

## Write-Offs for Damaged Inventory

### Cross References

- T.C. Memo. 2024-104, *IQ Holdings, Inc.*

The taxpayer was a manufacturer of aerosol consumer products, including products for personal and home care, and automotive products. The taxpayer made a seller financed sale of its aerosol products and raw packaging materials to a related corporation that had applied for status as a tax-exempt private foundation. The taxpayer had intended to forgive the loan once the related corporation received its IRC section 501(c)(3) approval to become a tax-exempt organization.

However, by the time the related corporation got that approval in 2014, some or all of the aerosol products and packaging materials were found to be rusted, leaking, broken, or otherwise damaged. As a result, the taxpayer and the related corporation decided to reverse the sale. After reversal, the taxpayer wrote off the cost of the aerosol products and the raw packaging materials on its books and records and on its 2014 tax return, which increased its cost of goods sold deduction. During a 2016 audit by the IRS, the taxpayer was still in the process of decommissioning the aerosol cans by puncturing the bottom of each can, collecting the liquid contents, and preparing the cans and liquid for disposal or recycling.

Also for the 2014 tax year, the taxpayer wrote off aerosol can inventory that was originally manufactured for the WD-40 company. The taxpayer had discovered a design defect in the cans that left them in violation of Department of Transportation regulations.

The IRS disallowed the increase to cost of goods sold on account of damaged or obsolete inventory. In court, the IRS cited Regulation section 1.471-2(a) that states there are two tests to which each inventory must conform:

- 1) It must conform as nearly as may be to the best accounting practice in the trade or business, and
- 2) It must clearly reflect the income.

The Supreme Court has remarked that “best accounting practice” is synonymous with generally accepted accounting principles (GAAP) and that IRC section 471 “vests the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income.”

The taxpayer argued that its write-off of inventory for 2014 was consistent with GAAP. The IRS did not dispute that contention but supports its deficiency determination by arguing that the write-off does not clearly reflect the taxpayer’s income. The IRS pointed to Regulation section 1.471-2(c), which general provides that businesses may value inventory at either:

- 1) Cost, or
- 2) The lower of cost or market price.

However, that regulation then sets forth the following:

*Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition...or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.*

The IRS noted that the taxpayer never offered for sale the damaged aerosol products or WD-40 cans, and he therefore concludes that the taxpayer's write-off did not comply with the regulations.

The court noted that the cited regulation encompasses inventory "unsalable at normal prices" but does not explicitly deal with inventory that is unsalable at any price, as the taxpayer contends was the case with its aerosol products and WD-40 cans. The Supreme Court did not address a situation in which the inventory is completely obsolete, hazardous, or illegal to sell, or in which the inventory's scrap value is zero.

The taxpayer argued that those are instances to which the regulation's general requirement to hold the property out for sale cannot apply, since holding such items out for sale would be nonsensical.

The court agreed with the taxpayer that the cited regulation cannot be read to require a taxpayer to offer for sale items that, in their current condition, would be tortious or illegal to sell. The court denied the IRS's summary judgement in this case and held off making a final ruling until more evidence is provided as to whether the taxpayer's inventory could be feasibly rehabilitated.