Internal Revenue Code Section 471(c)

General rule for inventories

(a) General rule.
Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

(b) Estimates of inventory shrinkage permitted.
A method of determining inventories shall not be treated as failing to clearly reflect income solely because it utilizes estimates of inventory shrinkage that are confirmed by a physical count only after the last day of the taxable year if-

(1) the taxpayer normally does a physical count of inventories at each location on a regular and consistent basis, and

(2) the taxpayer makes proper adjustments to such inventories and to its estimating methods to the extent such estimates are greater than or less than the actual shrinkage.

(c) Exemption for certain small businesses.

(1) In general.
In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year-

(A) subsection (a) shall not apply with respect to such taxpayer for such taxable year, and

(B) the taxpayer's method of accounting for inventory for such taxable year shall not be treated as failing to clearly reflect income if such method either-

(i) treats inventory as non-incidental materials and supplies, or

(ii) conforms to such taxpayer's method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures.

(2) Applicable financial statement.
For purposes of this subsection, the term "applicable financial statement" has the meaning given the term in section 451(b)(3).

(3) Application of gross receipts test to individuals, etc.

In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.

(4) Coordination with section 481.
Any change in method of accounting made pursuant to this subsection shall be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary.

(d) Cross reference.
For rules relating to capitalization of direct and indirect costs of property, see section 263A .