Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Lower of Cost or Market (LCM)	
Primary UIL Code	00471.04-00	Lower of Cost or Market

Library Level	**Title**
Knowledge Base	Corporate/Business Issues & Credits
Shelf	Inventory and IRC 263A
Book	Inventory General
Chapter	Valuation of Inventory

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General Overview

Lower of Cost or Market (LCM)

There are two tests under IRC 471 that each taxpayer's inventory must satisfy:

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

Any taxpayer whose income producing factors are producing, purchasing, or selling of merchandise must take inventory at the beginning and ending of the taxable year to correctly reflect income, unless the taxpayer is a small business taxpayer.

The Tax Cuts and Jobs Act (TCJA) of 2017 raised the gross receipts applicable for the small business taxpayer exception in IRC 471(c). For tax years beginning after 12/31/2017, a small business taxpayer who has average annual gross receipts of $25 million or less (indexed for inflation) for the three prior tax years and who is not a tax shelter (as defined under IRC 448(d)(3)) is not required to account for inventories.

There are two inventory valuation methods under IRC 471 that a taxpayer may choose to use:

1. Cost, and
2. Cost or market, whichever is lower.

IRC 471 states that the inventory method should be within the scope of the best accounting practice of the taxpayer's trade or business and must be applied consistently from year to year.

Detailed Explanation of the Concept

Lower of Cost or Market (LCM)

Analysis	Resources
When using the Lower of Cost or Market (LCM) to value inventory, a taxpayer compares the market value of each good on hand at the inventory date with the cost of that good. The taxpayer uses the lower value as the inventory value. Under LCM: 1. Cost means historical cost - the cost of goods that include direct materials costs, direct labor costs, indirect costs, purchasing costs, storage and handling costs, and properly allocable management costs that the taxpayer is required to include in inventory if they are subject to IRC 263A. 2. Market means the “current bid prices” on the date of the inventory, which includes all the costs associated with purchased goods on hand, unfinished goods in process of manufacture, and finished goods on hand.	▪ Treas. Reg. 1.471-4(c)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Lower of Cost or Market (LCM)</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>Inventory at cost is defined as follows:
1. For merchandise on hand, inventory at cost is the price of such merchandise at the beginning of the taxable year.
2. For purchased merchandise, inventory at cost is the invoice price less trade discounts, plus transportation costs and other costs incurred in acquiring such merchandise.
3. For produced merchandise, inventory at cost includes the cost of raw materials and supplies, plus the cost of labor and indirect costs incidental and necessary in producing such merchandise, including an appropriate portion of management expenses and other costs that are required to be included under IRC 263A.
4. Since ascertaining the actual cost of livestock and other farm products is difficult, farmers may value inventory according to the "farm-price method" or the "unit-livestock-price method".
5. For miners, inventory at cost is valued under Treas. Reg. 1.471–7.
6. Retail merchants may use the "retail inventory method" under Treas. Reg. 1.471–8.</td><td>▪ Treas. Reg. 1.263A-1
▪ Treas. Reg. 1.263A-2
▪ Treas. Reg. 1.263A-3
▪ Treas. Reg. 1.471-3(a)
▪ Treas. Reg. 1.471-3(b)
▪ Treas. Reg. 1.471-3(c)
▪ Treas. Reg. 1.471–6
▪ Treas. Reg. 1.471–7</td></tr>
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<u>Market for Normal Goods</u>

Inventory at market for normal goods is the bid price, or the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items. This is a replacement cost and not what the good would sell for.

1. For purchased goods and goods on hand, market means the prevailing price at the inventory date in the same quantity the taxpayer normally purchases.
2. For manufactured goods, market means the prevailing cost to replace or reproduce at the inventory date.
    i. Replacement cost is the same treatment as for purchased goods.
    ii. Reproduction cost includes all costs of the product such as direct materials, direct labor, and overhead in work-in-progress and finished goods, as well as the appropriate portion of management expenses and other costs that are required to be included under IRC 263A.

