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to: David W. Bulger
Inventory Technical Advisor

from: Eric R. Skinner
Associate Area Counsel, LMSB (Detroit)

subject: Valuation of Excess Parts Inventory

This Field Attorney Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Corp X =
D =
E =
F =
G =
H =
Bulk Sale Price =
Year 1 =
Year 2 =
Year 3 =
Amount 1 =
Amount 2 =
Amount 3 =

ISSUES

- (1) Whether Taxpayer's "Category 2" parts are "subnormal" under Treas. Reg. § 1.471-2(c).
- (2) Whether Taxpayer may write down the carrying value of its inventories of Category 2 parts under Treas. Reg. § 1.471-4(b).

CONCLUSIONS

- (1) Taxpayer's Category 2 parts are not subnormal under Treas. Reg. § 1.471-2(c). They are "new" replacement parts for D in H specifically required by the E to be F. Moreover, Taxpayer's offer to sell all its Category 2 parts in bulk to Corp X for Bulk Sale Price does not establish a "bona fide selling price" under Treas. Reg. § 1.471-2(c).
- (2) Even if the market for Taxpayer's Category 2 parts is deemed "inactive" under Treas. Reg. § 1.471-4(b), Taxpayer is not entitled to write down the carrying value of its inventories of Category 2 parts. Taxpayer has not provided evidence establishing the "fair market" prices of those parts. Moreover, Taxpayer's offer to sell all its Category 2 parts in bulk to one potential buyer is not an "offer in the regular course of business."

FACTS

Taxpayer produces D. To produce these D, Taxpayer either produces parts or purchases parts from third parties (collectively, "Category 1 parts"). Taxpayer ceases the acquisition of model-specific parts when it ceases the production of a model of D. A buyer of one of Taxpayer's D frequently uses it for G after Taxpayer has ceased the production of the model owned by that buyer. Because D require periodic maintenance and repair, and because the E mandates the use of new and F replacement parts in D, Taxpayer routinely produces or purchases more model-specific parts than it requires for the production of that model of D. When the demand for the replacement parts drops to low levels, the replacement parts are designated as excess parts. Taxpayer holds these excess model-specific parts for sale. To distinguish new parts used for production and routine replacement from excess new parts used only for replacement, Taxpayer changes the characterization of the latter from Category 1 to Category 2 and physically separates the latter from its inventories of Category 1 parts.

As the inventory of Category 2 parts continued to grow over the years, Taxpayer instituted periodic scrapping initiatives. One such scrapping effort occurred in Year 1, eliminating nearly Amount 1 parts.

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In Year 2, as part of a new initiative to reduce the size of Category 2 inventory and develop a more organized method of handling this inventory in the future, Taxpayer partnered with Corp X. Corp X assisted Taxpayer in another massive scrapping effort, while developing a new storage and distribution center for these parts. In the process over Amount 2 additional parts were scrapped. Taxpayer has maintained a balance of approximately Amount 3 Category 2 parts for the past 6 years.

Taxpayer also entered into a marketing agreement with Corp X. Under this marketing agreement, Corp X (upon locating a buyer for a particular Category 2 part) purchases that part from Taxpayer and immediately resells that part to its own customer. In Year 3, Taxpayer offered to sell its Category 2 parts, in bulk, to Corp X for Bulk Sale Price. Corp X was given 30 days to accept or reject this offer. Corp X rejected Taxpayer's offer, but continued to purchase Category 2 parts from Taxpayer on an "as needed" basis.

The sale of Category 2 parts generates millions of dollars in revenue for Taxpayer annually. Taxpayer values all its parts inventories at cost or market, whichever is lower, under Treas. Reg. § 1.471-4. Taxpayer has considered numerous methods of valuation for purposes of its inventory software, but Taxpayer has determined it is not feasible (or even possible) to value the Category 2 parts annually on a retrospective basis. Taxpayer does not make an effort to review the inventory and scrap what it does not need. Taxpayer does not prepare and maintain a catalog of Category 2 parts because of the marketing agreement with Corp X.

LAW AND ANALYSIS

Section 471 of the Code provides, whenever the use of inventories is necessary to clearly determine income, inventories shall be taken on a basis as the Secretary may prescribe as conforming to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treas. Reg. § 1.471-2(b) provides that the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is in accordance with Treas. Reg. §§ 1.471-1 through 1.471-11.

Treas. Reg. § 1.471-2(c) provides that the bases of valuation most commonly used by business concerns which meet the requirements of § 471 are (1) cost; and (2) the LCM method. Any goods that 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. 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

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above and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

Treas. Reg. § 1.471-4(a) provides that under ordinary circumstances and for normal goods in an inventory, "market" is determined with reference to replacement or reproduction costs. Specifically, section 1.471-4(a) provides that market means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand in ordinary circumstances and for normal goods in an inventory. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (for example, section 263A). For taxpayers to which *section 263A* applies, the basic elements of cost must reflect all direct costs and all indirect costs properly allocable to goods on hand at the inventory date at the current bid price of those costs, including but not limited to the costs of purchasing, handling, and storage activities conducted by the taxpayer, both prior to and subsequent to production of the goods. The determination of the current bid price of the basic elements of costs reflected in goods on hand at the inventory date must be based on the usual volume of particular cost elements incurred by the taxpayer.

Treas. Reg. § 1.471-4(b) provides an exception to the general rule of section 1.471-4(a). The "inactive market" exception set forth in section 1.471-4(b) provides that if no open market exists or when quotations are nominal due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer, in the regular course of business has offered for sale merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct costs of disposition and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory.

