

funeral homes, benefit.¹ The taxpayer whose principal source of revenue is from fabricating or modifying tangible personal property in accordance with customer specification can use the cash method, provided the gross receipts test is satisfied. As a final exception, the cash basis is available if the taxpayer's principal business activity is the provision of services, including the provision of property incident to the services. An example in the Revenue Procedure is of a medical doctor who provides chemotherapy. The doctor is deemed to be providing drugs incident to services, and regardless of the relative charges to patients (gross receipts) for drugs and medical attention, the doctor will be allowed to use the cash method.

As suggested above, gross receipts is the measure used to determine the taxpayer's principal business activity. The taxpayer's principal source of gross receipts is the business activity which provides the greatest percentage of gross receipts. The taxpayer can elect to measure relative gross receipts on an annual basis, or over a three-year period (the average over three years). If the annual basis is used, the gross receipts test is based on the immediately preceding year. The three-year test employs the average gross receipts for the three preceding years.

§ 1:13 Gross receipts from the principal business

As discussed above, if the taxpayer's principal source of gross receipts is one of the proscribed activities (e.g., retailing, wholesaling, manufacturing), the cash method is not available, even though the taxpayer's average annual gross receipts are less than \$10,000,000. Revenue Procedure 2002-28, Section 5.04 has two alternative tests for determining the principal business activity. The principal business activity is that activity that produces the largest percentage of gross receipts. Thus, if the qualified small business taxpayer has three businesses, the principal business could produce as little as 34% of the total gross receipts (e.g., activity 1 = 33%, activity 2 = 33% and activity 3 = 34%) during the testing period. Moreover, the Revenue Procedure allows two alternative testing periods: (1) the three preceding years, or (2) the immediately preceding years. Apparently, the test applied can vary between years, and the application of a particular test is not a method of accounting.

◆ **Example:** Assume the taxpayer's gross receipts from services and the sale of goods were as follows:

	2001	2002	2003	Three Year Average
Services	\$420	\$450	\$900	\$590
Sale of goods	\$600	\$900	\$450	\$650

In 2004, the taxpayer's gross receipts from services was \$600 and the gross receipts from the sale of goods was \$700. Applying the three year test, the principal source of gross receipts is the sale of goods and therefore the cash method cannot be used. However, in the immediately preceding year services was the principal source of gross receipts; therefore, the cash method can be used for the entire business in 2004.

If the qualifying small business taxpayer has more than one trade or business and its principal business activity is proscribed, generally, the accrual method must be used for all of the taxpayer's trades or businesses. However, if the taxpayer's trade or business that is not "the principal business activity" is a separate and distinct trade or business

[Section 1:12]

¹discussed at § 1:8.

and is not proscribed, the cash method may be used for that business. The regulations provide an example of a taxpayer who establishes its sales of plumbing materials and installations as separate activities. Selling goods was the principal business activity, but installation was considered a separate business; therefore, the cash method could be used to account for the installation income. To assure that the two businesses are considered separate, a separable set of books must be maintained for each activity.¹

§ 1:14 Supplies and inventories

Materials and supplies are items of tangible property that are used or consumed in the business, rather than held for resale and are not raw materials used in production. The primary issue in regard to materials and supplies is whether they can be expensed when acquired, or expensed as they are used, or whether their costs are included in the cost of inventories and deducted when the goods are sold. According to Reg. § 1.162-3(a)(2), the cost of incidental materials and supplies, for which no records of consumption are maintained, can be expense when the items are “paid.” This implies that the taxpayer treats these like a cash basis taxpayer regardless of the taxpayer’s actual method of accounting. It seems unlikely that an accrual basis taxpayer will be required to change to a cash basis for these items because the accrual basis will clearly reflect income.

The treatment of non-incidental materials and supplies is more complex. Reg. § 1.162-3(c) defines materials and supplies as follows:

Definitions—(1) Materials and supplies. For purposes of this section, materials and supplies means tangible property that is used or consumed in the taxpayer’s operations that is not inventory and that—

- (i) Is a component acquired to maintain, repair, or improve a unit of tangible property (as determined under section 1.263(a)-3(e)) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;
- (ii) Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer’s operations;
- (iii) Is a unit of property as determined under section 1.263(a)-3(e) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer’s operations;
- (iv) Is a unit of property as determined under section 1.263(a)-3(e) that has an acquisition cost or production cost (as determined under section 263A) of \$ 200 or less or other amount as identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see section 601.601(d)(2)(ii)(b) of this chapter); or
- (v) Is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see section 601.601(d)(2)(ii)(b) of this chapter) as materials and supplies for which treatment is permitted under this section.

