

# Inventory Overview

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## Reference Notes to Accompany Presentation Slides

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§1.471-1 – “In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see §1.472-1.)” [T.D. 6336, 12/1/58]

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*Wilkinson-Beane Inc. v. Comm'r.*, 420 F.2d 352, 70-1 USTC ¶9173, 25 AFTR2d 418 (1st Cir.)— Taxpayer operated an undertaking establishment and used the cash method, which the IRS disallowed on the basis that the taxpayer's caskets were inventory, which required use of the accrual method in order to clearly reflect income. The taxpayer's argument that the caskets were not merchandise, but merely incidental supplies necessary in performing its personal services, failed. The court interpreted the term, "merchandise" to mean something held for sale. Because the price of funeral services varied with the cost of the casket, the court held that they were merchandise. The court also held that the caskets were income-producing factors because their cost constituted approximately 15% of the taxpayer's receipts. The court also held that use of the cash method did not clearly reflect the taxpayer's income. The taxpayer produced records that showed that over a 5-year span, the difference in gross income between the cash and accrual methods was \$708.

*Knight-Ridder Newspapers, Inc. v. U.S.*, 84-2 USTC ¶9827, 54 AFTR2d 84-6120 (11th Cir.) - Court viewed ink and paper as raw materials. "[I]n our case, where the cost of raw materials for the newspapers was 17.6% of total revenues and the actual sales price accounted for 20% of revenues, we hold that the sale of newspapers was a material income-producing factor. We do not believe the newspaper is any less merchandise because it provides information. Books are classic examples of merchandise requiring the use of inventories, yet their primary value likewise inheres in the message they communicate.<sup>17</sup>

<sup>17</sup> We recognize that books may serve other purposes, e.g., filling empty spaces on one's bookshelf and lending a scholarly atmosphere to the den. Newspapers, however, can also serve residuary purposes, e.g., doubling as kindling for a holiday fire.”

*Surtronics, Inc. v. Comm'r.*, TC Memo 1985-277 - purchase and sale of metals by taxpayer in business of electroplating metals was held to be an income-producing factor, whereas taxpayer contended it was in a service business. Also, because there was no "substantial identity of results" between accrual and cash methods for this taxpayer, taxpayer was not allowed to continue to use the cash method. While the difference in total gross receipts for a 5-year period was only 1.32% less under the cash method than under the accrual method, based on \$18,000,000 of gross receipts over 5 years, the difference was over \$240,000, "a significant distortion."

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*Osteopathic Medical Oncology and Hematology P.C. v. Commissioner*, 113 T.C. 376 (1999),<sup>1</sup> reviewed opinion - The court held that the drugs administered by a medical clinic specializing in chemotherapy and hematology treatments were supplies rather than merchandise. Chemotherapy drugs are pharmaceuticals that may only be prescribed by a doctor and sold by a licensed pharmacist. OM was not a licensed pharmacist and thus, did not (and could not) sell the drugs, but used them only in providing services to patients. OM typically had only a two-week supply of the chemotherapy drugs on hand. OM used the cash method for financial and tax purposes and expensed the drugs as purchased.

Key to the majority's conclusion was that OM did not look like or behave like a typical "merchandiser." That is, OM was prohibited from selling the drugs, it did not display the items as a grocery store would, and the drugs did not play a role in whether or not a customer decided to purchase OM's services. The court did not view OM as "peddling products." Instead, OM was a service business that only provided the drugs to patients as an integral and inseparable part of its services. While OM did separately state the drugs on patient bills, the court noted that this was mostly due to insurance rules. Finally, the majority noted that it was not relevant that the cost of the drugs represented 26% of OM's gross receipts because the "income-producing" factor determination<sup>2</sup> is not applicable if the drugs are not merchandise under §471.

Dissenting judges noted that health care providers do sell goods. While a physician may recommend the drug, patients decide whether or not to receive the drugs. "Moreover, if those patients decide to receive chemotherapy drugs, they want the drugs and nothing in the record (or in common sense) leads me to believe that the drugs are necessarily subordinate to the physician's services."

*RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. 211 (2000), another reviewed opinion - The court held that a provider of concrete foundations and walkways did not have to account for inventory or use the accrual method. The majority viewed RACMP as primarily a service provider and under various laws, including the UCC, was treated as operating under contracts for labor, not for the sale of personal property. The liquid concrete used by RACMP was viewed as a supply because it was used up in providing services to customers. Also, since liquid concrete can't be stored it cannot be considered as "held for sale."<sup>3</sup> The majority also viewed the sand and rock used by RACMP as a supply, rather than inventory, noting that such items lost their "separate identity to become an integral and inseparable part of the real property in the construction activity" just as chemotherapy drugs lost their identity separate

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<sup>1</sup> Similarly, see *Mid-Del Therapeutic Center Inc.*, T.C. Memo. 2000-130. In April 2000, the Service issued Action on Decision 2000-05 acquiescing, in result only, to the *Osteopathic* case (acq. 2000-23 I.R.B. 1149).

<sup>2</sup> In *Wilkinson-Beane Inc.*, 420 F.2d 352 (1st Cir.), the court established a rule that "income-producing factor" is measured by a fraction where cost of the merchandise is the numerator and gross receipts is the denominator. In *Wilkinson-Beane*, the fraction was 15%, which the court concluded made the merchandise an income-producing factor. In TAM 9808003, fractions of 3%, 3% and 6% in three consecutive years led the Service to conclude that the merchandise was *not* an income-producing factor.

<sup>3</sup> The majority also relied on *Galedrige Constr., Inc.*, T.C. Memo. 1997-240, which held that a contractor of asphalt pavements did not have inventory due to the ephemeral nature of emulsified asphalt.

from that of the patient. Also, customers did not want to buy materials from RACMP, thus RACMP was not a merchant.

Dissenting judges noted that while RACMP was in a service-oriented business, it did produce a product, such as a walkway. They also noted that there is no requirement that materials be held for a certain period of time in order to be considered inventory. They also distinguished the *Osteopathic* case where calling the items a supply was clearer because “no product resulted from the administration of drugs into patient’s bodies.” Finally, dissenting judges noted that the majority’s conclusion would lead to wrong results for other businesses that primarily provided services, such as restaurants and dot.com companies that provide the service of being able to shop at home.

*Edward G. Smith v. Comm’r.*, T.C. Memo. 2000-353 - The court found that a business that installed flooring materials (carpet, tile, etc.) was not selling merchandise. The taxpayer did purchase and store the materials needed for each job and customers were charged a markup on the cost of the materials. The court noted that this practice was due to the need to manage the project and that the markup was to cover taxpayer’s services of storing and inspecting the materials.

Important factors leading to the court’s conclusion that Smith was a service provider and not subject to §471 included:

- “The high cost of materials relative to labor costs is insufficient, standing alone, to transform the sale of a service to the sale of merchandise and a service.”
- “Smith Floors is inherently a service provider. Smith Floors’ stock in trade is its expertise in installing flooring materials in a variety of unique applications and petitioner’s skill and craftsmanship in hand-cutting and incorporating specialized designs into flooring materials. The companies contracting with Smith Floors are primarily interested in the firm’s labor and contractual skills.”
- The taxpayer does not manufacture or sell flooring materials; it only purchases materials as needed for a particular job. “Smith Floors’ practice of purchasing the flooring materials for a particular job is incidental and secondary to Smith Floors’ provision of flooring installation services.”<sup>4</sup>

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*Asphalt Products*, 58 AFTR2d 86-5453 (6<sup>th</sup> Cir. 1986) – production of asphalt required taxpayer to use accrual and inventory methods.

*Galedrige Construction Inc.*, T.C. Memo 1997-420 – taxpayer in the business if purchasing emulsified asphalt and laying driveways held to be a service-provider able to use the cash method.

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*Additional inventory reminders:*

- Purchase of inventory only on an "as needed" basis, such as a construction contractor might do, does not matter. Such a taxpayer is still subject to the inventory accounting rules and the requirement to use the accrual method for purchases and sales of inventory (unless the inventory is de minimis). See *J.P. Sheahan Assoc., Inc. v. Comm’r.*, T.C. Memo. 1992-239, which involved a roofing contractor.

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<sup>4</sup> This is one of the rare cases involving the issue of whether a taxpayer had merchandise that did not mention the *Wilkinson-Beane* case. Thus, there was no discussion as to whether Smith charged more to clients who had more expensive flooring materials.

