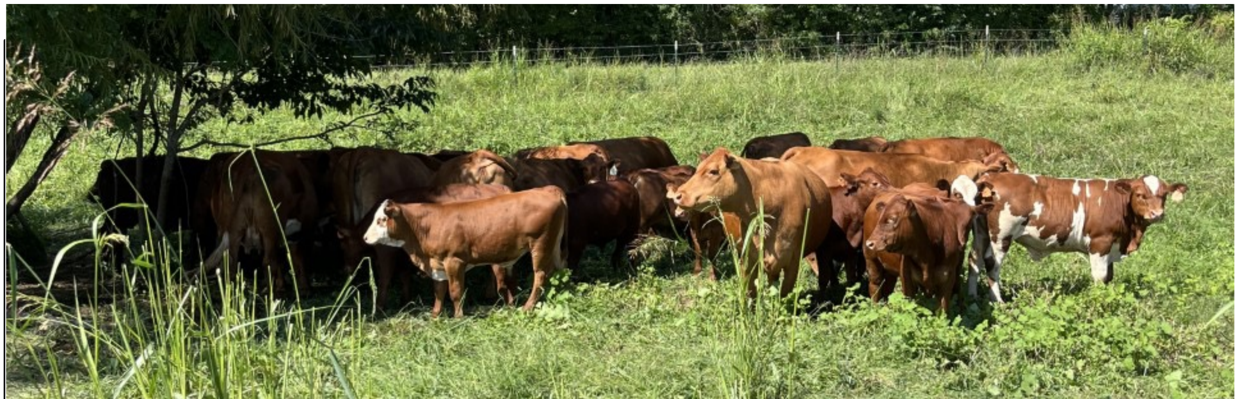

# Lesson 6.4: Special Tax Rules for Agriculture - Value-Added Inventory

UNIVERSITY OF ARKANSAS School of Law

LL.M. PROGRAM IN AGRICULTURAL AND FOOD LAW



**This training provides greater detail on the special tax treatment of value-added inventory.**

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## Legal Disclaimer

This presentation is intended to provide general information on agricultural income tax issues and should not be construed as providing legal advice. It should not be cited or relied upon as legal authority. State laws vary and no attempt is made to discuss state specific laws. For advice about how these issues might apply to your individual situation, consult an attorney.

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## Program Overview

1. Filing: Federal Income Tax Filing Requirements
2. Records: Recordkeeping Requirements
3. Taxes: Individual Federal Income Tax Return
4. Entities: Business Entities and Federal Tax
5. Agricultural Income: Special Rules
6. **Special Tax Rules for Agriculture** <- We are here.

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There were five lessons previously in this series.

The s[illegible]ing covers special tax rules for agriculture.

## Lesson 6
## Overview - Special Tax Rules for Agriculture

6.1 USDA Payments

6.2 Debt Relief

6.3 Mixed Use Real Property

**6.4 Value-Added Inventory** <- We are here.

6.5 Conservation

6.6 Catastrophe and Disasters

6.6.a Livestock Losses and Weather Related Events

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## What is Value-Added Inventory?

- For the purpose of this lesson, value added inventory is: items you have physically transformed which you hold available for sale on the last day of your tax year, and which you reasonably expect to sell before the items spoil.
- Note: Growing crops and animals held for sale are not treated as inventory for tax purposes. (All expenses are deducted as they are paid.) See Pub 225 Chapter 3.
- Note: Supplies and inputs on hand at the end of the year are sometimes called “prepaid” and sometimes called “inventory.” The tax treatment of supplies and materials used in your farming and ranching operation was covered in Lesson 2. See Also Pub 225 Chapter 4.



For this lesson, value-added inventory includes anything where you have physically transformed from the product you grew, raised, or harvested, and transformed into a new product with different physical qualities. Examples include: wine, beer, cheese, jam, nut butters, baked goods, fermented foods and beverages, spun wool, meat which has been custom cut, packaged and frozen, soaps, salves, candles, etc.

## What is the tax treatment of Value-Added Inventory?

- Prior to 2018, taxpayers were generally not allowed to deduct the cost of value-added inventory before the inventory was sold.
- Since 2018, taxpayers have new choices which can allow them to deduct some inventory costs before the inventory is sold.

## So when can you deduct the costs associated with Value-Added Inventory?

- Generally, you can deduct the cost or an inventory item in the year when the item is sold (not when you incur the expense).
- If you incur the expense and sell the items all in the same year you may choose to do inventory accounting for internal management purposes, but you do not have inventory for tax purposes.
- If you have a cost to create an inventory item in one year, but the item is still on hand at the end of the year and you reasonably expect to sell it in a future year then you need to make a choice about how you will treat the items for tax purposes.



Inventory is a type of asset account. That means it appears on the balance sheet along with other assets like cash, accounts receivable, and equipment. Assets are not types of expenses, so they are not deducted except according to special rules.

An inventory item is an asset, and it becomes an expense when the item is sold. The dollar value of the inventory asset, and the dollar value of the "Cost of Goods Sold" expense it becomes is calculated using an ***inventory method***.

There are several acceptable inventory methods for management purposes, and for preparing financial statements. For tax purposes we talk about a ***tax inventory method.***

## What is the tax treatment of Value-Added Inventory?

Since 2018 Taxpayers with less than $25 million in gross revenues may choose to:

1. Use a simplified inventory method called “Non-Incidental Materials and Supplies” or NIMS.

OR

2. Report inventory on their tax returns using the method they use for their internal accounting or on their CPA-prepared financial statements.

A taxpayer chooses NIMS by making a “NIMS election.”



The NIMS method is generally the simplest and most advantageous method because it allows taxpayers to deduct some inventory-related expenses without keeping detailed records on all inventory costs or specific sales of inventory items.

