

# Overview to Tax Accounting for Inventory

---

Professor Annette Nellen

Bus 223F





# IRC and Regs

---

- IRC: §471
- Regulations: §§1.61-3(a), 1.162-3, 1.471-1, 1.471-2, 1.471-3, 1.471-4

# How to talk about inventory

---

- Do I have it?
- Why do I care?
- What is the optimal tax treatment?
- Possible issues





# Chapter 5 Question #1

---

What do we think we know  
before looking at §471?

Are video tapes of a video rental store considered inventory which would require the store to use the accrual method of accounting? Explain.

Explain what tax accounting rules you would use for your video rental store client.

[Rev. Rul. 75-544]



# Why is inventory important?

---

- ❑ Also requires use of accrual method (some exceptions though)
- ❑ Special recordkeeping for measuring EI and COS
- ❑ May need to apply §263A unicap rules
- ❑ Special elections – cost, LCM, LIFO, others
- ❑ Not a capital asset or §1231 asset
- ❑ Usually can't apply installment method
- ❑ May have special treatment under property tax rules

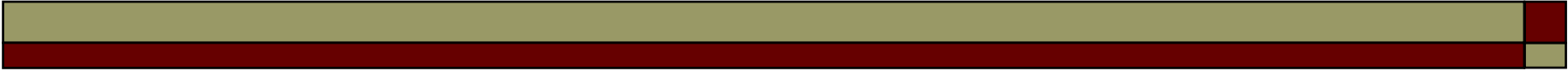


# Accrual method

---

Required:

- ❑ If taxpayer is subject to §448
- ❑ For purchases and sales if taxpayer has mdse that is an income-producing factor
  - §1.446-1(b)(2)(i) – “In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.”
- ❑ If more clearly reflects income compared to cash or hybrid method



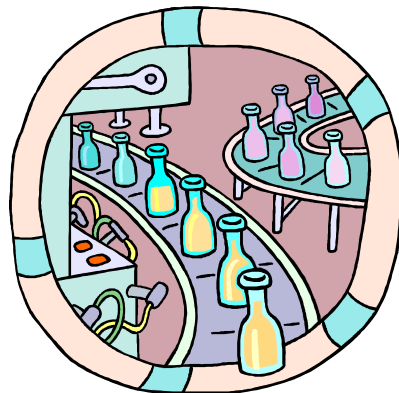
## §448 is not the end of the accounting method questions

---

- If t/p subject to §448, you know it must use accrual method, but still need to determine if it has mdse that is an income-producing factor because if it must account for inventory, then must also consider:
  - Tracking (FIFO, LIFO, etc.)
  - Measuring COS and EI (LCM, cost, subnormal goods writedowns, §263A)

# When must a taxpayer account for inventory?

---





# 1.471-1 Need for inventories

---

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.)

# When must a business account for inventory?

---

- In any case where (i) production, purchase, or sale of merchandise (ii) is an income-producing factor (§471)
  - Unless an exception exists:
    - De minimis
    - Rev. Proc. 2001-10 (small business)
    - Rev. Proc. 2002-28
- Need to define the terms used at §471 and §1.471-1
- §1.446-1(c)(2)(i)— "in any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales"



# Does the business have inventory/merchandise?

---

- This is the first (and longest) question
  - Exceptions (“de minimis,” RP 2001-10, RP 2002-28) only relevant if the business has inventory.
- If no inventory, then apply “normal” rules to determine overall accounting method:
  - §448
  - Clear reflection of income
- Apply §1.162-3 and related guidance to determine if have incidental or non-incidental supplies (assuming business has supplies)



# “Merchandise”

---

- Something held for sale
- Property transferred to a customer even if the transfer occurs in connection with services
  - Caskets of an undertaker (*Wilkinson-Beane*)
  - Newspapers of a publisher (*Knight-Ridder*)
  - Metal used to plate objects (*Surtronics*)
  - Toys in a mechanical skill crane device (TAM 200121006)



# What is NOT inventory?

---

- Supplies:
  - Inventory is something held for sale, while supplies are items consumed in taxpayer's business of providing services
  - Examples:
    - Latex gloves and syringes of a medical clinic
    - Paper and pencils of an accounting firm
    - Uniforms of a uniform rental business if useful life is 1 year or less (if longer life, depreciable) (Rev. Rul. 78-382)



# Supplies or Inventory?

---

1. T enters contracts with customers to wash, replace and fix lighting fixtures regularly. Are lights supplies or inventory?
2. Truck leasing business – are gas, tires, misc truck parts supplies or inventory?
3. Are linens used by linen rental business supplies or inventory?



