When Inventory Must be Maintained For A Small Business

FEBRUARY 5, 2009

BE IN A POSITION OF STRENGTH

IRC Sec. 471(a) requires the use of inventories whenever necessary to clearly determine income. Beginning and end of tax year inventories are necessary whenever the production, purchase, or sale of merchandise is an income-producing factor. In general, when inventories are required, the accrual method of accounting must be used. However, there are exceptions to this rule. One such exception applies to certain small businesses.

Special Rules for Certain Small Businesses

In Rev. Proc. 2001-10, the IRS announced that small businesses with average gross receipts of $1 million or less are **excepted from the requirement to maintain inventories** or account for inventory costs under IRC Sec. 263A. Qualifying taxpayers that choose not to maintain inventories must treat merchandise on hand at the end of the tax year in the same way as materials or supplies. A taxpayer is permitted to deduct materials or supplies actually consumed and used in operations during the year. In essence, the taxpayer must determine the cost of materials and supplies (other than incidental materials and supplies) on hand at the end of its tax year. That cost cannot be deducted in the current year but must be carried forward and deducted in the tax year when the materials or supplies are consumed.
Further relief was granted from the use of the accrual method to certain small businesses. Qualifying taxpayers having annual gross receipts of more than $1 million, but less than $10 million, may convert to and **use the cash method of accounting**. Qualifying small businesses are those that are not prohibited from using the cash method of accounting under IRC Sec. 448. Since IRC Sec. 448 precludes the use of the cash method of accounting by C corporations with more than $5 million of gross receipts, this procedure is not available for such C corporations. Also, corporations with gross receipts of $5 million or less, C corporations in the farming business, and personal service corporations already qualify to use the cash method of accounting under the provisions of IRC Sec. 448.

CERTAIN SMALL BUSINESSES ARE EXCEPTED FROM MAINTAINING INVENTORIES.

Questions or comments?

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Therefore, the relief applies only to C corporations with gross receipts of $5 million or less (and greater than $1 million) that would otherwise be required to use the accrual method because inventory is a material income producing factor. However, qualifying under these circumstances may be difficult since mining, manufacturing, retail, wholesale, and information producing businesses do not qualify for the $10 million exception. Nevertheless, a C corporation that does not fall into one of these business categories, has gross receipts of more than $1 million and less than $5 million, and has inventory that is a material income producing factor, can use the cash method of accounting.

Qualifying businesses that elect to switch to (or start out using) the cash method have the option of not following the normal Section 471 inventory accounting rules. Instead, inventory on hand at the end of the year is treated in the same manner as material or supplies that are not incidental. This means the taxpayer has to quantify it and deduct the cost in the later of (1) the year the item is sold or consumed in the process of providing services to a customer, or (2) the year the taxpayer pays for the item. Any reasonable method may be used to determine the amount of the allowable deduction (such as first in, first out or average cost), provided the method is used consistently. For this purpose the last in, first out (LIFO) method is not considered a reasonable method.

If you have any questions, please contact the WS+B tax department. *#308*

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