- The fact that a taxpayer is primarily a service-provider does not matter. Such a taxpayer is still subject to the inventory accounting rules (unless the items are supplies, rather than inventory) and the requirement to use the accrual method for purchases and sales of inventory (unless the inventory is de minimis). See *Knight-Ridder Newspapers v. Comm'r.*, 743 F.2d 781, 790 (11th Cir. 1984) [newspaper must use the accrual method even though bulk of revenue was from advertising and provision of information to customers]; *Wilkinson-Beane, Inc. v. Comm'r.*, 420 F.2d 352, 355 (1st Cir. 1970) [undertaker]; and *Surtronics, Inc. v. Comm'r.*, T.C. Memo. 1985-277 [electroplating service also involved transfer of inventory (metals) that was an income-producing factor].

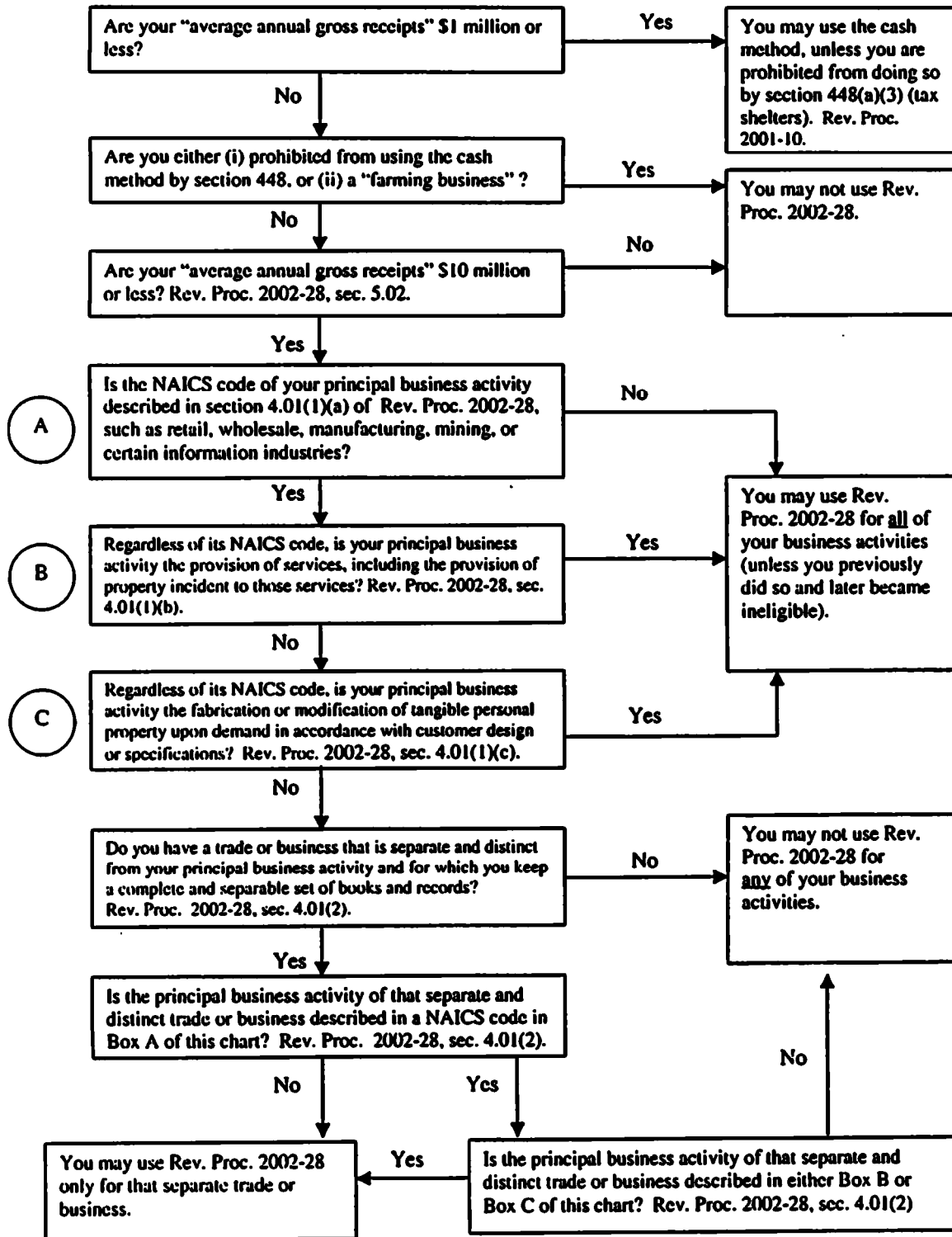
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TAM 9808003, inventory was held to be de minimis because the amount purchased over three years represented 3%, 3%, and 6% of taxpayer's gross receipts. Taxpayer maintained and landscaped lawns for both businesses and homes and used the cash method. The IRS stated that mulch and plants provided to customers constituted inventory.