The application of this definition may depend upon the taxpayer’s financial accounting treatment of the items. Reg. § 1.263A-1(f) provides a “de minimis” safe harbor election

[Section 1:13]

¹See Rev. Proc. 2002-28, § 4.02.

that permits expensing or adding to production cost the entire cost of items (rather than annual depreciation) costing \$5,000 or less. The regulations provide the following example:¹

Election to apply de minimis safe harbor. (i) N provides consulting services to its customers. In Year 1, N pays amounts to purchase 50 laptop computers. Each laptop computer is a unit of property under section 1.263(a)-3(e), costs \$ 400, and has an economic useful life of more than 12 months. Also in Year 1, N purchases 50 office chairs to be used by its employees. Each office chair is a unit of property that costs \$ 100. N has an applicable financial statement (as defined in section 1.263(a)-1(f)(4)) and N has a written accounting policy at the beginning Year 1 to expense amounts paid for units of property costing \$ 500 or less. N treats amounts paid for property costing \$ 500 or less as an expense on its applicable financial statement in Year 1.

(ii) The laptop computers are not materials or supplies under paragraph (c) of this section [Reg. 1.162-3(c)1(i), the computer is a unit of property]. Therefore, the amounts N pays for the computers must generally be capitalized under section 1.263(a)-2(d) as amounts paid for the acquisition of tangible property. The office chairs are materials and supplies under paragraph (c)(1)(iv) of this section [the cost is less than the \$5,000 per item, the “amount identified in published guidance.”]. Thus, under paragraph (a)(1) of this section, the amounts paid for the office chairs are deductible in the taxable year in which they are first used in N’s business. However, under paragraph (f) of this section, if N properly elects to apply the de minimis safe harbor under section 1.263(a)-1(f) to amounts paid in Year 1, then N must apply the de minimis safe harbor under section 1.263(a)-1(f) to amounts paid for the computers and the office chairs, rather than treat the office chairs as the costs of materials and supplies under section 1.162-3. Under the de minimis safe harbor, N may not capitalize the amounts paid for the computers under section 1.263(a)-2 nor treat the office chairs as materials and supplies under section 1.162-3. Instead, in accordance with section 1.263(a)-1(f)(3)(iv), under section 1.162-1, N may deduct the amounts paid for the computers and the office chairs in the taxable year paid.

It should be noted that the regulations require that the financial accounting conformity must generally be as used on “certified audited financial statements.” In essence, the election is to not capitalize the cost of the items that qualify for the election. However, if the item benefits production of inventory or other self-constructed property, the cost must be capitalized.

In some cases, it is still necessary to distinguish supplies from inventory. The same taxpayers who are most likely to be eligible to use Revenue Procedure 2000-22 for inventories will often face supplies versus inventories issue, whether they immediately recognize this or not. In Revenue Procedure 2001-10, 2001-2 I.R.B. 272, modifying and superseding Revenue Procedure 2000-22, the IRS made clear that inventory items that are accounted for as material supplies under Regulation § 1.162-3. The costs of these items are deducted in the later of: (1) the year the goods are paid for, or (2) the year the goods are sold.²

The Service and the majority of the Tax Court have taken different approaches to the question of whether an item is incidental. The Service applies a somewhat mechanical

[Section 1:14]

¹Reg. § 1.162-3(h) Example 14.

²See also Rev. Proc. 2002-28, § 4.05.

(and predictable) approach, looking to the use of the item and to its materiality, while the Tax Court looks to the substance of the transactions.³ In TAM 9723006 (June 6, 1997), the Service reasoned that merchandise, or inventory, is property transferred to the customer, whereas materials and supplies are property consumed in the production of property or the provision of services. Thus, for the medical clinic that was the subject of the TAM, the medicines and bandages were merchandise, while rubber gloves and syringes were materials and supplies.

