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Tax aspects of inventories

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The Tax Aspects

Why should there be a continuing interest in the techniques of valuing inventories? The simple answer is that "inventory" is one of the most important factors in the existence of any business. It accounts for a large part of the company's investment in assets, and it is usually the largest single cost on the income statement. It is important, therefore, to know what is an "acceptable" inventory for tax purposes; what the Internal Revenue Service is doing in this area to insist that taxpayers follow accepted rules; and what the courts have said about the subject.

"Inventories" is a subject that is too often taken for granted, insofar as income taxes are concerned. That is, "good" accounting dictates what to do and *we* naturally follow along for tax return purposes, accepting the book inventory as correct for tax purposes with no further thought given to this item. But how many people, and especially those responsible for tax planning and tax returns, have become involved in the technical tax rules? These rules are discussed in the following paragraphs, and their implications analyzed.

THE TAX LAW — SECTION 471:

Perhaps the natural starting point is a glance at the law on this subject, since in the final analysis this will dictate the acceptability of an inventory for tax purposes, and will also enable an appreciation of the "problems" involved. This very brief "law" is Section 471, the General Rule for Inventories:

> "Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

This one sentence is then "interpreted" by the IRS in several pages of Regulations, and in greater detail than the basic law itself.

The basic law contains *two* tests to which every inventory must conform:

First, it must conform as nearly as possible to the best accounting practice in the trade or business, and

Second, it must clearly reflect income.

It follows, then, from the first test that inventory rules cannot be uniform but must follow trade customs within the scope of the best accounting practice in the particular trade or business.

The second test, the clear reflection of income, requires that the inventory practice of a taxpayer be consistent from year to year. Consistency, however, is not sufficient as a test if, in other respects, the inventory fails "clearly to reflect income." Consistency in turn has three aspects:

1. Consistency in the method or basis used from year to year;

2. Consistency in the method or basis applied as to all items in one inventory; and

3. Consistency in the method used in the opening and closing inventories of the taxable year.

Thus, inventories must be calculated according to acceptable accounting practices and must *also* clearly reflect income.

The regulations, in explaining the basic law, indicate that the most common inventory valuation methods are cost and cost or market, whichever is lower. These terms are then defined as follows:

"Cost" in regard to "normal" inventory is defined in three different ways:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods;

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(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods; and the most difficult area of determination —

(3) In the case of merchandise produced by the taxpayer since the beginning of the year: (a) the cost of raw materials and supplies entering into or consumed with the product, (b) expenditures for direct labor, and (c) indirect expenses incident to and necessary for the production of the particular article, including a reasonable proportion of management expenses, but not including any cost of selling or return on capital.

This last definition makes it pretty clear, then, that a manufacturing operation is required to consider factory overhead in inventory valuation.

Under the cost or market method, whichever is lower, the market value of each item, or group of items, of inventory on hand is compared with "cost" and the lower amount is taken as the inventory value. This is probably the most common method of valuation and allows a deduction for loss in inventory values prior to sale. The regulations define market (under ordinary circumstances) as the current bid price prevailing at the inventory date in the quantity usually purchased by the taxpayer. It applies to goods purchased and goods produced and includes the basic elements of cost—materials, labor and factory overhead.

The above definitions are applicable to the "normal" quantities of goods still being manufactured and sold, as opposed to damaged goods, excess quantities and obsolete items. This latter area is the one which gives the auditors headaches, and which perhaps offers the IRS the greatest potential in inventory adjustments. Here again the regulations spell out the ground rules.

Insofar as finished goods are concerned, if they are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style (obsolete) or other similar causes, they should be valued at "bona fide" selling prices less direct cost of disposition, whether using the cost, or the lower of cost or market method. Raw materials and work in process should be valued at a price which considers the utility and condition of such goods. In no event should the inventory components be valued at less than their scrap value. With regard to valuing inventory at selling price, less cost to sell, it is required that such goods must be offered for sale at such price within thirty days after the inventory date. Further, the taxpayer has the burden of showing that the write-downs of inventory are caused by the reasons indicated previously, and must maintain records to show the disposition of the goods at the prices used in the inventory calculation.

