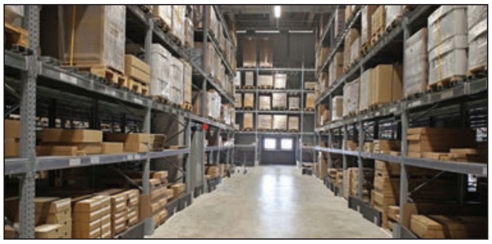

TAX YEAR
2019

Inventory/ Cost of Goods Sold

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Inventory

An inventory is necessary to reflect gross profit when the production, purchase, or sale of merchandise is an income-producing factor. However, if an inventory is necessary to account for your income, you generally must use and accrual method of accounting for sales and purchases, unless you are a small business taxpayer.

Small business taxpayer. You are a small business taxpayer if you have average annual gross receipts of $25 million or less for the prior three tax years and are not a tax shelter.

Method of accounting. All taxpayers must use a method of accounting for inventory that clearly reflects income. If you choose not to keep an inventory, you will not be treated as failing to clearly reflect income if your method of accounting for inventory treats inventory as non-incidental material or supplies, or conforms to your financial statement treatment of all inventories.

Cost of Goods Sold

If a business manufactures products or purchases them for resale, some expenses are included in figuring cost of goods sold (COGS). Expenses includable in COGS are not deductible until the item is sold, even if the business qualifies to use the cash method of accounting. The following are examples of expenses that go into figuring COGS.

- The cost of merchandise and products that are resold to customers.
- Raw materials and supplies that physically become part of a product, including the cost of having them shipped to the taxpayer, but not the cost of shipping the finished product to customers.
- The cost of storing the products until sold.
- Direct labor costs, including contributions to retirement plans, for workers who produce the products (manufacturing business), but not the cost of labor in a wholesale or retail business (buying and selling products).
- Indirect costs such as factory overhead expenses if the taxpayer is subject to uniform capitalization rules (UNICAP).

The cost of goods sold deduction is calculated as follows.

- Value of inventory at beginning of the tax year, plus
- Purchases and other costs during the year, minus
- Value of inventory at the end of the tax year.

Inventory Valuation Methods

The taxpayer must have a method for identifying and valuing the items in inventory. One of the following methods is generally used.

Specific identification method. For example, a car dealership can identify specific inventory items and match them with specific cost invoices. If the specific identification method cannot be used, FIFO or LIFO is generally used.

First-in first-out (FIFO) method. The FIFO method assumes that items purchased or produced first are the first items sold, consumed, or otherwise disposed of. Items in inventory at the end of the tax year are matched with costs of similar items that were most recently purchased or produced.

Last-in first-out (LIFO) method. The LIFO method assumes that items of inventory purchased or produced last are the first items sold, consumed, or otherwise disposed of. LIFO rules are complex. IRS approval is required and may be obtained by filing Form 970, *Application to Use LIFO Inventory Method.*

Inventory/ Cost of Goods Sold

Materials and supplies. Unless a deduction was claimed in a previous year, the cost of materials and supplies is generally deductible when actually consumed and used during the tax year. If items that would normally be required to be included in inventory are treated as materials and supplies, the cost is deductible in the year the inventory item is sold, or the year the materials and supplies are paid for, whichever is later.

If incidental materials and supplies are kept on hand, the cost of these is deductible at the time of purchase if:
- A record of when they are used is not maintained,
- An inventory of the amount on hand at the beginning and end of the tax year is not kept, and
- Deducting the costs in the year of purchase does not distort income.

Valuing Inventory

The following methods are available for valuing inventory.

Cost method. The cost method values ending inventory with the invoice cost of similar items, plus other direct and indirect costs that are required to be added to inventory. The FIFO cost method takes the invoice price of similar items most recently purchased and applies that price to the quantity of items on hand at the end of the year.

Lower of cost or market method. This method compares the market value of each item on hand with its cost at the time inventory is taken. The lower of the two is the value of inventory. If there is a drop in the current price of items that are similar to items remaining in ending inventory, the cost of goods sold deduction will be higher using the market value rather than cost to value ending inventory. The lower of cost or market method is not allowed for LIFO, or for goods that will be delivered at a fixed price on a firm sales contract.

Retail method. The total retail selling price of goods on hand at the end of the tax year is reduced to approximate cost by using an average markup expressed as a percentage of the total retail selling price.

Goods that cannot be sold. Goods that cannot be sold at normal prices or are unusable in the usual way because of damage, imperfections, shop wear, changes in style, odd or broken lots, or other similar causes should be valued at their bona fide selling price minus direct cost of disposition no matter which method is used to value the rest of the inventory.

Physical inventory. A physical inventory must be taken at reasonable intervals, and the book amount for inventory adjusted to agree with the actual inventory.

Loss of inventory. A casualty or theft loss for inventory that is shoplifted, broken, spoiled, or otherwise lost during the year is taken through the increase in the cost of goods sold deduction. An additional deduction for a casualty or theft loss is not allowed. Any insurance or other reimbursement received for the lost inventory is reported as taxable income.

If the casualty loss is due to a federally declared disaster, the taxpayer can choose to deduct the loss as a casualty loss on the return for the immediately preceding year. If the taxpayer chooses this approach, decrease opening inventory for the year of the loss so the loss will not show up again in inventory.

Uniform Capitalization Rules (UNICAP)

Under the uniform capitalization rules a business must capitalize the direct costs and part of the indirect costs for production or resale activities. For purposes of calculating the cost of inventory, a business subject to UNICAP must add a portion of indirect costs to the direct costs that make up inventory. These costs are then recovered through the cost of goods sold deduction rather than as a current deduction.

Activities subject to UNICAP rules. Any trade or business that:
- Produces real or tangible personal property, or
- Acquires property for resale with average annual gross receipts of more than $26 million (2019).

Note: Exceptions apply.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:
- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.