The Service has provided further analyses of the supplies regulation in TAM 9209007:

Under the general rule of Regulation § 1.162-3 of the regulations, a taxpayer carrying materials and/or supplies (“supplies”) on hand may deduct the cost of supplies when consumed and used in operation during the year. However, for the convenience of taxpayers, Section 1.162-3 contains an exception to this general rule, allowing a taxpayer to deduct the cost of supplies in the year purchased. A taxpayer may deduct the cost of supplies under this exception (the “incidental supplies exception”), provided all four of the conditions specified in the second sentence of Section 1.162-3 are satisfied. First, the supplies must be “incidental”; that is, the supplies must be of minor or secondary importance to the taxpayer. Second, the taxpayer must not keep a record of consumption for the supplies. Third, the taxpayer must not take a physical inventory of the supplies at the beginning and end of the tax year. Fourth, the taxpayer must not distort its taxable income by deducting the cost of supplies in the year purchased.

The TAM is one of the few authorities on the meaning of “incidental”:

There are two senses in which supplies can be incidental to a taxpayer’s trade or business. First, supplies can be incidental to the nature and operation of a taxpayer’s trade or business. Second, the cost of supplies can be incidental in an absolute sense when compared to other financial data of the taxpayer’s trade or business. In order to be incidental under the incidental supplies exception, the taxpayer’s supplies must be incidental in both an operational and financial sense.

In Revenue Ruling 78-382, 1978-2 CB 111, the Service explained that “incidental” in the financial sense means that the taxpayer’s treatment must clearly reflect income. In that ruling, the Service concluded that a uniform rental business must treat as supplies, uniforms that had a life of less than 12 months. According to the ruling, the uniforms are not “incidental in nature because they are not an item that is of minor or secondary importance in the operation of the taxpayer’s business and the deduction of their cost in the year of purchase would not clearly reflect income”; that is, the aprons were not incidental in the operational sense. Also, in TAM 8630003 the Service ruled that the costs of paper and ink were an integral part of the taxpayer’s advertising services business—not incidental in the operational sense—and thus could not be considered minor or secondary because it was through the paper and ink that the advertising was created.

It would seem that the Service has cast a wide net classifying most supplies as not incidental. It is difficult to envision a supply that is not more than incidental in the operational sense. Because the purposes of Revenue Procedure 2000-22, Notice 2001-76, and Revenue Procedure 2002-28 are to simplify compliance, the clear reflection of

³See *Osteopathic Medical Oncology and Hematology, P.C. v. C.I.R.*, 113 T.C. 376, Tax Ct. Rep. Dec. (RIA) 113.26, 1999 WL 1051964 (1999), recommendation regarding acquiescence, AOD-2000-5, 2000 WL 502413 (I.R.S. AOD 2000) and acq., 2000-23 I.R.B.2, citing *Honeywell Inc. and Subsidiaries v. C. I. R.*, T.C. Memo. 1992-453, T.C.M. (RIA) P 92453, 64 T.C.M. (CCH) 437 (1992), aff’d, 27 F.3d 571, 74 A.F.T.R.2d 94-5192 (8th Cir. 1994).

income approach should be applied, thus allowing a current deduction for the minor (in the financial sense), reoccurring items.⁴

§ 1:15 Gross receipts test

The gross receipts test, when combined with the conformity requirement (discussed below) is a “rough justice” approach to the complexity versus materiality trade off. If the gross receipts are less than the \$1,000,000 or \$10,000,000 threshold, then the accrual basis benefit of more accurate measurement of income is not worth the additional compliance burden.

§ 1:16 Which gross receipts?

The Revenue Procedure cross-references Regulation 1.448-1(f)(2)(iv) for the definition of “gross receipts.” Section 448 requires C corporations to use the accrual method but provides an exception for corporations whose average annual gross receipts do not exceed \$5,000,000. According to Regulation § 1.448-1(f)(2)(iv), gross receipts includes the gross proceeds from sales (which are not reduced by cost of goods sold, but are reduced by returns and allowances, and sales tax levied on the customers) and services. Also included are investment income such as interest and dividends, and gains (amount realized less the seller’s basis in the asset) on the sale of capital assets. It should be noted, however, that while the Section 448 test is based on the entity’s gross receipts, the revenue procedure expresses the limitation in terms of the gross receipts from all of the “taxpayer’s trades or businesses.”¹ This suggests that investment income would not be included in gross receipts. On the other hand, the revenue procedure specifically lists “interest and dividends” as included in gross receipts. If the Revenue Procedure is intended to track the Section 448 regulations, it is clear that the dividends, interest and other investment type receipts are included in gross receipts regardless of whether they are earned in a trade or business activity, provided they are received by an “employer.” Moreover, as will be further discussed below, the gross receipts from related employers must be aggregated.