The tax regulations go one step further and also indicate practices that are not allowable:

1. Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof;
2. Taking work in process or other parts of the inventory, at a nominal price or at less than its proper value;
3. Omitting portions of the stock on hand;
4. Using a constant price or nominal value for so-called normal quantity of materials or goods in stock;
5. Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

The above summarizes the tax rules that should be followed by the IRS in verifying an inventory. But why all the concern, if, historically, the IRS has not shown much interest in the area of inventories?

Donald I. Hausman, tax manager in the Chicago office, joined Touche, Ross in 1955 after receiving a B.S. degree in accounting from the University of Illinois and later attended DePaul University where he became a Juris Doctor (Law). A lecturer on taxation at DePaul's Graduate School of Business, Mr. Hausman serves as chairman of the Taxation Committee of the Illinois Society of CPA s and is also a member of the American Institute of CPA s and the Illinois State Bar Association.

RECENT HISTORY:

Prior to 1961, the IRS usually avoided a detailed or "in depth" review of inventories during a tax examination. The theory behind this was that, so long as tax rates didn't vary greatly from year to year, any adjustment to inventory would merely "switch" income from one year to the next. However, increased interest in this area culminated in President Kennedy's Tax Message to Congress in April of 1961. Highlights of this message were as follows:

> "It is increasingly apparent that the manipulation of inventories has become a frequent method of avoiding taxes. Current laws and regulations generally permit the use of inventory methods which are acceptable in recognized accounting practice. Deviations from these methods, which are not always easy to detect during examination of tax returns, can often lead to complete nonpayment of taxes until the inventories are liquidated; and, for some taxpayers, this represents permanent tax reduction. The understating of the valuation of inventories is the device most frequently used. I have directed the Internal Revenue Service to give increasing attention to this area of tax avoidance, through a stepped-up emphasis on both the verification of the amounts reported as inventories and on examination of methods used in arriving at their reported valuation."

Secretary of the Treasury Dillon, in May of 1961, then explained that two types of deviations particularly bothered the Treasury:

1. Improper application of the lower of cost or market rule, and
2. Understatement of inventory by not including therein a proper count of all inventory items.

These remarks were then followed up by:

1. A change in business tax returns to include a detailed questionnaire regarding inventory practices, and
2. Several announcements from the IRS:
   (a) TIR (Technical Information Release) 317 (May 5, 1961) indicated that examining agents have been instructed to place increased emphasis on inventory reserves, valuation methods, omission of inventory items, and allocation of costs.
   (b) This was followed in January of 1962 by TIR 354, in which Commissioner Caplin again reminded taxpayers of the increased emphasis that will be placed on inventory valuations and methods. He stated further that if the inventory question on the 1961 business tax return regarding cost and market of items valued at market was not answered, then the particular return may be selected for audit.
   (c) In March of 1962, TIR 367 was issued. This explained the manner in which the inventory question appearing on tax returns should be answered. This TIR ended with the following statement:

   > "The Service also emphasized that, while the answers to the inventory questions will be considered in selecting returns for examination, taxpayers who have properly valued their inventories need have no cause for concern."

There have been no further IRS pronouncements on increasing the audits of inventory. In addition, the detailed inventory questions no longer appear on tax returns.

What is the significance of this apparent lack of interest by IRS in the inventory area? Perhaps some guidance can be obtained by reviewing recent developments.

RECENT DEVELOPMENTS:

In view of the increased emphasis placed on inventories in 1961, businessmen were required to determine whether their inventories complied with the IRS rules. Were they consistent in their practices? Did they conform with the best accounting practices in their trade or business? If the answer to either of these questions was or is *no,* what does it mean? That is, was the inventory practice "incorrect," and if so, could it be corrected? These questions lead into the area of changes in accounting methods which will not be covered in this paper. But, be put on notice that if an inventory practice is questionable, it may not be possible to merely "change" it. Likewise, an examining agent may decide not to require a change, even though he recognizes the method being followed is wrong. This result is quite common in the "very confused world" of accounting methods and changes.