# More on supplies

---

- NOT always easy to distinguish inventory from supplies
  - Metal of a metal plating company – inventory (*Surtronics*)
  - Shoe polish of a shoe shine business – same answer as *Surtronics*?



## Odd state of law currently - ?

---

- *Osteopathic Medical Oncology and Hematology P.C. v. Commissioner*, 113 T.C. 376 (1999) [Action on Decision 2000-05 acquiescing in result only to the (acq. 2000-23 I.R.B. 1149)]
- *RACMP Enterprises*, 114 TC 211 (2000)
- *Edward Smith*, TCM 2000-353 [student presentation]
- Would *Wilkinsen-Beane* and *Surtronics* be decided the same today?



# What is NOT inventory? 2

---

Real and Depreciable property:

- Assets used in the trade or business with a life over 1 year
- Supplies are items with a useful life of one year or less and thus, are not depreciable.
- Real property is not considered inventory, therefore, it may not be accounted for using the LIFO method (or other inventory rules of §1.471); land is unique (Rev. Rul. 86-149).
  - NOTE: T/P producing real property will still be subject to<sub>8</sub> the UNICAP rules of §263A (is a producer).

# What is NOT inventory? 3

---

Items with peculiar physical properties:

- *Galedrige Construction Inc. v. Comm'r.*, T.C. Memo 1997-420 - asphalt paving contractor acquired emulsified asphalt from a supplier and used it to provide paving services to customers.
  - Emulsified asphalt must be laid within 2 to 5 hours of picking it up or it becomes useless. Taxpayer only acquired such asphalt after it had a job. Taxpayer used cash method and IRS argued it should use accrual method because it had inventory.
  - Court noted that "the authorities in this area are not easily reconcilable."

# Peculiar physical properties – cont'd

- Fact that t/p did not have any EI did not end query. There is a "significant difference between t/p who has no material on hand at the end of year because it was returned to supplier for credit, ..., and t/p who has no material on hand at end of the day because of the ephemeral quality of the material."
- Unlike Knight-Ridder Newspapers, t/p could have no RM on hand.
- Court concluded - physical properties of emulsified asphalt prevented it from being held for sale.
- Because the emulsified asphalt is not mdse held for sale, court did not need to consider whether mdse was an income-producing factor for t/p.
- The “peculiar physical property of emulsified asphalt is a material difference that distinguishes it from roofing materials [*Sheahan*], electrical materials [*Thompson Electric*], and caskets [*Wilkinsen-Beane*]”



# More on defining inventory

---

- Could be intangible (§1.471-1 is silent wrt tangible or intangible)
- TAM 9527003 - IRS ruled that provider of electricity had to use accrual method because electricity was merchandise. Even if under state law, electricity not viewed as inventory, state law not necessarily controlling for federal income tax purposes.
  - “[S]ection 471 and 1.471-1 do not empower the Commissioner to require a taxpayer to maintain an inventory of merchandise. Rather, section 471 and section 1.471-1 empower Commissioner to require a taxpayer to use an inventory method for the property it produces and sells whenever in the Commissioner's opinion the use of an inventory method is necessary to clearly reflect income.”
- Similar rationale likely applicable for software sold online.



