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## Donation of Food Inventory

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### Overview

In the early years of the income tax, private philanthropy was encouraged by the inclusion of a charitable contribution deduction in the Internal Revenue Code.<sup>1</sup> The original charitable contribution deduction was provided in the War Income Tax Revenue Act of 1917. The present version of the Internal Revenue Code provides a deduction for charitable contributions made within the taxable year.<sup>2</sup> A corporation reporting taxable income on the accrual method is allowed a charitable contribution deduction if the board of directors authorizes the contribution during the year and the contribution is made on or before the 15<sup>th</sup> day of the fourth month following the close of the year.<sup>3</sup>

Charitable contributions of food are provided special rules in the Internal Revenue Code. A recent change in the law makes it easier for farmers to claim charitable deductions for food products donated to charity.<sup>4</sup>

### Charitable Deduction Basics

No charitable deduction is allowed for the contribution of services, although unreimbursed expenditures made incident to the performance of services to a charitable organization may constitute a deductible contribution.<sup>5</sup> Charitable contributions of property require additional computations. The first step in determining the deductible amount is to determine the fair market value of the property. The charitable contribution of property is reduced by the gain which would not have been long-term capital gain had the property been sold at its fair market value.<sup>6</sup> For this purpose, depreciable property and real property used in a trade or business is treated as a

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<sup>1</sup> Unless otherwise stated, all references to a "Section" are to sections of the Internal Revenue Code of 1986, as amended.

<sup>2</sup> § 170(a)(1).

<sup>3</sup> This post year-end deduction is to be made on or before the 15th day of the fourth month after the close of the year. I.R.C. §170(a)(2).

<sup>4</sup> P.L. 114-113, Sec. 113.

<sup>5</sup> Treas. Reg. § 1.170A-1(g).

<sup>6</sup> § 170(e)(1)(A).

capital asset, except for that portion of the gain which is treated as ordinary income under certain recharacterization provisions.<sup>7</sup>

## Charitable Deductions for Food

Unlike contributions of non-food inventory items, the deductibility of the contribution of food inventory is not limited to C corporations.<sup>8</sup> Any form of entity is entitled to the charitable deduction. The food must be apparently wholesome food,<sup>9</sup> the fair market value of which is determined without regard to the internal standards of the taxpayer, a lack of market or similar circumstances, or by reason of being produced by the taxpayer exclusively for the purpose of transferring the food to a qualified charity<sup>10</sup> described below. The fair market value considers the price at which the same or substantially the same food items (type and quality) are sold by the taxpayer at the time of the contribution, or if no sales at that time, in the recent past.<sup>11</sup>

“Apparently wholesome food” has the meaning provided by §22(b)(2) of 42 USC §1791(b)(2). This provision states:

The term “apparently wholesome food” means food that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

Note. The “pull date” is therefore irrelevant to the determination of the fair market value, as long as the quality and labeling standards are otherwise met.

Contributions of food inventory are based upon fair market value, but reduced under a specific provision. For zero-basis inventory of a cash method taxpayer not required to maintain inventories (e.g., a cash method farmer), the charitable deduction under this provision is 50% of fair market value.

The 2015 PATH Act<sup>12</sup> opened up the deduction for cash method taxpayers not required to account for inventories (e.g., farmers) by deeming the tax basis of the apparently wholesome food to be 25% of the fair market value of the food. In this manner, the deduction is fair market value, reduced by one-half of the ordinary income which would have been recognized had the property been sold,<sup>13</sup> and also reduced by an additional amount to the extent that the deduction would exceed twice the tax basis of the property.<sup>14</sup> By deeming the tax basis to be 25% of the fair market value of the food, this second clause (i.e., § 170(e)(3)(B)(ii)) has no effect.

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<sup>7</sup> Treas. Reg. § 1.170A-4(b)(4).

<sup>8</sup> § 170(e)(3)(C)(i)(I).

<sup>9</sup> § 170(e)(3)(C)(i)(II).

<sup>10</sup> § 170(e)(3)(C)(v).

<sup>11</sup> § 170(e)(3)(C)(v)(II).

<sup>12</sup> P.L. 114-113, Sec. 113.

<sup>13</sup> § 170(e)(3)(B)(i).

<sup>14</sup> § 170(e)(3)(B)(ii).

Note. This provision was added for years beginning after 2015. Before the addition of this special provision, a taxpayer holding zero basis inventory received no charitable contribution deduction.