THE PHOTO-SONICS CASE—The Prime Cost Method:

A 1964 Tax Court decision illustrates the problem involved when a manufacturer includes in inventory direct material and direct labor only, and charges off in the current period factory overhead expenses (such as factory rent and depreciation, utilities expense, indirect labor, etc.). This technique is known as the "prime cost" method, and this case (Photo-Sonics, Inc. v. Commissioner, 42 TC 926) indicates the practice followed and the IRS reaction to it. In this case the company, a manufacturer of high speed cameras, had consistently valued its closing inventory by including therein the cost of direct labor and direct materials only. The IRS redetermined the cost of the company's inventories by using the method known as "absorption costing." Under this method, a portion of the factory overhead expense is allocated to the ending inventories, recognizing that all applicable expenditures incurred in the manufacturing process should be included in determining the value of inventories on hand at the end of an accounting period.

The Tax Court, after stating that the company's method of inventory valuation did not clearly reflect its income nor did it conform to accepted accounting standards for a manufacturing concern, held that the Commissioner was within his rights in redetermining the inventory by use of the "absorption cost" method. The fact that the company had used its method consistently constituted no defense; the Court stated: "an erroneous method does not become acceptable solely upon the consistent use over an extended period of time."

The case was appealed by the taxpayer to the Court of Appeals for the Ninth Circuit (66-1 USTC 9282, 357 Fed (2d) 656), which agreed with the Tax Court opinion rejecting the "prime cost" method of inventory valuation. This case illustrates the dilemma faced by many companies, except that here the IRS took the initiative and required a change to an acceptable method.

What, then, can be done if one is faced with the same situation? Better still, assume that a company is going public or for some other reason *must* have a "proper" inventory valuation on its financial statements. Assuming that the statements have been adjusted to include in inventory a proper allocation of factory overhead, what are the alternatives available for tax return reporting? The same adjustment can be made on the books and tax returns, thereby increasing taxable income by the aggregate understatement of the year-end inventory. Or, the adjustment may be made on the books and financial statements, but the tax method of "prime costs" may be continued. Finally, the books and tax return may continue the past treatment, and whatever adjustments may be necessary reflected only on the financial statements. This, however, may require a footnote to the financial statements disclosing the amount of difference. Furthermore, each of these alternatives has certain tax implications which must be considered before a choice is made.

THE McNEIL CASE—Direct Costing:

Considerable discussion resulted from the Court of Appeals' decision affirming the Tax Court's opinion in the *Photo-Sonics* case. The Appeals Court, while rejecting the "prime cost" method, suggested that "direct costing" may "clearly reflect income" and therefore be an acceptable method. Under the direct cost method of pricing inventories, costs are separated into two categories: period or fixed costs, and direct or variable costs. Period costs are those costs which are incurred whether or not production takes place. Included in this category are such items as rent, factory superintendent's salary, insurance, depreciation, etc. Direct or variable costs are the additional costs incurred in order to manufacture the product, such as the direct costs of labor and materials, the fringe benefits on productive labor, shop and tool expense, etc. In direct costing, the fixed or period prices are deducted in the year they are incurred and only the variable costs are taken into consideration in valuing the closing inventory.