In *City Line Tobacco and Candy Corp. v. Commissioner*, the taxpayer was a licensed cigarette dealer and wholesaler who was required to include in gross receipts a cigarette tax the wholesaler was required to collect, for purposes of applying the simplified resale method.² Unlike a retail sales tax, the reseller was required to purchase the stamps and then attempt to sell the merchandise and recover the cost of the stamps.³

⁴*Cincinnati, New Orleans & Texas Pacific Ry. Co. v. U. S.*, 191 Ct. Cl. 572, 424 F.2d 563, 70-1 U.S. Tax Cas. (CCH) P 9344, 25 A.F.T.R.2d 70-988 (1970); *Fort Howard Paper Co. v. Commissioner of Internal Revenue*, 49 T.C. 275, 284, 1967 WL 1266 (T.C. 1967).

See also GCM 35259; *U.S. v. Wehrli*, 400 F.2d 686, 68-2 U.S. Tax Cas. (CCH) P 9575, 22 A.F.T.R.2d 5568 (10th Cir. 1968).

[Section 1:16]

¹Rev. Proc. 2000-22, 2000-20 I.R.B. 1008, § 5.02, Notice 2001-76, and Rev. Proc. 2002-28

²*City Line Candy & Tobacco Corp. v. C.I.R.*, Tax Ct. Rep. (CCH) 59695, Tax Ct. Rep. Dec. (RIA) 141.13, 2013 WL 6084609 (T.C. 2013).

³See § 3:8.

§ 1:17 Whose gross receipts?

Frequently, the most complex aspect of pursuing the benefits of the revenue procedure will be determining whose gross receipts must be included in the calculations. The revenue procedure requires the aggregation of the gross receipts for all entities treated as a single employer under I.R.C. §§ 52(a), (b), 414(m) and (o). I.R.C. §§ 52 and 414 define commonly controlled entities for purposes of calculating limitations on the work opportunity credit and the retirement plan benefits. These provisions were enacted to limit the taxpayer's ability to divide activities between entities so as to maximize the work credit and the pension benefits of the business owners.

I.R.C. § 52(a) includes the brother-sister and parent-subsidary groups as defined in I.R.C. § 1563(a), except "more than 50% stock ownership" (voting and value) is substituted for the "more than 80%" stock ownership found in Section 1563(a). I.R.C. § 52(a) aggregates trades or businesses under common control, whether or not the trades or businesses are incorporated. Here a more than 50% ownership test is used. Thus, a proprietor who also has a greater than 50% interest in a partnership must aggregate the gross receipts of the proprietorship and the partnership to apply the test. Apparently, the proprietor's gross receipts from investments must be aggregated with those of his or her proprietorship. Moreover, all of the partnership's gross receipts (including investment income) must be included, and not merely the partner's greater than 50% interest.

I.R.C. § 414(m) and (o) define related taxpayers in such a way as to address a specific practice. Before these provisions, professionals would construct their ownership and employment arrangements so as to exclude employees from pension, profit-sharing and other fringe benefits. A common arrangement for a group of medical doctors operating a practice was as follows: Each doctor would form a separate professional corporation with no employees other than the medical doctor. The professional corporation would adopt a pension plan that covered its only employee. All of the medical doctor's staff would be provided through a partnership in which the professional corporation was a partner. The medical doctor's fees would be channeled through the partnership that would pay the staff and distribute the profit to the doctors' corporations. In turn the professional corporation would pay the doctor a salary and make contributions to the corporation's pension plan on the doctor's behalf. I.R.C. § 414(m) requires that for the above described arrangement the partnership and the professional corporation partners must be treated as a single entity for purposes of determining whether the pension plan discriminates in favor of the higher paid employees.¹ Thus, for purposes of the gross receipts test under the partnership of professional corporations scheme, each professional corporation must combine its gross receipts with those of the service partnership, even though the professional corporation does not control the partnership.

It should be noted that the attribution of receipts is between commonly controlled corporations, and between other related employers. The rules generally do not attribute an individual's receipts to his or her related employer-entity. For example, in the partnership of professional corporations scheme addressed in I.R.C. § 52, the doctor-shareholder's gross receipts are not attributed to the doctor's controlled corporation.

[Section 1:17]

¹See Rev. Rul. 81-105, 1981-1 C.B. 256 for a further description of the practices which were the targets of I.R.C. § 414(m). I.R.C. § 414(o) requires including leased employees as the lessor's employees for purposes of the anti-discrimination rules.

