[1] Background and details on the small business taxpayers prior to TCJA

In general, a business that kept inventory could not claim a tax deduction for the inventory until the inventory was sold. Pursuant to IRC § 471 and Treas. Reg. § 1.471.1, taxpayers need to keep track of inventory in which the production, purchase, or sale of merchandise is an income-producing factor in order to reflect taxable income clearly. If a business was required to keep track of inventory under this law, they were also required to use the accrual method of accounting under Treas. Reg. § 1.446-1(c)(2)(i) with regard to purchases and sales. Revenue procedures that came out in 2001 and 2002 provided a welcome exception to these rules for small business taxpayers. To qualify as a small business taxpayer, the average annual gross receipts were not to exceed $1,000,000 (Rev. Proc. 2001-10) or $10,000,000 in certain industries (Rev. Proc. 2002-28), and the taxpayer could not be a tax shelter prohibited from using the cash method of accounting under IRC § 448(a)(3).

The gross receipts test is computed using an average of the three taxable years immediately preceding the current taxable year. If a trade or business has not been in existence for three taxable years, then the taxpayer must determine average annual gross receipts for the number of years (including short taxable years) in existence. Taxpayers should be mindful of whether the aggregation rule of IRC § 448(c) applies to combined gross receipts of another entity.

In satisfying the pre-TCJA gross receipts test, some businesses would be exempt from accounting for inventories under IRC § 471 and could either treat all inventoriable items as "non-incidental materials and supplies" or utilize the method that conforms to the taxpayer's accounting method reflected in their applicable financial statement [IRC § 471(c)(1)(B)]. The result is an inventory write-off through the use of the 481(a) adjustment to income, which would lower taxable income.

Non-incidental materials and supplies are amounts paid to acquire or produce materials and supplies which are deductible in the taxable year they are first used or consumed in operations [Treas. Reg. § 1.162-3(a)(1)]. Any reasonable and consistent method may be used to determine what has been used or consumed. The most favorable impact would be to manufacturers and restaurants, who would deduct the cost of purchased raw materials when the materials move out of storage and into the work-in-process phase. In contrast, incidental materials and supplies are amounts paid to acquire or produce materials and supplies that are carried on hand for which no record of consumption is kept or physical inventories at the beginning and end of the taxable year are not taken. Amounts in this category are deductible in the taxable year in which they are paid [Treas. Reg. § 1.162-3(a)(2)].

The Revenue Procedures describing the small business taxpayer exemption do not explicitly state which costs are to be capitalized as costs to procure or create nonincidental materials and supplies. However, the procedures do highlight that qualifying taxpayers do not need to apply IRC § 263A, uniform capitalization (UNICAP) rules, which mandate capitalization of indirect overhead and labor. From this distinction, many have inferred that qualifying taxpayers only need to account for materials and supplies that actually flow into inventory.