Potential Inventory Write-off for Restaurants in Light of New Tax Law

The overhaul of the Tax Cuts and Jobs Act (TCJA) has proven to be a challenge since it took effect in 2018. As tax advisors struggle to understand the implications for their clients, the resource-deprived Internal Revenue Service has made efforts to issue guidance on how to implement many of the complex provisions. One of the changes set forth by the TCJA that impacts many restaurants and businesses, offers simplifications in how they report their revenues and expenses. The scope of this article will focus on the tax law's change in the definition for "qualifying small business taxpayers" by increasing the gross receipts threshold to $25 million and its impact on Internal Revenue Code (IRC) Section 471 related to the general rule for inventories.[1]

Expansion of Small Business Exception

With the new TCJA raising the qualifying gross receipts ceiling to $25 million, more businesses and restaurants are allowed to qualify as small business taxpayers and avoid general inventory accounting. This is a major shift from prior law and is a pleasant change for many small businesses that have historically earned between $10 million and $25 million in gross receipts and paid large tax bills. In July 2019, California conformed to the gross receipts ceiling increase, but treatment in other states may vary.

If a taxpayer wishes to change their accounting method to not account for inventory under IRC § 471, a cost-benefit analysis should be performed to determine whether the non-incidental materials and supplies treatment or their book accounting treatment would be most beneficial. If the restaurant has a requirement to issue GAAP basis financial statements, then it will be prevented from making the accounting method change because GAAP will not allow a company to expense inventory until it is sold. Most small businesses with no external stakeholders may have the opportunity to expense all inventory otherwise sitting on the balance sheet. If the restaurant is operating at a net loss, then it would not make sense to justify the administrative cost of making the accounting method change.

Change in Accounting Method

To make the change in accounting method to not account for inventory under IRC § 471, taxpayers must file Form 3115, Application for Change in Accounting Method, using designated change number (DCN) #235 on a timely filed Federal tax return beginning with the 2018 taxable year. Fortunately, the IRS, on August 3, 2018, released Revenue Procedure 2018-40, which provided a reduced filing requirement in effectuating this change rather than forcing taxpayers to complete Form 3115 with all of its required schedules and disclosures.

According to the simplified procedures, a taxpayer is required to complete only the following portions of Form 3115:

1) The identification section of page 1 (above Part I);
2) The signature section at the bottom of page 1;
3) Part I;
4) Part II, all lines except line 16; and
5) Part IV, all lines except line 25

The automatic change is allowable for any of the taxpayer's first three tax years beginning after December 31, 2017, even if it previously changed the method of accounting for the same item within the past five years. The taxpayer accounts for this specific change with a negative 481(a) adjustment (resulting in a reduction in taxable income) performed in one tax period. This adjustment will allow taxpayers to take large deductions on inventory remaining on their books or even write-off the entire amount for tax purposes.

Once the restaurant files the change in accounting method to elect to treat inventory as “non-incidental materials and supplies,” the regulations mandate that the financial statements also reflect these changes. As mentioned earlier, restaurants that are required to issue GAAP basis financial statements will not be able to implement this change. Although the rules dictate that a business should expense the inventory on the financial statements, they do not prevent a business from tracking inventory as they always have for internal management purposes. One best practice would be to change or maintain the internal written accounting policy to expense all inventory purchases when used or consumed for financial and tax reporting purposes.

An Expanded Benefit

The gross receipts threshold increase resulting from the TCJA of 2017 provided simplified reporting and potentially lower taxes from the larger inventory write-off. More taxpayers may now be able to treat costs that would otherwise be capitalized as inventory to be treated as non-incidental materials and supplies deductible in the year used or consumed rather than sold. If a restaurant wants to write-off inventory for tax purposes due to the law change, then the business must change their accounting policies to reflect the same treatment; the book and tax treatments must be the same. As this is a highly technical and fluid area of tax law, this article may not be cited as authority and is no replacement for appropriate counsel. As with anything tax-related, there are unique items specific to a restaurant or other business that could impact the strategy mentioned in this article.

If you have any questions about the TCJA's impact on small businesses, please do not hesitate to contact us.

Authors: Aric Wong, CPA, MBT & Amanda Standel

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