



1 Bench Opinion by Special Trial Judge Lewis R. Carluzzo

2 May 23, 2019

3 David L. McCrea & Denise McCrea v. Commissioner of

4 Internal Revenue

5 Docket No. 11648-18S

6 THE COURT: The Court has decided to render oral  
7 findings of fact and opinion in this case and the  
8 following represents the Court's oral findings of fact and  
9 opinion (bench opinion). Section references made in this  
10 bench opinion are to the Internal Revenue Code of 1986, as  
11 amended, in effect for the relevant period, and Rule  
12 references are to the Tax Court Rules of Practice and  
13 Procedure. This bench opinion is made pursuant to the  
14 authority granted by section 7459(b) and Rule 152.

15 This proceeding for the redetermination of a  
16 deficiency is a small tax case subject to the provisions  
17 of section 7463 and Rules 170 through 174. Except as  
18 provided in Rule 152(c), this bench opinion shall not be  
19 cited as authority, and pursuant to section 7463(b) the  
20 decision entered in this case shall not be treated as  
21 precedent for any other case.

22 David L. McCrea and Denise McCrea appeared  
23 unrepresented by counsel.

24 Estevan D. Fernandez appeared on behalf of  
25 respondent.

1           In a notice of deficiency dated April 2, 2018  
2     (notice), respondent determined a deficiency in  
3     petitioners' 2014 Federal income tax and further  
4     determined that petitioners are liable for a section  
5     6662(a) penalty. In addition to computational adjustments  
6     that will not be addressed in this bench opinion, the  
7     deficiency results from adjustments respondent made to the  
8     cost of goods sold computation shown on a Schedule C,  
9     Profit or Loss From Business, included with petitioners'  
10    2014 joint Federal income tax return (return). After  
11    concessions, the issue for decision is the value of the  
12    ending inventory maintained by petitioners in connection  
13    with the trade or business to which that Schedule C  
14    relates.

15           Some of the facts have been stipulated and are  
16    so found. At the time the petition was filed, petitioners  
17    resided in California.

18           At all times relevant, Denise McCrea owned  
19    Natura Maya LLC, apparently an entity treated as a sole  
20    proprietorship engaged in business as a wholesale seller  
21    of herbal medical products (Natura). Natura sold hundreds  
22    of different items to dozens of small retail businesses  
23    located throughout the United States. The income and  
24    deductions attributable to that business are shown on the  
25    above-referenced Schedule C. Although Denise McCrea is

1 identified as the owner of Natura on the Schedule C, the  
2 evidence shows that both petitioners participated  
3 substantially in the operation of the business.

4 According to the Schedule C, the income and  
5 expenses of Natura were computed under the cash receipts  
6 and disbursement method of accounting, apparently on the  
7 basis of a calendar year. Natura maintained an inventory  
8 of the products it held for sale, and it used the cost  
9 method to value closing, or ending inventory.

10 Anyone familiar with basic accounting principles  
11 recognizes that the value of ending inventory is a factor  
12 in the computation of cost of goods sold, which in turn  
13 must be used to compute the gross income and ultimately  
14 the net profit of the business. Other factors, such as  
15 beginning inventory (that, absent adjustments, is merely  
16 carried over from ending inventory for the prior  
17 accounting period) and purchases during the year are also  
18 included in the computation of cost of goods sold.

19 In this case, petitioners now agree that the  
20 amounts shown on the Schedule C for both beginning  
21 inventory and purchases are overstated. They further  
22 agree to the adjustments made to those items as shown in  
23 the notice. The parties disagree, however, as to the  
24 proper amount of the value of Natura's ending inventory.  
25 According to petitioners, it is the amount shown on the



1 Schedule C and supported by trial Exhibit 7-J. Relying  
2 upon an \$89,177 entry shown on the last page of trial  
3 Exhibit 4-J, respondent takes the position that the value  
4 of the ending inventory shown on the Schedule C is  
5 understated by \$21,112. Respondent's position assumes the  
6 \$89,177 entry is the value (cost) of the inventory on hand  
7 as of the close of 2014, a point not entirely clear to the  
8 Court.

9           Apparently exhibit 4-J was provided to  
10 respondent's revenue agent during the course of the  
11 examination, although neither of the petitioners nor their  
12 return preparer recall giving the document to the agent.  
13 Exhibit 7-J, which identifies itself as a physical  
14 inventory, was provided to respondent later, although the  
15 circumstances of its preparation are less than clear.  
16 Petitioners claim that a physical inventory is taken at  
17 the end of each year, and the results of the physical  
18 inventory are noted on a document turned over to the  
19 return preparer. Petitioner's return preparer claims that  
20 he used the document in the preparation of the return.  
21 That document, however, has not been provided, and  
22 petitioners only vaguely connect the missing document to  
23 Exhibit 7-J.

24           Exhibit 4-J contains entries showing hundreds of  
25 purchase and sales transactions on an item-by-item basis.