Finally, there is no double counting for transactions between members of the group. Thus, in a transaction between related entities whereby one entity has gross receipts from the other entity, the gross receipts are eliminated from the \$1,000,000 gross receipts for the group.²

§ 1:18 Three-year rolling average look-back

The three-year average gross receipts must be calculated after the end of each year (assuming all of the related entities use the same tax year), in the case of a taxpayer and all related entities that have been in existence for three years or longer. If the average for the three prior years exceeds \$1,000,000 or, for each taxable year ending on or after December 31, 2000, \$10,000,000, the taxpayer is not eligible for the cash method of accounting in the current year (the fourth year), unless the taxpayer could qualify for the cash method without the benefit of Revenue Procedure 2000-22, Notice 2001-76, or Revenue Procedure 2002-28.

In the case where an entity has been in existence for less than three years, the taxpayer must determine the average annual gross receipts for the number of years the entity has been in existence.¹ Thus, if the entity began in 1999 and its gross receipts were less than \$1,000,000 and the conformity requirement was satisfied, the cash method is available for 2000.

§ 1:19 Accounting method used to measure the average annual gross receipts

According to the Revenue Procedure the measurement of gross receipts used to calculate the three-year moving average should be based on the accounting method actually used by the taxpayer during the measurement period.¹ Apparently, this is true even though the taxpayer was using an incorrect method.

§ 1:20 Conformity requirement

Revenue Procedure 2000-22 contained a conformity requirement—the tax treatment of the inventories was required to be the same as financial reporting. This conformity requirement was eliminated by Revenue Procedure 2001-10, 2001-2 I.R.B. 272 and Revenue Procedure 2002-28, 2002-18 I.R.B. 815.

§ 1:21 Making the change

Revenue Procedure 2000-22 and 2002-28 apply to taxpayers changing from the accrual to the cash method, from the cash method without inventories to the cash method with inventory accounted for as supplies (to comply with Reg. § 1.162-3T). Thus, the

²Reg. § 1.448-1(f)(2)(ii).

[Section 1:18]

¹Short periods must be annualized.

See Rev. Proc. 2000-22, 2000-20 1008, § 5.04.

[Section 1:19]

¹Rev. Proc. 2000-22, 2000-20 I.R.B. 1008, § 5.02.

change in methods is the same for a taxpayer who has expensed inventories as purchased, as well as the accrual basis taxpayer changing to the cash method.¹

Generally, Revenue Procedure 2000-22 is a supplement and amendment to the current automatic change in methods procedure, Rev. Proc. 2015-13 and 2015-14. However, the taxpayer can make the change under Revenue Procedure 2000-22 even though the taxpayer's return is under examination, before an appeals officer, or before the Tax Court.²

In addition to allowing taxpayers that formerly used the accrual method to change to the cash method, the procedures also provide amnesty to taxpayers for which inventories were an income-producing factor but the taxpayer nevertheless used the cash method in the prior year. Many of these taxpayers will not be required to change methods of accounting; nor, will these taxpayers be required to notify the Service of their prior misconduct. However, taxpayers in this group that did not conform to prior law will be required to file the Form 3115 to comply with the Regulation § 1.162-3 rules. That is, the taxpayers who have expensed inventories in the past must now account for them as supplies, which means the taxpayer will be required to make a Section 481 adjustment for the cost of supplies on hand on the date of the change in methods. But the taxpayer will not be required to record the accounts receivable as of the first day of the year of the change.

Taxpayers changing from the accrual to the cash method, generally, should have a negative adjustment for the accounts receivable that were included in income in the year preceding the change. No adjustment will be required for inventories, if they are carried at FIFO cost, which should be their cost as a supply under Regulation § 1.162-3. However, inventories carried at lower of cost or market must be restored to their cost, thus creating a positive adjustment to income. The Service will not permit the use of the LIFO method to value supplies.³

However, taking advantage of the cash basis election comes at a cost to the small producer because of Section 199. According to Notice 2005-14, 2005-7 I.R.B. 498, § 3.04(3)(b), as a requisite for taking the Section 199 deduction, the taxpayer must be subjected to the inventory accounting rules of Section 263A. Cash basis producers should consider whether the deferral benefits of the cash method outweigh the loss of an additional deduction. The change in methods procedures discussed in chapter 9 may impact the decision.