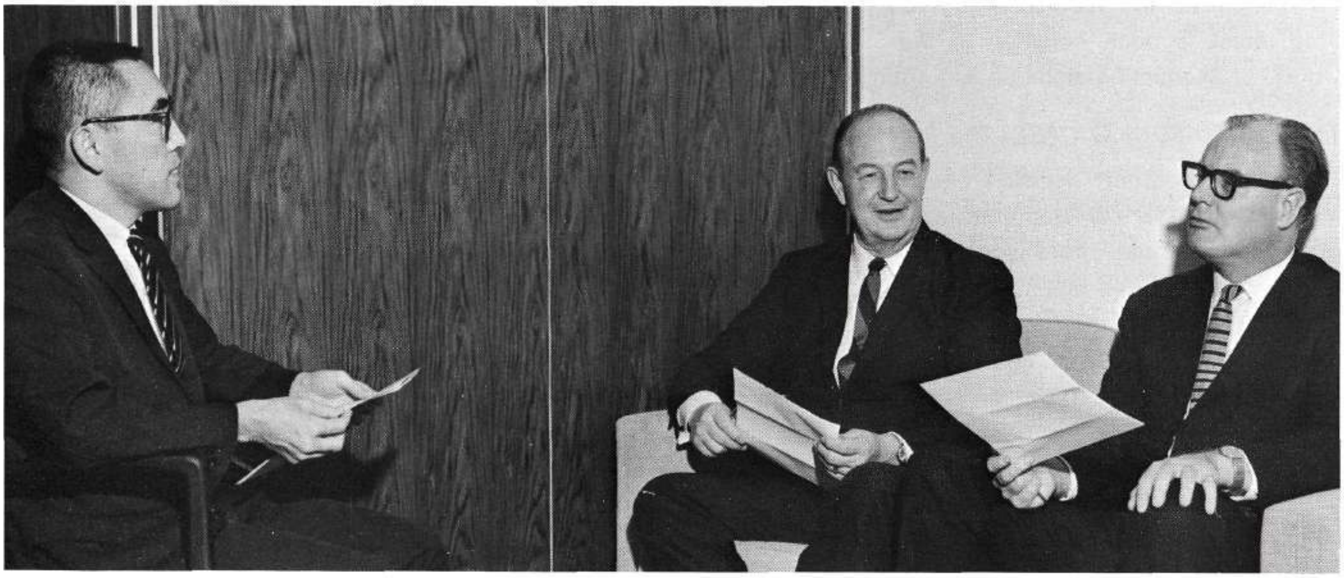
In early 1967, a case was reported in which the taxpayer's use of the direct cost method was upheld. In McNeil Machine & Engineering Co. vs. U.S. (U.S. Court of Claims No. 66-63, March 29, 1967), a Court of Claims Trial Commissioner determined that the direct cost method "clearly reflected income" because it was:

1. Consistently used in this case;
2. Within the scope of generally accepted accounting principles; and
3. In conformity with the income tax regulations.

Although this case has not as yet (November, 1967) been reviewed by the full Court of Claims, its conclusions are nonetheless significant.

CONCLUSION:

The IRS is becoming increasingly interested in the inventory techniques being used for tax purposes. The ability to test these techniques and to challenge their use will increase as the computer begins to play a larger part in tax examinations. Now is the time for taxpayers to examine their inventory methods and techniques to determine if they will be acceptable to the IRS.



Dave Nageo and Thomas ("Jeff") Ennis are shown meeting with client G. Barry Seyman. Mr. Seyman is important in the applied hydraulic power field, and is general manager for far eastern operations of Applied Power International, vice president of TOKYO YUATSU KOGYO and president of Applied Power Far East Ltd.

Tokyo Office Expands

Our Tokyo office has undergone several changes since its move to a new building in October. Thomas J. Ennis has moved to Tokyo to become partner in charge of the Tokyo office and coordinator in the Asian-Pacific area, and Dave Nagao has been promoted to manager.

Mr. Ennis, who recently completed some work in Turkey for the U.S. State Department, brings to his new post almost a decade of experience as partner in charge of the San Francisco office. He made his first exploratory trip to this region some years ago, and it is his feeling that trade and investment will continue to expand. He expects the Tokyo office to participate in this growth.

Dave Nagao worked in the San Francsico and Honolulu offices before moving to Tokyo in 1964, and is one of the few people who have met certification requirements in both Japan and the U.S.A.. Mr. Nagao, who has an M.B.A. degree from U.C.L.A., refuses to commit himself on which examination is tougher. His only comment is, "I wouldn't like taking either of them again."

The other key men in the office are Japanese CPAs, Mr. Takayama and Mr. Kobayashi, who developed an interest in international work as college classmates. (Mr. Kobyashi is active in the international committee of the Japanese Institute of CPAs.) With the aid of these associates, the Touche, Ross office in Tokyo offers clients an attractive combination of talents; professional services of CPAs with both a rich background of United States experience and an intimate knowledge of Japanese business customs and practices.