1 Specific vendors and customers are identified in most of  
2 the entries in a series of transactions categorized by  
3 item number. Many entries show inventory adjustments not  
4 related to a purchase or sale, again categorized by item  
5 number. The document shows increases and decreases in the  
6 number of a particular item depending upon whether items  
7 were purchased ("bill") or sold ("invoice"). A fair  
8 reading of the document suggests that it is exactly what  
9 it and respondent claim it to be, that is, the detail of  
10 Natura's ending inventory. Petitioners claim that it is  
11 no such thing, although they offer little explanation for  
12 its existence. Their claim that Exhibit 4-J cannot be  
13 used to value ending inventory because it is cumulative,  
14 of course, is easily rejected. Inventory records are by  
15 nature, cumulative, especially in situations where all  
16 inventory is not sold in the same year it is acquired or  
17 manufactured. As noted, according to petitioners, Exhibit  
18 4-J is not used for inventory purposes and is otherwise  
19 unreliable or inaccurate. According to petitioners,  
20 Exhibit 7-J more accurately shows the value of Natura's  
21 ending inventory. Petitioners' attempt to distance  
22 themselves from Exhibit 4-J, however, is greatly  
23 undermined by the fact that virtually all of the entries  
24 in Exhibit 7-J are exactly as shown in Exhibit 4-J.

25 Respondent, on the other hand, attacks the

1 reliability of Exhibit 7-J by pointing out, correctly so,  
2 that many categories of items shown in Exhibit 4-J are  
3 omitted from Exhibit 7-J. Exhibit 4-J, however, shows  
4 that there were no inventory items remaining in numerous  
5 categories as of the close of 2014, so the omission of  
6 those items from Exhibit 7-J is understandable.

7 Nevertheless, we cannot understand, and petitioners have  
8 failed adequately to explain why numerous items shown to  
9 be remaining in inventory in Exhibit 4-J are not included  
10 in Exhibit 7-J. Some of those omissions were pointed out  
11 by respondent during trial, and the Court, after  
12 comparison of the two exhibits, has identified numerous  
13 other examples. The omissions strongly suggest that  
14 Natura's ending inventory as shown on the return is  
15 understated, but not necessarily as determined by  
16 respondent in the notice.

17 More likely than not the correct value of  
18 Natura's ending inventory is a number in between the  
19 amount petitioners claim it to be and the amount  
20 determined by respondent. Because it is clear that  
21 petitioners are entitled to take into account cost of  
22 goods sold in the computation of Natura's gross income,  
23 see Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir.  
24 1930); see also Vanicek v. Commissioner, 85 T.C. 731, 742-  
25 743 (1985), we could use typical gross profit margins

1 shown for businesses similar to Natura, that is, within  
2 standard industry code 446190 as shown on the Schedule C,  
3 to estimate the ending inventory of the business. After  
4 all, the gross receipts reported on Natura's Schedule C  
5 have been accepted as reported. But we think it more  
6 appropriate to determine the value of Natura's ending  
7 inventory with reference to a record created from  
8 information somehow or another entered into Natura's  
9 bookkeeping system even if that record was not, as  
10 petitioners claim, routinely used for inventory tracking  
11 purposes. That record is Exhibit 4-J.

12 We find that the value of Natura's ending  
13 inventory is the sum of the values for each category of  
14 items shown to be "on hand" as of December 31, 2014, on  
15 Exhibit 4-J. If the number of any particular item shown  
16 to be "on hand" varies from the number for the same item  
17 shown on Exhibit 7-J, then the number and the value shown  
18 on Exhibit 7-J shall be used. In short, the ending  
19 inventory value shown on Exhibit 7-J shall be supplemented  
20 with those items shown on Exhibit 4- J, but not shown on  
21 Exhibit 7-J. In the absence of agreement between the  
22 parties on the computation, it will be up to each of them  
23 to do the math. It might be that the total is as shown on  
24 the last page of Exhibit 4-J. If so, that needs to be  
25 confirmed. If the total is less, then the lesser amount

1 is to be used in the calculation of Natura's ending  
2 inventory, and ultimately in the calculation of the  
3 deficiency in petitioners' 2014 Federal income tax.

4 As noted, in the notice respondent imposed a  
5 section 6662(a) penalty. The evidence shows that a  
6 supervisor approved the imposition of the penalty on  
7 November 11, 2017, which date precedes the issuance of the  
8 notice. See secs. 6751(b) and 7491(c); Graev v.  
9 Commissioner, 149 T.C. 485, 492-493 (2017), supplementing  
10 and overruling in part Graev v. Commissioner, 147 T.C. 460  
11 (2016). But petitioners were first formally advised of  
12 the imposition of the penalty on August 29, 2017, which  
13 precedes the date of the supervisory approval.  
14 Consequently, respondent's imposition of the section  
15 6662(a) penalty must be rejected. See Clay v.  
16 Commissioner; 152 T.C. (April 24, 2019).

17 To reflect the foregoing, a decision will be  
18 entered under Rule 155. This concludes the Court's bench  
19 opinion in this case.

20 (Whereupon, at 12:53 p.m., the above-entitled  
21 matter was concluded.)

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