Either of these methods may be acceptable, however National Office has maintained that replacement cost is the appropriate standard for manufacturers.
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▪ Treas. Reg. 1.471-4(a)
▪ Treas. Reg. 1.471-4(c)
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Detailed Explanation of the Concept (cont'd)

Lower of Cost or Market (LCM)	
Analysis	**Resources**
No Open Market The existence of market and the evidence of market price. When there is no market or the market is inactive, the taxpayer may deviate from the general definition of "market" however, the taxpayer must: 1. Prove no open market exists or quotations are nominal. 2. Provide evidence of a fair market price at or near the inventory date, which can be proven by: i. Specific purchases or sales by the taxpayer or others that are a reasonable volume or made in good faith; or ii. Compensation paid for cancelling purchase commitments. Prices which vary materially from the actual prices will not be accepted as reflecting the market value.	▪ Treas. Reg. 1.471-2(c) ▪ Treas. Reg. 1.471-4(b) ▪ TAM 9317004 (1993)

Detailed Explanation of the Concept (cont'd)

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No Open Market (cont'd.)

In Neusteter Suit Co. v. C.I.R., 8 B.T.A. 477 (1927), the board of appeals allowed the taxpayer to use the retail value as the market price because:

- There was no stability to the market and no replacement cost was available due to rapid changes in styles and the short period of reasonability of most of the merchandise of the taxpayer's inventory.
- The taxpayer consistently applied the method used to value inventory for all business purposes, income-tax returns, credit statements and financial reports.
- The taxpayer conformed as close to the best accounting practice in the trade or business.

In Elder Mfg. Co. v. U.S., 80 Ct. Cl. 666 (1935), the court dismissed the taxpayer claim of no market, because:

- The evidence showed there was a market for the merchandise, even though the sales volume was lower, although the taxpayer contended that no market existed because it was stagnant.
- The market price for the merchandise on the inventory date had not been reduced.
- The "quotations are nominal" in the regulations refers to the quoted prices for the merchandise, not to the volume of sales.

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- Treas. Reg. 1.471-4(b)
- Elder Mfg. Co. v. U.S., 80 Ct.Cl. 666 (1935)
- Neusteter Suit Co. v. C.I.R., 8 B.T.A. 477 (1927)

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<tr><td><u>Evidence of Market Price</u>

In Sam Goldberger, Inc. v. Commissioner of Internal Revenue, 88 T.C. No. 87 (1987), the court concluded that the taxpayer failed to establish the inventory was valued in accordance with Treas. Reg. 1.471-4(b) and found that:
▪ The taxpayer did not consistently adhere to the industry practice as testified to by the taxpayer's expert witness.
▪ The taxpayer inconsistently valued its inventory from year to year based on only one or two sales in the audit cycle with insufficient evidence of market price.
▪ There were several goods that appeared in the ending inventory of year one but not year two of the audit, with no evidence indicating that these goods were sold or the sales price.

The court stated that:
▪ Under LCM, a taxpayer must substantiate its lower inventory valuation by providing evidence of actual offerings, actual sales, or actual contract cancellations.
▪ Taxpayer bears a heavy burden of proof with respect to overcoming a finding by the Commissioner that the inventory valuations did not clearly reflect income.</td><td>▪ Treas. Reg. 1.471-2(c)
▪ Treas. Reg. 1.471-4(b)
▪ Sam Goldberger, Inc. v. Commissioner of Internal Revenue, 88 T.C. No. 87 (1987)</td></tr>
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Detailed Explanation of the Concept (cont'd)

Lower of Cost or Market (LCM)	
Analysis	**Resources**
<u>Lower Price Exception</u> If the taxpayer has regularly offered a product for sale at a lower price than market, the inventory may be valued at the lower price less direct costs of disposition, otherwise referred to as Net Realizable Value (NRV). To use the lower than market price, the taxpayer must substantiate the price by reference to actual sales of the product within a reasonable period before and no later than 30 days after the inventory date, with preference given to sales nearest the inventory date as possible. In Space Controls, Inc. v. C.I.R., 322 F.2d 144 (1963), the court allowed the taxpayer to value its inventory at the lower price because: ▪ The taxpayer had a firm sales contract with an offering for sale at a price lower than cost. ▪ The contract with the government to manufacture, sell and deliver the specific military trailers was 'in the regular course' of its business, where at year end the costs exceeded the contract price. ▪ The trailers were of a special military design, were not suitable for commercial or civilian use, and their market value would be for scrap, which can be considered sub-normal goods. ▪ The court cited Treas. Reg. 1.471-4(b) stated that "inventory may be valued at such prices less direct cost of disposition" where "the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price."	▪ Treas. Reg. 1.471-4(b) ▪ In Space Controls, Inc. v. C.I.R., 322 F.2d 144 (1963)

Detailed Explanation of the Concept (cont'd)

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<tr><th colspan="2">Lower of Cost or Market (LCM)</th></tr>
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<tr><td><u>Subnormal Goods</u>

Subnormal goods are goods in 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, second-hand goods taken in exchange, or other similar causes.