# And more on defining inventory

---

- Does not matter if inventory is custom-ordered.
  - “[T]he fact that goods are custom ordered does not change their character as merchandise. Custom-ordered goods are still considered merchandise and, therefore, included in inventory if a taxpayer is required to maintain inventories.”  
[TAM 9848001]
- Does not matter that have no ending inventory (*Sheahan*)
- Does not matter that t/p is primarily a service provider (unless fall under RP 2002-28, §4.01(1)(b))



# More on defining inventory

---

- Rotable spare parts cases
  - Honeywell needed to keep the parts in order to service the mtc contracts – they were assets used in its business.
    - Similar to any other depreciable asset used in the business.
  - HP (Fed Cir) – cost of spare parts not factored into the prices charged to customers for the mtc contracts; instead, depreciation on the parts pool was factored in
  - While passage of title may be needed for a sale to exist, passage of title by itself does not create a sale where facts and circumstances indicate a different result
  - Key activity was service rather than sale of a part
  - Transfer of the parts did not reduce HP's inventory level (since replaced with the broken part)
  
- Q2 – continued relevance of Honeywell & Hewlett Packard cases?



# Title and §1.471-1

---

- “While it could be argued that the "title" clause in 1.471-1 is an absolute and strict prerequisite, and in most situations it is extremely relevant, we believe that the title requirement should not be elevated to the status of an absolute and immutable prerequisite. Clearly, in this case we must look to the **true burdens and benefits of ownership**; and in our opinion, Corp X has satisfied those standards.” [TAM 8510003]
- “We believe that "title" does not control the question of whether X holds inventory or is simply providing a service. Clearly, X is producing b and has a need for an inventory. The language of [§1.471-1] that appears to require title should not be interpreted so as to limit the use of inventories in situations where inventories are needed to accumulate costs in order to reflect clearly taxable income.” [TAM 9233003]
- *Epic Metals*, TC Memo 1984-322 [student presentation]



# How to Account for Supplies

---

## §1.162-3

- incidental supplies may be expensed as acquired
- non-incidental supplies may only be expensed as used
- IRS interpretation of incidental: [TAM 9209007]
  1. Operational sense - incidental to the nature and operation of taxpayer's business
  2. Financial sense - incidental when compared to other financial data of the taxpayer's business
  3. Reg – no records kept



## NOTE – proposed changes to 1.162-3

---

- Proposed regs under §263(a) on amounts paid to acquire, produce or improve tangible property (REG-168745 (3/10/08))
- More specific (and longer) than current reg
  - Also addresses rotatable spare parts
- Also defines materials and supplies
  - Tangible
  - Generally, has an economic useful life of 12 months or less (or other options)



# Considerations – Mdse. vs. Supplies

---

- Review cases and rulings
- Is t/p selling “something”?
- Is primary activity (a) “peddling” products or (b) providing a special service? (if both, likely have mdse) What is the objective of t/p’s business
  - EX – laying asphalt vs producing asphalt
- Is treating t/p as having inventory a better way to accumulate costs to clearly reflect income?
- Substance over form, and facts are important considerations



## 2<sup>nd</sup> - Is the mdse an income-producing factor?

---

This is the second question because if the merchandise is not an income-producing factor, §1.471-1 n/a regardless of whether or not the t/p is “small” per RP 2001-10 or RP 2002-28.

[If no mdse, don't need to answer this question.]

# “Income-producing factor”

---

- Per *Wilkinson-Beane* – use this fraction:

$$\frac{\text{cost of the merchandise}}{\text{gross receipts}}$$

- *Wilkinson-Beane* fraction was 15% and court concluded the merchandise was an income-producing factor
- TAM 9808003, fractions of 3%, 3% and 6% in 3 consecutive years led IRS to conclude that merchandise was *not* an income-producing factor
- No % has ever been specified as the minimum to make merchandise an income-producing factor



# Example - TAM 9848001

---

IRS National Office held dentist could continue to use the cash method because merchandise (crowns, bridges and dentures created by third party dental lab) was de minimis and there was no evidence that dentist had manipulated or intentionally delayed collecting receivables.

IRS noted that crowns, bridges, and dentures were merchandise (rather than supplies). It did not matter that they were custom-ordered, and it did not matter that there were no items on hand at year end because the items were only ordered as needed.

IRS did not specify the dentist's ratio of merchandise to sales.