**The Use of the Donated Food.** The charity must use the donated food inventory in furtherance of its purpose or function constituting the basis for its exemption as a charitable organization. The food inventory must be used by the organization solely for the care of the ill, needy or infants. No goods or services may be received in exchange for the donation, and the taxpayer must receive from the donee a written statement representing that its use and disposition of the property will be in accordance with these provisions. The food must satisfy the requirements of the Federal Food, Drug and Cosmetic Act.<sup>15</sup>

### Example 1

Alex, a cash method farmer, raises fruits and vegetables on his five-acre farm. He harvests seasonal products to take to four local farmers' markets, held on different days of the week in the nearby metropolitan area. At the end of the day, he has unsold tomatoes,<sup>16</sup> sweet corn, carrots and radishes. He delivers the unsold fruits and vegetables to the local food bank. Because he is not required to maintain inventories for tax purposes, he has no tax basis in the produce. He may deduct a charitable contribution deduction equal to one-half of his normal sales price, assuming he meets the documentation requirements including receiving a written acknowledgment from the charity that no goods or services were rendered in exchange for the contribution.

**Limitation on the Deduction.** This charitable contribution is subject to special limitations. For a taxpayer other than a C corporation, the limitation is 15% of the taxpayer's aggregate net income for the year from the trades or businesses from which the contributions were made (determined without regard to this charitable contribution).<sup>17</sup> For example, if the only business generating the food to be contributed is the farmer-taxpayer's Schedule F, the limitation is 15% of the Schedule F net income. The other income of the taxpayer, reported on Schedules B, C, E, etc. is not considered. Presumably, if a sale of Schedule F depreciable asset is reported on Form 4797, the gain (or loss) from the sale is considered as part of the Schedule F business income for purposes of this limitation.

The limitation for a C corporation is 15% of taxable income determined without regard to charitable contributions.<sup>18</sup> For other corporate charitable contributions, the 10% of taxable income limitation is reduced (not below zero) by the contributions subject to the 15% limitation.<sup>19</sup> Carryovers of excess contributions are available for each of the five succeeding tax years.<sup>20</sup>

### Example 2

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<sup>15</sup> § 170(e)(3)(A).

<sup>16</sup> Despite the U.S. Supreme Court's ruling in *Nix v. Hedden*, 149 U.S. 304 (1893), holding that tomatoes are vegetables for customs purposes, a tomato is botanically a fruit.

<sup>17</sup> § 170(e)(3)(C)(ii)(I).

<sup>18</sup> § 170(e)(3)(C)(ii)(II).

<sup>19</sup> § 170(e)(3)(C)(iii)(II).

<sup>20</sup> § 170(e)(3)(C)(iii)(I).

Synergy Acres, Inc., a C corporation, raises apples on part of its 2,000-acre farm. It has its own storage and processing plant. The apples are washed, sorted, graded, waxed and boxed to be sold on the fresh market. It ships its apples throughout the United States and to other countries. It donates several boxes of its apples a week to the local mission for the homeless. It determines the fair market value of the donated boxes based upon its sales prices for the grades of apples donated. Even though it has no tax basis in the apples (in accordance with its cash method of accounting, it is allowed to deduct all of the cost of raising the apples),<sup>21</sup> it may deduct as a charitable contribution one-half of the fair market value of the apples donated, limited to 15% of its taxable income (determined before the charitable contribution). Any excess charitable deduction is carried over to the succeeding five years.

### **Conclusion - The Opportunity**

The charitable contribution deduction for apparently wholesome food may be claimed by any type of taxpayer. Owners of fresh product packed for shipping may benefit from this provision, as well as other cash method owners of food inventory, even if that inventory is in excess of the market for that day of the perishable commodity. Cash method farms, including Community Supported Agriculture, now may receive the benefit of a charitable contribution deduction for donating that excess to the local food bank or homeless shelter. This includes the unsold product from the day's local farmer's market. A cash method grower/packer/shipper of fresh fruit or vegetables may also receive an "above basis" charitable contribution deduction.

Accrual method taxpayers including taxpayers required to maintain inventories (e.g. grocery stores), should review the computation to determine the reduction from fair market value to determine the charitable contribution deduction.

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<sup>21</sup> Treas. Reg. § 1.162-12(a); Treas. Reg. § 1.471-6(a).