3. PROPERTY INCLUDED IN INVENTORIES

§ 1:22 In general

Regulation § 1.471-1 provides that:

The inventory should include all finished or partly finished goods and, in the case of raw

[Section 1:21]

¹The procedure can also be applied to change from a long-term contract method to the cash method. However, the taxpayer may fare better under the completed contract method than under the cash method if the contractor receives advance payments that can be deferred under Reg. § 1.451-5.

²Rev. Proc. 2000-22, 2000-20 I.R.B. 1008, § 6.02(a), provides that § 4.02 of Rev. Proc. 99-49, 1999-52 I.R.B. 725, will not apply to the change.

³Rev. Proc. 2002-28, 2002-18 I.R.B. 815.

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 . . .” (emphasis added).

§ 1:23 Materials and supplies not acquired for sale

The tax treatment for materials and supplies not acquired for sale is set forth in Reg. § 1.162-3, effective for tax years beginning on or after January 1, 2014. The most frequently encountered issues regarding materials and supplies is whether their costs can be deducted at the time of purchase, whether or not they have been used by the end of the tax year, and whether their cost must be included in the cost of producing other property.

The new Reg. § 1.162-3(c)(1) defines materials and supplies as any tangible property that is used or consumed in the taxpayer’s operations that is not inventory and is either:

- (i) a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property (e.g., nuts and bolts, spark plugs, pulleys belts);
 - (ii) fuel, lubricants, water, and similar items, that are reasonably expected to be consumed in 12 months or less;
 - (iii) a unit of property that has an economic useful life of 12 months or less,
 - (iv) a unit of property and has an acquisition cost or production cost of \$100 or less;
- or
- (v) is an item that is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies for which treatment is permitted under this section.

◆ **Example.** The company keeps on hand a supply of ultraviolet lights that are used in its water treatment system. The lights cost \$150 each and have an average life of for years. The lights are used to maintain the water treatment system and therefore they are materials and supplies even though their cost is greater than \$100 each and the life of each light is over 12 months.

The definition in the proposed regulations is narrower than the commonly used definition of materials and supplies. For example, packing materials and office supplies do not appear in the list of materials and supplies, but are often treated as such by most accounting systems. Perhaps such items will be addressed by other published guidance, “(v)” above.

Some examples of official guidance are presented below:

Rev. Proc. 2002-12, 2002-1 C.B. 374 permits restaurants to account for the cost of “smallwares” as incidental supplies under Regulations § 1.162-3, although these items have a useful life of slightly more than one year. Smallwares consists of the following ten categories of items: (1) glassware and paper or plastic cups; (2) flatware (silverware) and plastic utensils; (3) dinnerware (dishes) and paper or plastic plates; (4) pots and pans; (5) table top items; (6) bar supplies; (7) food preparation utensils and tools; (8) storage supplies; (9) service items; and (10) small appliances that cost \$500 or less.

Also, in *Prudential Overall Supply v. C.I.R.*,¹ the taxpayer was allowed to expense as purchased the cost of uniforms it leased to customers. The Service argued that the garments had a life in excess of one year and therefore should be capitalized. However, the Tax Court allowed a current deduction for the items because of the Service's unconvincing proof as to useful life and the consistent pattern of replacements throughout the year.

In Letter Ruling 200351009 (December 19, 2003) the Service extended the "smallwares" method of accounting for supplies and equipment used in connection with food and beverage services. The Letter Ruling permitted the smallwares method by a taxpayer in the business of providing coffee and related food and refreshment products and small appliances to customers via a national network of route sales personnel. Catalogues distributed at no charge to customers are considered a selling supply rather than inventory.² Similarly, tires and tubes held by a company in the truck leasing business are supplies, rather than inventory, because the tires and tubes are not held for resale and are not used in the production of other goods.³

The new regulations distinguish between materials and supplies that are incidental and non-incidental. Under Reg. § 1.162-3(a)(2), the supplies can be deducted at the time of purchase if: (1) the supplies are "incidental," (2) the taxpayer does not maintain records of the consumption of the supplies, (3) no physical inventory of the supplies is on hand at the beginning and end of the year, and (4) deducting the cost at the time of purchase does not distort the taxpayer's income. However, if the incidental materials and supplies are used in the process of producing other property or will physically become a part of merchandise intended for sale (e.g., glue used in the production of furniture), including containers, such as kegs, bottles, and cases, their costs would become an indirect cost of production (Section 263A) that enters into cost of goods sold and ending inventory as soon as the items are acquired.⁴