## Third Question – “Small Taxpayer”

(relevant if t/p has mdse that is an income-producing factor)

---

### Does Rev Proc 2001-10 apply to taxpayer?

- YES – may treat mdse as supplies and use cash method
- NO – does RP 2002-28 apply?
  - YES – may treat as supplies and use cash method
  - NO – use accrual unless there is substantial identity of results with the cash method (tough standard)

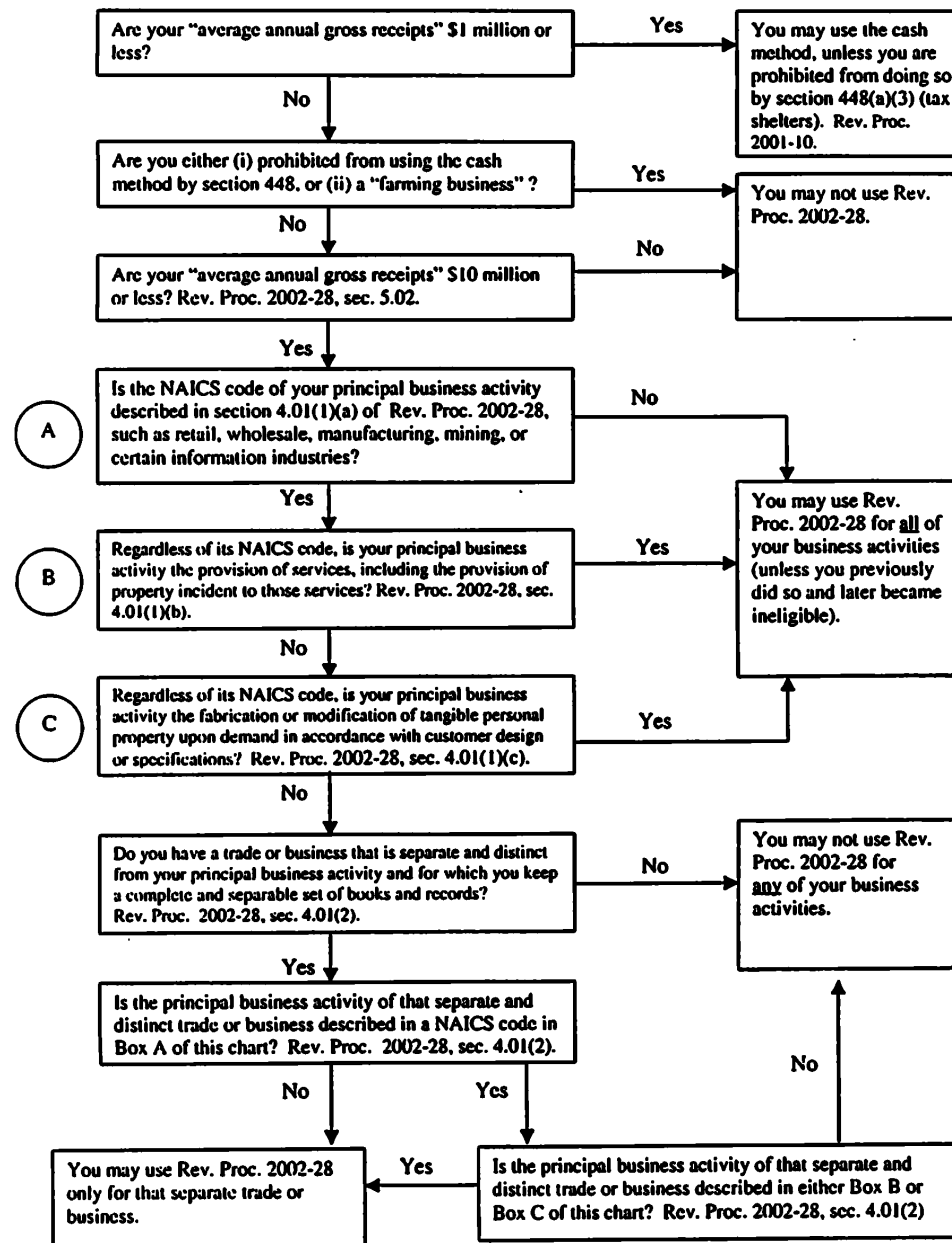


# Rev. Proc. 2001-10

---

- For t/p with avg annual GR in prior 3-year period of \$1 million or less
- Excepted from requirement to use accrual and inventory methods. Instead may..
  - Use cash method
  - Treat mdse as non-incidental supplies (§1.162-3)
    - Treat mdse as consumed and used in year in which t/p sells the merchandise or finished goods (or in year t/p actually pays for the mdse, if later).
    - Producers may use any reasonable method of estimating amount of raw materials in their year-end work-in-process and finished goods inventory to determine amount of raw materials used to produce finished goods sold during the tax year, provided that method is<sup>32</sup> used consistently.

