Entrepreneur

When It Comes to Taxes, Here Is How to Handle Inventory

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Q: I have just started an online store where I will hold some inventory and want to know how I will be taxed, what tax forms I need to complete and how to value my inventory for tax purposes.
-- *Isaiah Cox*

Congratulations on starting your business!

Your business will be taxed on its profits at the end of the year. In its most basic form you would determine your profits as follows:

1. Your sales make your **Total Revenue**.
2. Your beginning inventory plus the items you buy each year minus your ending inventory form your **Cost of Goods Sold ("COGS")**.
3. What you have not sold by the end of the year valued at your cost, is your **Inventory**.

Total Revenue – COGS = Profit

You will then be taxed on your profits. How you will report these profits will depend on the type of corporate structure you have chosen. Your corporate structure is more about how your assets are protected -- your personal assets from business liabilities and vice versa -- than tax advantages, but the structure does play a role in what tax forms you need to file.

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In order from least asset protection to greatest asset protection, here are the various corporate structures:

Sole proprietorship: You have no business entity; you will file a Schedule C with your personal tax return

Single member LLC: You will file a Schedule C form with your personal tax return

Multi-member LLC: You will file either a partnership tax return – form 1065, or a Small Corporation tax return – form 1120-S

Partnership: You will file form 1065 and the net income will flow through to the partner's personal tax returns.

Corporation: You will file form 1120 with the IRS. The business is taxed separately from the owners (stockholders). Stockholders are taxed on any dividends paid to them by the corporation throughout the year.

In addition, if you are drawing a salary from your business you will likely need to pay your own Social Security and Medicare Taxes, known as "Self-Employment Tax." The current rate is 15.3 percent, and you would need to pay this quarterly. You can calculate the amount you need to pay using the work sheet found in Form 1040-ES and make the payment using the voucher in 1040-ES or the Electronic Federal Tax Payment System (EFTPS). The exception is if you have a corporation, which is taxed separately from the owners (stockholders) and then the business would pay the employer portion of the Social Security and Medicare taxes for you, and you would just pay the employee portion.

How do I value my inventory for tax purposes?

Your inventory should be valued at your purchase cost. Items that cannot be sold or are "worthless" can be taken out of inventory, and the loss is reflected as a higher cost of goods sold on your tax return. (You have the cost of the item, but no revenue for the sale). Higher cost of goods sold means more deductions against your total income from sales, lowering your profit subject to taxation.

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When you start a business that includes inventory you need to decide how you will value your inventory, the IRS accepts these three ways:

1. Cost. Simply value the item at your purchase price plus any shipping fees etc.
2. Lower of cost or market. You would compare the cost of each item with the market value on a specific valuation date each year.
3. Retail. You would add the retail value (i.e. your selling price) and then subtract a set mark-up percentage to determine the cost.

Generally, entrepreneurs and small businesses utilize the cost method, as it's the easiest to keep track of with smaller inventories.

When you can't specifically identify the cost of individual items in your inventory, or the same types of goods are intermingled in your inventory and they can't be identified with specific invoices you can use one of two methods of keeping track of your inventory: the First In First Out Method (FIFO) or the Last In First Out Method (LIFO).

If you sell products (that you purchase or manufacture), and the cost of your products tends to increase over time, using the LIFO method will typically result in a lower taxable income compared to FIFO. But if you need to maintain relatively strong financials, like a balance sheet, to qualify for bank loans and satisfy your partners and investors then FIFO may be the way to go.

There is no tax advantage to keeping an inventory that is larger than necessary for the business purpose. Purchases of inventory are not a tax deduction until the inventory items are sold, or deemed "worthless" and removed from the inventory. Alternately, keeping a smaller than necessary inventory on hand would not give you an advantage on your taxes. Many companies try to time the purchase of supplies/inventory to coincide with the production process (known as Just in Time Inventory) and can really help businesses conserve cash, avoid excess borrowing costs and excess facility costs (since they are not storing tons of supplies).

I would highly recommend speaking with an accountant to help you estimate your tax payments, pick the best inventory accounting method and of course help you manage your business financial records.

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