Subnormal finished goods must:
1. Be valued at bona fide selling prices less direct cost of disposition; and
2. Actually offered at that selling price within 30 days after the inventory date.

Subnormal raw materials or partly finished goods must be valued:
1. Reasonably based on the usability and condition of the goods; and
2. At no less than the scrap value.

The taxpayer has the burden to prove that the goods are subnormal. To do so, the taxpayer must:
1. Maintain records of the goods disposition.
2. Show evidence that within 30 days after the inventory date there was:
i. An offering for sale,
ii. An actual sale, or
iii. A contract cancellation.
3. Remove and exclude from inventory the goods that are completely unsalable due to physical deterioration or obsolescence.</td><td>▪ Treas. Reg. 1.471-2(c)</td></tr>
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<u>Subnormal Goods (cont'd)</u>

Custom goods may be considered subnormal goods. Excess or overstocked inventory is not subnormal goods, unless it is:
▪ Scrapped or completely obsolete at inventory date.
▪ Sold with an option to repurchase at arms-length.
▪ Offered at a reduced price in inactive markets.

In McKay Machine Co. v. C.I.R., 28 T.C. 185 (1957), the court found that:
▪ The taxpayer contracted with the foreign country to produce a specialized machine.
▪ The taxpayer was denied an export shipping license.
▪ The buyer representative left the country.
▪ The taxpayer was unable to resell the specialized machine.

The court held that:
▪ The reduction of the taxpayer inventory value was proper for the unfinished machine which was similar to an obsolete or damaged good.
▪ The valuation of the machine as scrap was consistent with the reasonable basis requirement of Treas. Reg. 1.471-2(c).
</td><td>
▪ Treas. Reg. 1.471-2(c)
▪ McKay Machine Co. v. C.I.R., 28 T.C. 185 (1957)
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<tr><td>In Queen City Woodworks & Lumber Co. v. Crooks, 7 F. Supp. 684 (1934), the court allowed the taxpayer to revalue its inventory without actual offering it for sale, due to the goods becoming “completely obsolete.”

The court found that:
▪ The evidence showed the dynamic radio devices and equipment were recognized as far more efficient and therefore, there were no demands for the magnetic radio.
▪ The overwhelming testimony showed that the magnetic device was obsolete and even many of the sporadic sales from occasional demand were canceled or rescinded.
▪ The taxpayer mistakenly valued its inventory at cost, then at the inventory date discovered goods were completely worthless.

The court held that:
▪ Treas. Reg. 1.471-2(c) does not contemplate complete obsolescence, so it would be unfair to strictly enforce the offer-for-sale requirement where there was no demand for an obsolete device.
▪ If the taxpayer was required to pay an income tax upon the closing inventory returned by it, for the reason that the closing inventory did not reflect its true income, then the tax would not be upon a true income.</td><td>▪ Treas. Reg. 1.471-2(c)
▪ Queen City Woodworks & Lumber Co. v. Crooks, 7 F.Supp. 684 (1934).</td></tr>
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<tr><td><u>Audit Tips</u>

Review the taxpayer's books and records to identify the addition and disposition of inventory. Consider requesting contemporaneous documentation supporting:
1. Disposition
2. An offering for sale
3. Sales contracts or cancellation of contract.

When the Service determines a taxpayer's Lower of Cost or Market (LCM) inventory method is not in compliance with the Code and regulations, the taxpayer is using an impermissible method of accounting. The Service may change the taxpayer's method of accounting to a permissible LCM inventory method or to another permissible inventory method by proposing a Service-imposed method change. See Rev. Proc. 2002-18.

The guidance on Service-imposed method change issues is in the Servicewide Virtual Library, Corporate and Business (Non-Credits) Knowledge Base, Change in Methods Book, Involuntary Change in Method (Service Initiated).</td><td>▪ Rev. Proc. 2002-18
▪ Corporate and Business Issues (Non-Credits) Knowledge Base, Change in Methods Book, Involuntary Change in Method (Service Initiated)
▪ Practice Unit, Accounting Method Basics</td></tr>
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Examples of the Concept

Lower of Cost or Market (LCM)

Examples

Determining the Value of Manufactured Goods

Taxpayer P manufactures tractors. P values its inventory using LCM.

