received the donation of food an organization that qualifies under section 501? The examining agent must determine that: the receiving organization qualifies under section 501; the donor received a written statement representing that the use and disposition of the goods is only for the care of the ill, the needy or infants; and that the donee did not transfer the goods in exchange for money, property or services.
2. Did the goods donated satisfy the applicable requirements of the Federal Food, Drug and Cosmetics Act?
3. If the food meets the requirements of the law and the donee is a qualified organization, then the amount of deduction has to be determined. To accomplish this, the following items must be taken into consideration:
  - a. The basis of the property contributed must be verified. Usually the basis is inventory value. This can be cost, or market, whichever is lower, or LIFO cost.
  - b. The appreciated value of the property has to be determined. Appreciated price can be normal selling price; or there may be a discounted price due to the age of the product. There may not be a selling price at all because there is no market for the product such as in the case of new products which are withdrawn from the market. What the appreciated value amounts to is a factual determination that has to be made in order to determine the correct amount of the contribution.
  - c. The proper reduction to cost of goods sold must be made. If the item is a contribution, it should appear as such on the return. The percentage limitations may affect the deductible amount.
4. The examining agent should also insure that the taxpayer is not taking a double deduction by reducing the cost of sales by the amount of the contribution and also taking the entire contribution as a deduction that is reflected on Schedule M-1 as an item for tax purposes not reflected on the books of the company. If all of the above items discussed are favorable for Company Z, then a deduction is allowable.

## **B. COMPUTATION OF DEDUCTION**

### **FACTS**

Company Z contributes excess inventory to a qualified charitable organization as defined in Code section 170(e)(3). It is allowed to take a deduction equal to the basis of the property, plus one-half of the property's appreciated value so long as the deduction does not exceed twice the property's basis.

Company Z computed the value of its contribution of property with a fair market value of \$ 160,000 as follows:

Cost of Property	\$ 100,000
1/2 of Appreciated Value	30,000
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TOTAL	<u>\$ 130,000</u>

In preparing its tax return, Company Z claimed a contribution in the amount of \$ 30,000 and did not reclassify the \$ 100,000 cost from cost of sales to contributions. It took the \$ 100,000 deduction as part of its cost of sales. Its taxable income before the deduction for contributions was \$ 800,000.

### **LAW**

Internal Revenue Code section 170(a)(2) limits the total deduction for any taxable year to 5% of the taxpayer's taxable income computed before deduction for contributions. Effective after December 31, 1981, the limitation is raised to 10%.

### **CONCLUSION**

By allowing the cost of the contributed goods to stay in the cost of sales, the taxpayer is circumventing the limitations imposed by Code section 170(a)(2). The computation of the deduction is shown as follows:

Cost of Goods	\$100,000.00
1/2 of Appreciated Value	30,000.00
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Total contribution	<u>\$130,000.00</u>

**Allowable Contributions:****Taxable Income Prior to Deduction for Contribution**

	\$800,000.00
Limitation %	.10
Limitation Dollar Amount	\$ 80,000.00
Contribution Carryover	\$ 50,000.00

The taxpayer is only entitled to a deduction of \$80,000.00, but by not reclassifying the cost of sales, the taxpayer took a deduction of \$130,000.00. Check this area for this abuse.

**C. PRODUCTION OF OVERRUNS****FACTS**

Company Q is a food processor and one of its divisions is a bakery that enjoys nationwide distribution. In baking bread each day, the baking division prepares batches of dough that will make loaves of bread that exceed the daily requirement by 15%. The reason for the excess is the possibility of failure of some individual batches and increase in demand for bread. Company Q does not discard the excess batches, but bakes and processes them into finished goods. The excess production is then disposed of in the following manner.

1. About 30% is sent to the Company's outlet or thrift store for sale at reduced prices, which approximates the cost.
2. Some 70% is contributed to a qualified charitable organization as defined under Code section 170(e)(3).

**QUESTION**

Can Company Q claim a charitable contribution deduction for the basis of the property (cost) plus one-half of the appreciated value, which is based on the selling price of the bread in the normal distribution channels or is the taxpayer precluded from claiming appreciated value on this excess production?

**LAW**

Code section 170(e)(3) allows a charitable contribution deduction equal to the basis of the property, plus one-half of the appreciated value, not to exceed twice the basis of the property.

**CONCLUSION**

The principal question is whether the contributed bread has an appreciated value? The contributed bread comes from the excess stock which cannot be sold through the normal marketing channels. Since it cannot be sold through such channels, appreciated value for the excess stock does not exist. Thus, the taxpayer is not entitled to claim appreciated value.

**D. REPORTING REQUIREMENTS**

For contributions made after June 6, 1988, reporting requirements for C corporations mandate that Form 8283, Noncash Charitable Contributions, be filed with the tax return. This form provides for a limited appraisal for C corporations with a 170(e)(3) deduction. Regulation section 1.170A-13(c)(4)(ii) and (iv) outline the restricted requirements.

The appraisal summary must document the following on Form 8283:

- 1) Acknowledgment by the donee as described in Regs. Section 1.170A-13(c)(4)(iii);
- 2) The name and taxpayer identification number of the donor;
- 3) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed;
- 4) In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;
- 5) The manner of acquisition (e.g., purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statement to that effect and the approximate date the property was substantially completed;

- 6) The cost or other basis of the property adjusted as provided by section 1016;
- 7) The name, address, and taxpayer identification number of the donee;
- 8) The date the donee received the property;
- 9) For charitable contributions made after June 6, 1988, a statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;
- 10) Include the amount claimed or reported as a charitable contribution deduction.