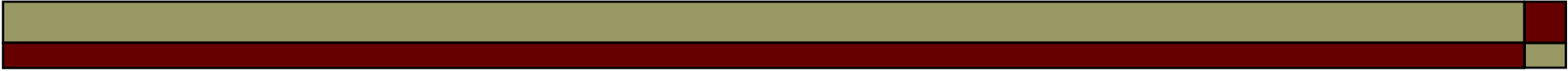
APPLICATION OF REV. PROC. 2002-28



Flowchart from  
Rev. Proc. 2002-28

T/P must be a  
“qualifying small  
business t/p”:

- avg annual GR of \$10M or less
- not prohibited from using cash method under §448



# Rev. Proc. 2002-28 Example 5

---

- Sole proprietor plumbing contractor
  - 60% business is installation; 40% sales in store
  - Avg annual GR in prior 3-years \$7 million
  - Principal business activity is installation (NAICS #23)
    - #23 is not an “ineligible” code
  - May use cash method for entire business operation
  - May treat mdse as non-incidentals supplies
  - If were C Corp, would be required to use accrual per §448 and inventory rules



## Chapter 5 Question #8

---

- Provide 2 examples of companies that fall under RP 2002-28.

## Q4 - “Substantial Identity of Results” (a very high standard to meet)

---

- *Wilkinson-Beane*: "The standard we apply is whether taxpayer's method reflects his income with as much accuracy as standard methods of accounting permit. This means taxpayer must demonstrate substantial identity of results between his method and method selected by the IRS. This he has failed to do. **The fact that over a 5 year period the difference in totals was less than two-tenths of 1%, apart from being purely fortuitous, is immaterial.** Federal taxation is keyed to a system of annual accounting. ... regardless of accuracy of taxpayer's cash method in the past, there is no guarantee that the stability of sales, costs, collections, and other factors which make for that result will continue in the future. Hence, even if a taxpayer may avoid the imposition of the full accrual system, despite the presence of §471 inventories, by showing that his method reflects income clearly, the standard it must satisfy is extremely high."

# If no inventory – what overall method?

---

- If t/p subject to §448, must use accrual
  - (not cash or hybrid)
- If t/p not subject to §448, may use cash if it clearly reflects t/p's income.
  - See rulings mentioned in handout as examples of this standard (TAM 9723006 and *Austin*)



# Review – Inventory or Service?

## Chap 5 - Question 6

---

- Silk screening t-shirts?
  - Similar to TAM 92230003 and 92330003
  - Mdse – yes, something is held for sale
  - Producer – if add utility to products
    - Similar to situations (1) and (2) in RR 81-272



# Rev Rul 81-272

---

- Examples of producers for 1.471-11 purposes:
- (1) T sells printed towels. T purchases white towels and contracts with unrelated party to furnish the dye work and design work. T has title to the towels at all times. When dye work and design work are completed T stores, packages, and markets the towels.
- (2) same as (1), except that unrelated contractor, in addition to dyeing and designing the towels, also stores, packages, and distributes the finished product to T's customers.



## Situations with no production

---

- (3) Taxpayer is the unrelated party in *Situation 1* that furnishes the dye work and design work for the white towels. Taxpayer does not have title to the towels.



