

§ 1.471-3

26 CFR Ch. I (4-1-04 Edition)

acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

(e) 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 district director, and the taxpayer must satisfy the district director of the correctness of the prices adopted.

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

(6) Segregating indirect production costs into fixed and variable production cost classifications (as defined in § 1.471-11(b)(3)(ii)) and allocating only the variable costs to the cost of goods produced while treating fixed costs as period costs which are currently deductible. This method is commonly referred to as the "direct cost" method.

(7) Treating all or substantially all indirect production costs (whether classified as fixed or variable) as period costs which are currently deductible. This method is generally referred to as the "prime cost" method.

[T.D. 6500, 25 FR 11724, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973]

§ 1.471-3 Inventories at cost.

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, 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 §§ 1.263A-1 and 1.263A-3 for additional amounts that must be included in inventory costs.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§ 1.263A-1 and 1.263A-2 for more specific rules regarding the treatment of production costs.

(d) 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:

(1) Farmers and raisers of livestock (see § 1.471-6);

(2) Miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see § 1.471-7); and

(3) Retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 1.471-8).

Notwithstanding the other rules of this section, cost shall not include an amount which is of a type for which a deduction would be disallowed under section 162 (c), (f), or (g) and the regulations thereunder in the case of a business expense.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973; T.D. 7345, 40 FR 7439, Feb. 20, 1975; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42233, Aug. 9, 1993]

§ 1.471-4 Inventories at cost or market, whichever is lower.

(a) *In general*—(1) *Market definition.* 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. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (e.g., under section 263A and its underlying regulations for taxpayers subject to that section). For taxpayers to which section 263A applies, for example, 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 cost of purchasing, handling, and storage activities conducted by the taxpayer, both prior to and subsequent to acquisition or 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 purchased (or incurred) by the taxpayer.

(2) *Fixed price contracts.* Paragraph (a)(1) of this section does not apply to any goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss. Any such goods must be inventoried at cost.

(3) *Examples.* The valuation principles in paragraph (a)(1) of this section are illustrated by the following examples:

Example 1. (i) Taxpayer A manufactures tractors. A values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one of A's tractors on hand is determined as follows:

Direct materials	\$3,000
Direct labor	4,000
Indirect costs under section 263A	3,000
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Total section 263A costs (cost)	\$10,000

(ii) A determines that the aggregate of the current bid prices of the materials, labor, and overhead required to reproduce the tractor at the end of 1994 are as follows:

Direct materials	\$3,100
Direct labor	4,100
Indirect costs under section 263A	3,100
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Total section 263A costs (market)	\$10,300

(iii) In determining the lower of cost or market value of the tractor, A compares the cost of the tractor, \$10,000, with the market value of the tractor, \$10,300, in accordance with paragraph (c) of this section. Thus, under this section, A values the tractor at \$10,000.

Example 2. (i) Taxpayer B purchases and resells several lines of shoes and is subject to section 263A. B values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one pair of shoes on hand is determined as follows:

Acquisition cost	\$200
Indirect costs under section 263A	10
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Total section 263A costs (cost)	\$210

(ii) B determines the aggregate current bid prices prevailing at the end of 1994 for the elements of cost (both direct costs and indirect costs incurred prior and subsequent to acquisition of the shoes) based on the volume of the elements usually purchased (or incurred) by B as follows:

Acquisition cost	\$178
Indirect costs under section 263A	12
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Total §263A costs (market)	\$190

(iii) In determining the lower of cost or market value of the shoes, B compares the cost of the pair of shoes, \$210, with the market value of the shoes, \$190, in accordance with paragraph (c) of this section. Thus, under this section, B values the shoes at \$190.

(b) *Inactive markets.* Where no open market exists or where quotations are