In Ltr. Rul. 9209007, the IRS ruled that the "incidental" requirement is to be judged in terms of: (1) the role the supplies play in the business and (2) the absolute financial sense. The two-pronged test was sufficiently vague as to allow an IRS agent to seriously challenge any current deduction for supplies. Reg. § 1.162-3(c) took a different approach by defining incidental materials and supplies as those items carried on hand but no records are maintained as to the flow of the goods. An obvious example is the cost of paper used in a law office. The author is not aware of any law firm that separately bills its clients for paper, and keeps records of the cost of paper on hand at the end of the year. Thus, the paper is expensed at the time it is purchased.

As discussed above, the non-incidental materials and supplies are those for which the taxpayer does maintain records of use and items on hand. Their costs become an expense

[Section 1:23]

¹*Prudential Overall Supply v. C.I.R.*, T.C. Memo. 2002-103, T.C.M. (RIA) ¶ 2002-103, 83 T.C.M. (CCH) 1545 (2002).

²*Spiegel, May, Stern Co. v. U.S.*, 69 Ct. Cl. 110, 37 F.2d 988, 2 U.S. Tax Cas. (CCH) ¶ 474, 8 A.F.T.R. (P-H) ¶ 10108 (1930).

³*Smith Leasing Co., Inc. v. C. I. R.*, 43 T.C. 37, 1964 WL 1150 (T.C. 1964), acq., 1965-2 C.B. 3, acq. Rev. Rul. 65-200, 1965-2 C.B. 6.

⁴Reg. § 1.471-1.

in the year the materials and supplies are used or consumed, or become a production cost as they are placed into production.⁵

◆ **Example:** The Morgan Manufacturing Company applies a compound when sweeping the factory floor each day. The compound, which absorbs moisture and dust, is purchased in 55 gallon drums. At the end of the year the amount of compound on hand is recorded and its cost is computed using an average method. The company uses a smaller quantity of a similar compound on the floors of the administrative offices, but records of the compound on hand are not maintained.

At the end of the year, the cost of compound used in production can be computed and that cost becomes an indirect production cost for the period. The cost of the compound used must be allocated between ending inventory and cost of goods sold. The office cleaning materials are incidental materials and supplies and their cost is deducted as an administrative expense in the period they are purchased.

As is discussed in Chapter 2, if the cleaning material in the previous example were used on both the factory floor and administrative offices, it would be a “mixed service cost” (to be discussed in Chapter 2) because the materials were used in production and for administration and its cost must be allocated between two functions. The portion allocated to administration may be currently deducted, but the cost allocated to production becomes a cost of the ending inventory. Whether the costs were taken into account at the time of purchase, or at the time of use would depend upon the necessary records being maintained (as in the case of production in the example).

Finally, materials and supplies may qualify for the de minimis deduction rules under Reg. § 1.263(a)-1(f). That regulation provides an automatic deduction in the year acquired for the otherwise capitalized costs of units of property (other than inventory and land) and materials and supplies, provided a financial conformity requirement is satisfied.

The de minimis rule allows the taxpayer with “applicable financial statements” (AFS) to deduct in the year of acquisition individual items costing not more than \$5,000 each. For taxpayers that do not have AFS, the limitation is \$500 per item. If the election is made to deduct these items, materials and supplies must also be included in the election. However, if the de minimis items directly benefit or are incurred by reason of production, their cost must be capitalized as a cost of what is being produced.

§ 1:24 Property for sale, but not at profit

In one case, the court held that the property is not inventory unless it is held for sale at a profit.¹ Goods held for sale at cost (i.e., in the “company store”) to employees working in a remote location were not an income-producing factor because income is defined as

⁵Reg. § 1.162-3(c)(4).

[Section 1:24]

¹Francisco Sugar Co. v. C.I.R., 14 B.T.A. 1062, 1929 WL 945 (B.T.A. 1929), order rev'd on other grounds, 47 F.2d 555, 2 U.S. Tax Cas. (CCH) P 663, 9 A.F.T.R. (P-H) P 938 (C.C.A. 2d Cir. 1931); Illinois Cereal Mills, Inc. v. C.I.R., T.C. Memo. 1983-469, T.C.M. (P-H) P 83469, 46 T.C.M. (CCH) 1001, 1983 WL