# Add'l examples of produce

---

## □ Rev Rul 79-339

- T incurs labor and overhead costs to transform surplus vessels, wrecked automobiles, and other scrap metals into more readily marketable scrap materials.
- T is a producer under 1.471-11

## □ PLR 9108053

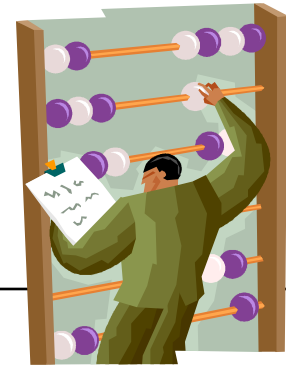
- Blending an additive into gasoline = manufacturing

# Accounting for inventory:

~ Tracking/Pricing

~ Valuation

- 
- Unsalable goods
  - Lower-of-cost-or-market versus cost
  - Shrinkage
  - §263A





## §1.471-2. Valuation of inventories

---

### [Question #3]

(a) Section 471 provides two tests to which each inventory must conform:

- (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and
- (2) It must clearly reflect the income.



# Tracking/Pricing

---

- LIFO only available if:
  - Election made (Form 970 and §472 and regs)
  - Simplified LIFO for small businesses (§474 – avg annual gross receipts for prior 3 years \$5M or less)
  - Also use for financial statements
  - Valuation must be at cost (LCM not available)
- Generally, FIFO presumed
- Could also use specific identification if appropriate (such as items of inventory with separate invoices per each item – auto dealer, jeweler, etc.)

# Common Valuation Methods

---

- ❑ Cost - see §1.471-3
- ❑ LCM - see §1.471-4
- ❑ Are methods of accounting
- ❑ Must also consider §263A, which also involves methods of accounting



# Cost means ... (§1.471-3)

- 
- BI – inventory price of such goods
  - Purchases:
    - invoice price
    - - trade discounts (but not necessarily cash discounts)
    - + transp or other necessary charges incurred in acquiring possession of the goods
    - + §263A amounts
  - Production:
    - (1) cost of raw materials and supplies entering into or consumed in connection with the product,
    - (2) direct labor, and
    - (3) indirect production costs incident to and necessary for the production of the particular article, including an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit (see §263A and regs)
  - Cost shall not include an amount which is of a type for which a deduction would be<sub>46</sub> disallowed under section 162(c), (f), or (g)



## Chapter 5 – Question 7

---

- How should a manufacturer treat cash discounts and trade discounts received on purchases?
- NOTE:
  - Cash discounts – have choice of methods
  - Trade discounts – must be factored into cost of goods



# Trade Discounts

---

- “[R]epresent adjustments to purchase price granted by a vendor. If a discount is always allowed irrespective of time of payment, it is a trade discount. ... Rev. Rul. 84-41. ... From the standpoint of seller, trade discounts reduce sales prices, and cash discounts or rebates offered for prepayment, a specified volume of purchases, etc. are treated as section 162 deductions.” [FSA 1999-998]
- “Service defines trade discounts as reductions to purchase price granted by a vendor, which vary depending upon volume or quantity purchases. Rev. Rul. 84-41. If allowance is contingent upon performance of services by purchaser, allowance is not a trade or other discount. ... Any reduction in purchase price representing compensation for services performed, or to be performed, or as a reimbursement of an expenditure is not a trade or other discount. ... If an allowance is a trade discount, it represents a reduction in purchase price and not an accession to wealth requiring inclusion in gross income under §§61 and 451. ... Whether an allowance<sup>48</sup> is a trade discount is a question of fact.” [FSA 199915011]



# Cash Discounts

---

- §1.471-3 – “may be deducted or not at the option of the taxpayer, provided a consistent course is followed”
- May account for them using:
  - Net invoice method
  - Gross invoice method
  - Are methods of accounting (automatic change possible under RP 2002-9) [Rev. Rul. 73-65]



# Market

---

- For both resellers and manufacturers, "market" = replacement price.
- "Generally, applicable price should be in the particular market in which taxpayer normally purchases comparable goods, in the same quantities normally purchased by the taxpayer. ... "Bid price" of purchased goods under normal conditions is the replacement cost - i.e., the cost to taxpayer to acquire goods of comparable quality in quantities normally purchased by taxpayer. In case of a manufacturer or processor, "market" means the bid price prevailing on the inventory date for the components of cost - materials, labor, and burden." [TAM 9121003]

# Example from regs

---

- X manufactures tractors and values its inventory using LCM.
- At y/e, cost of one of X's tractors on hand is determined as follows:
  - Direct materials..... \$3,000
  - Direct labor..... 4,000
  - Indirect costs under 263A..... 3,000
  - Total 263A costs (cost)..... \$10,000
- X determines that aggregate of the current bid prices of materials, labor, and overhead required to reproduce the tractor at y/e are:
  - Direct materials..... \$3,100
  - Direct labor..... 4,100
  - Indirect costs under 263A..... 3,100
  - Total section 263A costs (market)..... \$10,300
- Per LCM method X values the tractor at \$10,000.

