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Memorandum

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to: Larry I. Walter
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subject: Temporary Markdowns Under the Lower-of-Cost-or-Market Inventory Method

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

LEGEND

ISSUES

(1) Whether a retailer using the retail method of accounting may estimate the amount of temporary mark-downs (*e.g.*, seasonal and promotional discounts) that will not be cancelled after the end of the taxable year and, thus, are permanent.

(2) Whether a retailer using the retail method may account for discounts offered only to select clientele under the retail method.

CONCLUSIONS

(1) No. When reducing the retail selling price of a good, a retailer using the retail method must determine whether that "mark-down" is permanent or temporary. Section 1.471-8(e) does not permit retailers to estimate its mark-downs.

(2) No. Corporate discounts offered only to special clientele are not mark-downs under the retail method.

FACTS

Taxpayer uses an overall accrual method of accounting and the retail method for inventories, which Taxpayer values at approximate cost or market, whichever is lower ("Retail LCM"). On March 31, 2005, the Office of the Associate Chief Counsel (Income Tax & Accounting) ("National Office") granted Taxpayer permission to change its inventory method to Retail LCM, for its 52/53 week taxable year ending January 29, 2006. Taxpayer signed and returned the applicable Consent Agreement, whose terms and conditions include the following:

> [T]he taxpayer will use the retail method to value ending inventories at approximate LCM. See 1.471-8. When determining the retail value of ending inventories, the taxpayer will account for permanent mark-downs, but will not account for temporary markdowns. Stated differently, when computing retail LCM, the taxpayer will not reduce the retail value of ending inventories by temporary markdowns. When computing costs complements, the taxpayer will use the following formula: (A + B)/ (C + D +E), where A is the value of beginning inventories at retail LCM; B is the cost of current year purchases (net of discounts permitted by 1.471-3); C is the retail selling price of beginning inventories; D is the contemporaneous retail selling prices of current year purchases; and E is permanent current year net markups. For this purpose, "contemporaneous retail selling price " means the permanent retail selling price in effect when the taxpayer first offers the particular units for sale.

Taxpayer implemented the accounting method change with a negative section 481(a) adjustment of approximately $27 million, which meant that Taxpayer reduced the carrying value of its inventory by approximately $27 million. Part of this negative section 481(a) adjustment was attributable to Taxpayer's estimate of the amount of temporary mark-down that it would not cancel after the end of the taxable year. Taxpayer used historical data when determining this amount. The balance of the negative section 481(a) adjustment was attributable to Taxpayer's treating as permanent mark-downs corporate discounts offered only to select customers. Moreover, Taxpayer has not yet sold (or contracted to sell) the underlying merchandise that will be subject to these discounts.

LAW AND ANALYSIS

Law:

Treas. Reg. §1.471-8(e) provides that in no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

Treas. Reg. §1.471-2(a) provides 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.

Treas. Reg. §1.471-2(b) provides that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, 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 accord with sections 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 and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. The burden of proof rests upon the taxpayer to show that the market value is less than cost and the taxpayer must maintain the records that will enable verification of the inventory.

Treas. Reg. §1.471-2(e) provides that inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the director, and the taxpayer must satisfy the director of the correctness of the prices adopted.

Treas. Reg. §1.471-3(a) provides that in the case of merchandise on hand at the beginning of the taxable year, "cost" means the inventory price of such goods.

Treas. Reg. §1.471-3(b) provides that in the case of merchandise purchased since the beginning of the taxable year, "cost" means the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see sections 1.263A-1 and 1.263A-3 for additional amounts that must be included in inventory costs.

Treas. Reg. §1.471-3(d) provides that in any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be

reasonable and in conformity with established trade practice in the particular industry. Among such cases are retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see section 1.471-8).

Treas. Reg. §1.471-4(a)(1) provides that under ordinary circumstances and for normal goods in an inventory, 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.

Treas. Reg. §1.471-4(c) provides that where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Treas. Reg. §1.471-8(a) provides that retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that method, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in paragraph (e) of section 1.446-1. Under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as –

1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs, less

2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit. See sections 1.263A-1 and 1.263A-3 for rules regarding the computation of costs with respect to property acquired for resale.

Treas. Reg. §1.471-8(d) provides that a taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories in accordance with the retail method, except that, to obtain a basis of approximate cost or market, whichever is lower, has consistently and uniformly followed the practice of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the taxable year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the markups included must be reduced by the mark-downs made to cancel or correct such markups.

Rev. Rul. 79-115, 1979-1 C.B. 185, holds that promotional markdowns should not be used when computing cost complements under the retail LIFO method because the retail price of the inventory does not reflect promotional markdowns.

Analysis:

Under the retail method, inventories are recorded initially at both cost and original retail selling price and then converted to approximate cost or retail LCM, whichever is applicable, using a "cost complement." In the case of retail LCM, the cost complement is computed by dividing the sum of the costs of both the opening inventory and purchases made during the year by the sum of the retail prices of both the opening inventory and purchases made during the year. Finally, to compute retail LCM, the retailer multiplies the cost complement by the retail value of ending inventories, which often has been reduced by mark-downs.

A retailer may reduce the retail value of ending inventories by all permanent mark-downs allowed during the taxable year, but may not reduce the retail value of ending inventories by any temporary mark-downs. If a retailer were permitted to reduce the retail value of ending inventories by temporary mark-downs, the resulting valuation, retail LCM, will not clearly reflect income because it will be below LCM, as determined under § 1.471-4, in almost all cases. *See also* Rev. Rul. 79-115, which holds that temporary mark-downs in price on promotional merchandise, which are eliminated at the end of the promotion period and for which the retail price of the inventory is not adjusted at any time, should not be used as an adjustment to retail prices in computing the cost complement for determining inventory value under the retail last-in, first-out (LIFO) method of pricing inventories.

Taxpayer has misclassified a portion of what are actually temporary mark-downs as permanent markdowns based on estimates of what Taxpayer anticipates will be the final selling price of the goods in the next taxable year. Although the retail method is a method used to approximate the value of ending inventories (*i.e.*, at cost or LCM), § 1.471-8 does not permit a retailer to approximate its permanent markdowns when determining the retail value of ending inventories. Moreover, Taxpayer has estimated the amount of discounts that it expects to grant to some customers and has misclassified these as permanent mark-downs, too. Discounts, whether offered to employees or special customers, are not general price reductions and, thus, cannot be permanent mark-downs under the retail method.

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