At the end of 2020, the cost of one of P's tractors on hand is determined as follows:

Direct materials	$ 3,000
Direct labor	$ 4,000
Indirect costs including section 263A costs	$ 3,000
Total cost of the tractor	$10,000

P determines that to reproduce the tractor at the end of the year, the aggregate of the current bid prices of the materials, labor, and overhead are as follows:

Direct materials	$ 3,100
Direct labor	$ 4,100
Indirect costs including section 263A costs	$ 3,100
Total market cost of the tractor	$10,300

In determining the lower of cost or market value of the tractor, P compares the $10,000 cost of the tractor with the $10,300 market value of the tractor, resulting in a $10,000 value (the lower of cost or market).

Examples of the Concept (cont'd)

Lower of Cost or Market (LCM)

Examples

Determining the Value of Resale Merchandise

Taxpayer S purchases and resells several lines of shoes that are subject to section 263A. S values its inventory using LCM.

At the end of 2020, the cost of one pair of shoes on hand is determined as follows:

Acquisition cost	$200
Indirect costs including section 263A costs	$ 10
Total cost of the pair of shoes	$210

S determines the aggregate current bid prices prevailing at the end of 2020 for all the cost elements of cost (both direct and indirect costs incurred prior and subsequent to acquisition of the shoes), and based on the volume of the elements usually purchased or incurred by S as follows:

Acquisition cost	$178
Indirect costs including section 263A costs	$ 12
Total market cost of the pair of shoes	$190

In determining the lower of cost or market value of the shoes, S compares the $210 cost of the pair of shoes with the $190 market value of the pair of shoes, resulting in a $190 value (the lower of cost or market).

Index of Referenced Resources

Lower of Cost or Market (LCM)
IRC 263A
IRC 448(d)(3)
IRC 471
IRC 471(c)
Treas. Reg. 1.263A-1
Treas. Reg. 1.263A-2
Treas. Reg. 1.263A-3
Treas. Reg. 1.471-2(c)
Treas. Reg. 1.471-3(a)
Treas. Reg. 1.471-3(b)
Treas. Reg. 1.471-3(c)
Treas. Reg. 1.471-4(a)
Treas. Reg. 1.471-4(b)
Treas. Reg. 1.471-4(c)
Treas. Reg. 1.471–6
Treas. Reg. 1.471–7

Index of Referenced Resources (cont'd)

Lower of Cost or Market (LCM)
Treas. Reg. 1.471–8
Tax Cuts and Jobs Act (TCJA) of 2017
TAM 9121003
TAM 9317004 (1993)
Rev. Proc. 2002-18
Elder Mfg. Co. v. U.S., 80 Ct.Cl. 666 (1935)
In Space Controls, Inc. v. C.I.R., 322 F.2d 144 (1963)
McKay Machine Co. v. C.I.R., 28 T.C. 185 (1957)
Neusteter Suit Co. v. C.I.R., 8 B.T.A. 477 (1927)
Queen City Woodworks & Lumber Co. v. Crooks, 7 F.Supp. 684 (1934).
Sam Goldberger, Inc. v. Commissioner of Internal Revenue, 88 T.C. No. 87 (1987)
Corporate and Business Issues (Non-Credits) Knowledge Base, Change in Methods Book, Involuntary Change in Method (Service Initiated)
Practice Unit, Accounting Method Basics

Training and Additional Resources

Lower of Cost or Market (LCM)	
Type of Resource	**Description(s)**
Other Training Materials	▪ CPE - Basic FIFO Inventory Class ▪ Inventory FAQs ▪ Inventory write-down questions ▪ Inventory write-down tax law summary ▪ Job Aid - Lower of Cost or Market

Glossary of Terms and Acronyms

Term/Acronym	Definition
CPE	Continuing Professional Education
FAQs	Frequently Asked Questions
FIFO	First-In First-Out
IRC	Internal Revenue Code
LCM	Lower of Cost or Market
NRV	Net Realizable Value
TAM	Technical Advice Memorandum
TCJA	Tax Cuts Jobs Act
Treas. Reg.	Treasury Regulations

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
446.00-00	Accounting Method Basics