NIMS is only used for tax purposes. It is not a method that creates accurate inventory valuation for purposes of managing a business or creating formal financial statements for lenders or others outside of the business.

## What happens if a taxpayer does not choose a method?

- A taxpayer chooses an inventory method the first year they file a tax return for a business with inventory.
- This is true even if the taxpayer is not aware that they have made a choice.
- A taxpayer may not change accounting methods without IRS approval.



A taxpayer chooses the inventory method they will use for their business by filing the tax return the first year the inventory method is used. Whatever method they used - knowingly or unknowingly - on that first return is the method they must use going forward for that business for that type of inventory. Obtaining IRS permission to change accounting methods is a costly and cumbersome process.

## What happens if a taxpayer does not choose a method?

Either elect the NIMS method

OR

Elect to use the method you use for internal management or for CPA-prepared financial statements

OR

Run the risk of the IRS determining that you have by default elected your internal management records as your tax records and re-calculating your tax based on an audit of your internal inventory records, whatever those may be



A taxpayer may elect the NIMS method (the easiest and most advantageous method) by reporting NIMS inventory on their tax return the first year they have value-added inventory on hand at the end of the year. This is called a "protective election." By electing NIMS you protect yourself against the IRS determining your taxable income using another, less favorable, method.

The worst-case scenario is that a taxpayer is unaware of these rules and the IRS audits the return. If the IRS cannot see evidence that the taxpayer kept a NIMS inventory for tax purposes, the IRS will consider the taxpayer to have elected to use a book method - AND - the IRS may determine that the book method in use (any set of records the taxpayer keeps if those records associate quantity and dollar values) was not accurately reported on the tax return, and re-calculate taxable income using the taxpayer's inventory records.

## Making a NIMS election.

1. Determine the **direct costs** that go into value-added inventory. For NIMS direct costs are supplies and materials you purchased to create or pack the product, or the cost of custom processing/packing.
2. Determine how much value-added product associated with those costs is on-hand at the end of the tax-year (generally midnight on 12/31).
3. Report Supplies Expense at the full amount on line 28 of Schedule F.
4. Add a new expense line called “LESS: NIMS INVENTORY ADJUSTMENT” and record the amount calculated in Step 2 as a “NEGATIVE.”

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NIMS only requires you to consider direct costs in inventory. That means only supplies purchased or contract labor associated with custom-packed products. You do not have to include the cost of wages you pay, or any of the overhead associated with your facilities when you calculate NIMS inventory. That means you can deduct those costs in the year they are paid. Most book inventory methods require including these other costs in inventory.

To be very clear on your tax return you should show the amount of NIMS inventory as a negative expense clearly labeled as NIMS inventory. This reduces total deductions as required, and makes it clear to the IRS (or your future self) that you have made a NIMS election.

## Reporting in years after you first make the NIMS election

1. Add the prior year negative NIMS inventory adjustment amount to supplies expense - this increases supplies expense by the amount you did not deduct in the prior year.
2. Repeat steps 1-4 above.



When you account for NIMS inventory it typically means that you may not take a current year deduction for expenses you paid in the current year. Instead, you deduct thos[illegible]es in the following year.

If you do not account for inventory correctly on your tax return it means that in the first year you have over-deducted, and thus possibly under-paid your taxes. In all of the subsequent years you will both under-deduct and over deduct. You will under-deduct by the amount you over-deducted in the prior year, and you will over-deduct by the amount that should be deducted in the following year. If your year-end inventory amounts do not fluctuate much, there will be minimal tax effect after the first year. However, if you fail to account for inventory correctly and are unable to show the IRS records of your reasonable inventory calculations, the cost of working with the IRS and correcting your records and your prior tax returns can be greater than the total amount of taxes underpaid. This is why it is safest to make the NIMS election and show a NIMS adjustment each year.

## What is the easiest way to do this?

1. Tell your tax preparer you want to make a NIMS election on your tax return.
2. Describe to them the value-added inventory you have on hand at the end of the tax year.
3. Let them propose an amount for the NIMS inventory adjustment. Review the amount and the calculation with them and approve the adjustment.
4. Ask them to give you the adjusting entry to make on your books.



If you have an operation with value-added inventory on hand at the end of the year, you should be using a double-entry bookkeeping system. Lesson 2 reviews what the IRS r[illegible]n terms of records. As your business grows in size, volume and complexity, the requirements for clear and accurate records also increase. What may be adequate to represent the business activities of a small, simple business will not be adequate when that business grows and becomes more complex.

## What are other resources to help with this?

- A local Small Business Development Center (SBDC) may be able to help you to set up (or clean up and improve) your bookkeeping system and establish methods for tracking inventory. See SBDC.net
- The USDA Value Added Producer Grant Program (VAPG) is a cost-reimbursement program intended to help producers establish profitable value-added businesses. See USDA Rural Development Business Programs.



If you want to be successful with a value-added business, your success will depend on your ability to manage inventory. Managing inventory means knowing the cost of your inventory and knowing how fast (or slow) your inventory sells. NIMS is probably the best tax method for reporting inventory, but it is probably not the best method for actually managing your inventory to maximize profits.

One of the things you can do with VAPG funds is pay to design and implement good inventory systems for your internal management purposes and for proper tax reporting.

Questions?

Thank you!

## How do I learn more about federal income taxes and my farm or ranch?

- There are previous lessons in this series.
- For each lesson there is a short set of questions you can answer to help you decide if the training will be useful to you.
- You can access the questions and the trainings here:
- https://law.uark.edu/academics/llm-food-ag/llm-projects-agftap.php
- Additional project resources are available here: https://agftap.org

## How do I learn more about federal income taxes and my farm or ranch?

IRS Publication 225, The Farmers Tax Guide

RuralTax.org

IRS website and publications

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