TAX YEAR
2023

Inventory/ Cost of Goods Sold

Sprague & Jackson
ACCOUNTANTS AND ENROLLED AGENTS
The Seneca Building • 121 E Seneca St • Ithaca, NY 14850

David W. Sprague, EA, ABA Principal
Angie Jackson, EA, MSA Principal

Phone: (607) 273-5322
Fax: (607) 273-8138
Email: Admin@sprjac.com

Inventory

Accounting for 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 an 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 $29 million (2023) or less for the prior three tax years and are not a tax shelter.

Method of accounting. All taxpayers, even small business 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 calculating 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 calculating 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 (UNICAP) rules.

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 Identification 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.*