Treas. Reg. § 1.471-4(c) specifies that when inventory is valued using the LCM method the market value of each article on hand at the inventory date must be compared with the cost of the article, and the lower of these values must be taken as the inventory value of the article. Section 1.471-3 defines "cost" for various types of merchandise. Section 1.471-4 defines "market." Section 1.471-2(f)(2) specifically forbids the taking of work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 524 (1979), the United States Supreme Court held that Treas. Reg. §§ 1.471-4(b) and 1.471-2(c) require concrete evidence of reduced market value to substantiate a write-down of inventory below replacement cost.

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Analysis:

Under Treas. Reg. § 1.471-4(a), "market" is the aggregate of current bid prices prevailing at the date of inventory. The "bid price" of purchased goods is replacement cost -- *i.e.*, the cost incurred by the taxpayer to acquire goods of comparable quality in quantities normally purchased by the taxpayer. Similarly, the bid price of goods produced by a manufacturer is the cost of the various components used in the manufacturing process – *i.e.*, labor, materials, and overhead. Replacement and reproduction costs are determined on an item-by-item basis.

Taxpayer agrees that there has been no diminution in the replacement and/ reproduction costs and; therefore, Taxpayer is not basing its write-down on Treas. Reg. § 1.471-4(a).

- (1) Whether Taxpayer's Category 2 parts are "subnormal" under Treas. Reg. § 1.471-2(c).

Treas. Reg. § 1.471-2(c), which contains the so-called subnormal goods exception, requires a sound reason for the goods not being salable at normal prices. In *Thor Power*, the taxpayer improperly wrote down the same type of inventory as in the case at bar – *i.e.* replacement parts for products no longer produced but still in H. As observed by the Supreme Court, "[t]he second situation in which a taxpayer may value inventory below replacement cost is where the merchandise itself is defective." 439 U.S. at 533. But the Court concluded that Thor's excess inventory was normal and unexceptional, and was indistinguishable from and intermingled with inventory that was not written down. 439 U.S. at 534. Moreover, the Court noted that "the regulations demand hard evidence of actual sales and further demand that records of actual dispositions be kept." *Id.*

Taxpayer argues that its Category 2 parts are "obsolete" and "technologically dated." In our view, these claims are not true because Taxpayer's Category 2 parts satisfy the E mandate that replacement parts be in new and E condition. Furthermore, Taxpayer's Category 2 parts are not defective. Thus, Taxpayer's Category 2 parts, which are first-quality replacement parts, are not subnormal under Treas. Reg. § 1.471-2(c).

Taxpayer also attempts to distinguish *Thor Power* based, in part, on the fact that its Category 1 and Category 2 parts are not "intermingled." We disagree. In our view, the Supreme Court was not suggesting that it would have decided *Thor Power* differently if that taxpayer's "excess" parts had been physically separated from its other parts. In other words, the fact that Taxpayer physically separates its Category 1 and Category 2 parts does not render the latter subnormal.

- (2) Whether Taxpayer may write down the carrying value of its inventories of Category 2 parts under Treas. Reg. § 1.471-4(b) ("inactive market" exception).

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Treas. Reg. § 1.471-4(b), the so-called inactive market exception, applies only when no open market exists or quotations are nominal because of inactive market conditions. To qualify under this exception, a taxpayer first must provide evidence of the “fair market” price of a good based on recent purchases or sales by the taxpayer or others in reasonable volume and made in good faith. Then, if the taxpayer, in the regular course of business, has offered the good for sale at a price lower than the previously determined “fair market” price, the taxpayer may value its inventory of this good at the lower price, less the direct cost of disposition. The remainder of this analysis assumes *arguendo* that the market for Taxpayer’s Category 2 parts is “inactive” under Treas. Reg. § 1.471-4(b).

The fair market prices of Taxpayer’s Category 2 parts should be easily determinable. As noted previously, Taxpayer sells Category 2 parts to Corp X on an as-needed basis, and these sales generate millions of dollars of revenue for Taxpayer. Thus, the sale price(s) of a Category 2 part provide ample evidence of that part’s fair market price. In other words, the fair market price of a Category 2 part can be based on the price(s) received from Corp X throughout the year. In contrast, Taxpayer’s offer to sell all its Category 2 parts for Bulk Sale Price is not evidence of the fair market prices of the individual parts. First, sales and purchases of individual Category 2 parts did not result from this offer. Second, Taxpayer extended its offer to only one potential buyer, Corp X, with whom it had a pre-existing relationship. Thus, the “good faith” requirement might not be satisfied. Third, even if Corp X had accepted Taxpayer’s offer and Taxpayer had reasonably allocated the Bulk Sale Price among its Category 2 parts, a bulk sale is not a “reasonable volume” under Treas. Reg. § 1.471-4(b). Thus, Taxpayer must determine the fair market prices of its Category 2 parts based on its actual selling prices throughout the year. Regrettably, Taxpayer has neither provided evidence of the fair market prices of its inventories of Category 2 parts nor shown that these fair market prices are less than its corresponding costs. Thus, Taxpayer is not entitled to write down the carrying value of its inventories of Category 2 parts from cost to fair market price.

Furthermore, Taxpayer is not entitled to write down the carrying value of its inventories of Category 2 parts from fair market price to offering price because Taxpayer has not shown that it offered, in the regular course of business, to sell its Category 2 parts below fair market price. Taxpayer’s offer to sell all its Category 2 parts in bulk to one potential buyer is not an offer to sell individual parts in the regular course of business.

Eric R. Skinner
Associate Area Counsel (LMSB)

By: S/Grant E. Gabriel
Grant E. Gabriel

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Senior Counsel (LMSB)

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