The IRS National Office referred to merchandise as property transferred to customers. They referred to supplies as property consumed during the provision of services, such as gasoline and oil for the mowers. Given the low percentages, the IRS held that the production, purchase or sale of merchandise was not an income producing factor for the taxpayer. Thus, the de minimis inventory could just be accounted for as the taxpayer would account for supplies.



APPLICATION OF REV. PROC. 2002-28



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*Who is subject to §448:* The following taxpayers may *not* use the cash method or a hybrid method that involves use of the cash method (§1.448-1T(a)(4))—thus, the following entities must use the accrual method:

- A C corporation or a partnership with a C corporation partner, unless the entity (i) meets the definition of a qualified personal service corporation (§448(d)(2) and regulations), or (ii) has not had in any prior tax year, average annual gross receipts for the prior 3-year tax period in excess of \$5 million, or (iii) is a farming business per §448(d)(1).\*\*
- A tax shelter (as defined at §448(d)(3)).

\*\* Exceptions (i), (ii), and (iii) do not apply if the corporation or partnership is a tax shelter.

## *Clear Reflection of Income*

TAM 9723006

- "If a taxpayer is not required to maintain inventories, cash method will generally clearly reflect taxpayer's income unless taxpayer is manipulating the method and such manipulation results in a material distortion of income. See, e.g., *Oakcross Vineyards Ltd. v. Commissioner*, T.C. Memo. 1996-433."
- "[I]n the case of taxpayer that is not required to maintain inventories, failure of cash method to match income and expense does not cause the cash method to fail to clearly reflect income. ... Such mismatching is inherent in the cash method."
- "[I]n the case of a service provider that is not required to maintain inventories, failure of cash method to match income and expenses may not be used as a basis for disallowing use of the cash method. In addition, factors that rely upon such mismatching may not be used as the basis for disallowing use of the cash method. Such factors include the presence of accounts receivable, aging accounts receivable, steadily increasing accounts receivable, and failure of the cash method to comport with Generally Accepted Accounting Principles. Instead, mismatching, including the mismatching caused by accounts receivable, is considered only in the context of the [substantial identify of results test]. See *Asphalt Products, inc. v. Commissioner*, 796 F.2d 843, 849 (6th Cir. 1986); *Hospital Corp. of America*, T.C. Memo. 1996-105; *Thompson Electric, Inc.*, T.C. Memo. 1995-292; *J.P. Sheahan Associates, Inc.*, T.C. Memo. 1992-239."

*Austin v. Comm'r.*, T.C. Memo 1997-157

- IRS had to pay attorney's fees because court found that IRS insistence on having the service business change to accrual method was wrong.
- Taxpayer was sole shareholder of S corp that provided nurses to hospitals and other health care facilities.
- Taxpayer had no inventory, usually received payment from customers within 30 days of billing, and had wages as its major expense.
- IRS argued that cash method did not clearly reflect taxpayer's income because wages are a current deduction, while no accrual is needed for its receipts—thus, income was distorted.
- Interesting observations by the court:
  - IRS cannot require t/p to change accounting method just because IRS considers an alternate method to more clearly reflect taxpayer's income.
  - "The cash method of accounting has a long history of acceptance by Congress."
  - §446 specifically authorizes taxpayers to use the cash method.

- Cash method, by its nature, results in a mismatch of income and expenses. "However, mismatches between expenses and income will over time tend to cancel out provided no attempt is made to unreasonably prepay expenses or purchase supplies in advance."
- The fact that use of the accrual method would increase taxpayer's 1990 taxable income by over \$240,000 "is not, per se, indicative that [taxpayer's] use of the cash method failed to clearly reflect income. ... The best method is not necessarily the one that produces the most tax in a particular year."
- The substantial identity of results test does not apply where a taxpayer has no inventory.