# More on LCM

---

- §1.471-4(c) – “market value of each article on hand at inventory date shall be compared with cost of the article, and lower of such values shall be taken as the inventory value of the article”
  - Groupings and estimates not allowed:
    - *Thor Power Tool Co. v Comm'r*, 43 AFTR 2d 79-362 (S Ct 1979)
    - *Rockwell Int'l Corp. v Comm'r*, 50 AFTR 2d 82-6103 (3rd Cir. 1982)
    - *The Tog Shop, Inc. v U.S.*, 65 AFTR 2d 90-390 (DC Ga. 1989) [student presentation]
    - Rev. Rul. 77-364



## Chapter 5 Question #4

---

What are possible justifications for repealing the LCM method?



# Thor & Question #5

---

GAAP v tax accounting – what does  
Thor case tell us?



# Unsalable Goods - 1

---

- §1.471-2(b) – applies whether t/p has adopted cost or LCM valuation method
- Must show that goods are “unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes”



## Unsalable Goods - 2

---

- “Value at bona fide selling prices less direct cost of disposition”
- “If such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value.”
- “Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date.”
- T/P “shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.”



# Shrinkage - §471(b)

---

- A method of determining inventories shall not be treated as failing to clearly reflect income solely because it utilizes estimates of inventory shrinkage that are confirmed by a physical count only after the last day of the taxable year if—
  - (1) the taxpayer normally does a physical count of inventories at each location on a regular and consistent basis, and
  - (2) the taxpayer makes proper adjustments to such inventories and to its estimating methods to the extent such estimates are greater than or less than the actual shrinkage.

[Added by the Taxpayer Relief Act of 1997. Also see RP 98-29.]



# §263A Basics

---

- Applies to
  - Real or tangible personal property produced by t/p
  - Real or personal property (§1221(a)(1)) acquired by t/p for resale
- Provides guidance on what costs are to be included in inventory (if the property is inventory) or capitalized to basis (for non-inventory)
  - DM, DL and indirect costs and perhaps interest expense

# Exceptions relevant to small businesses

---

- Small producer
  - Total indirect costs  $\leq$  \$200,000 and simplified production method adopted (§1.263A-1(b)(12) and §1.263-2(b)(3(iv)))
- Small retailer
  - T/p acquires real or personal property for resale and has average annual gross receipts for prior 3-tax year of \$10 million or less (§263A(b)(2))
  - Exception also exists for de minimis production activities of small retailer that are incident to its resale activities (§1.263A-3(a)(2))



# Practice Points

---

- Does business have merchandise? If yes, is it an income-producing factor?
- No – consider how supplies to be treated, what overall accounting methods applies (does §448 apply)?
- Yes – is it (a) de minimis, (b) does RP 2001-10 apply or (c) does RP 2002-28 apply?
  - NO – accrual and inventory rules
  - YES – treat mdse as supplies and cash method possible; recheck each year for application of exceptions
- If wrong method – need to change to proper method – see RP 2008-52 and RP 97-27



## Chapter 5 – Question 9

---

- Possible book-tax differences a manufacturer is likely to have wrt inventory.



# Question – Must t/p account for inventory?

---

1. Sole proprietor producing small action figures; GR \$4M; NAICS code is 33



# Must t/p account for inventory?

---

2. Same except hires 3P to produce the action figures.



# Must t/p account for inventory?

---

3. Sole proprietor developed and sells software online only; NAICS code is 5112

(similar to case study (c) on Ostrich Software)



# Must t/p account for inventory?

---

4. Sole proprietor operates restaurant; GR \$3M;  
NAICS code is 72



# Must t/p account for inventory?

---

5. Surtronics in 2009