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### *More on LCM and unsalable goods valuation methods*

TAM 9317004

- T, a manufacturer, uses LCM method. In tax year X1, it wrote down and wrote off certain inventory of obsolete or unusable raw materials (RM) and work-in-process (WIP) and a small amount of finished goods (FG), due to the close down of an operating division.
- The inventory written down was actually sold or scrapped in year X2, but was not offered for sale within 30 days following the inventory date.
- T also wrote down to net realizable value, items that could be sold as scrap or modified into usable items. This inventory was never sold through T's normal sales channels.
- Has T had properly complied with rules for LCM and unsalable goods?
- IRS National Office interpreted §1.471-2(c) as meaning that RM and WIP may be valued at a reasonable basis, such goods do not have to be offered for sale within 30 days after the inventory date in order to be written down.
- However, T must satisfy its burden of proving that the goods written down are "subnormal" and were valued using a reasonable method.
- With respect to FG that were written down, IRS ruled that under LCM method, T must value *subnormal* FG using the strict 30 day rule at §1.471-2(c), rather than the offering for sale rule at §1.471-4(b) (which applies if no open market exists, or if goods have been sold at less than current prices in the regular course of business). Any other conclusion would make the 30 day rule at §1.471-2(c) "meaningless."
- T's subnormal FG may only be valued at below market prices if they are offered for sale within 30 days after the inventory date, per §1.471-2(c) and are not to be valued under the rule of §1.471-4(b). However, 30 day rule does not apply to subnormal RM and WIP.

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1. Sole proprietor producing small action figures; GR \$4M; NAICS code is 33
  - a. Has merchandise (something produced and held for sale). Likely also an income-producing factor.
  - b. Too large for RP 2001-10.
  - c. Ineligible code under RP 2002-28 and principal business activity is not the provision of services or fabrication or modification of tangible personal property per customer design.
  - d. Must use accrual and inventory methods.

2. Same except hires third party to produce the action figures.
  - a. Same result.
  - b. Still considered a producer under §263A(g).
3. Sole proprietor developed and sells software online only; NAICS code is 5112
  - a. Arguably, is selling something so has merchandise even though has no inventory on hand (customer makes copy upon purchase).
  - b. Cost of developing software was expensed per RP 2000-50 so numerator of fraction used to determine if it is an income-producing factor is zero and percentage is zero, so seems to fall outside of §471. But, formula for income-producing factor doesn't seem to make sense for this 21<sup>st</sup> century example.
  - c. If customers must pay using credit card to buy, would seem to have same revenues under both cash and accrual. But if delays in paying bills, won't have "substantial identity of results" under cash and accrual, so likely needs to use accrual.
  - d. However, should fall under RP 2002-28 since is not an ineligible NAICS code. However, if were not a small taxpayer, answer would not be that clear as to whether it falls under §471.
4. Sole proprietor operates restaurant; GR \$3M; NAICS code is 72
  - a. Is this like *Osteopathic* and *RACMP* cases – is taxpayer primarily a service provider and not a merchandiser? Probably hard to argue since really looks more like *Wilkinsen-Beane*, *Surtronics* and *Knight-Ridder*.
  - b. Code 72 is not ineligible and since taxpayer is a qualifying small business taxpayer under RP2002-28, should be able to use cash method. If were not a small taxpayer, would likely have to use accrual and inventory methods, but see dissent in *RACMP* case.
5. *Surtronics* today
  - a. Assume gross receipts are \$3 million.
  - b. Per court, taxpayer had merchandise that was an income-producing factor. Assuming that was true, would RP 2002-28 apply?
  - c. Electroplating is in ineligible NAICS code 33.
  - d. However, what if *Surtronics* views its a principal business activity as the provision of services, including the provision of property incident to those services? Will this argument work? Is RP 2002-28 intended to change the result for *Surtronics* assuming it is a qualifying small business taxpayer? Example 11 in RP 2002-28 involves a publisher in ineligible NAICS code 5111 that produces and sells high school and college yearbooks. Per this example, "Taxpayer is not providing a service for purposes of section 4.01(1)(b) because Taxpayer's principal business activity is the production of yearbooks for customers." Is *Surtronics* viewed as primarily providing metal to customers? Arguably, electroplating is not as specialized a service as the service in the *Osteopathic* or *Edwards* cases, however, not just anyone can electroplate an object. Also, unlike *RACMP*, *Surtronics* can hold the metals in inventory.