Inventory Write-Downs: Particularly Important in the Current Economic Environment

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Current economic recession has left everybody aware of the need for a socioeconomic reform. As businesses find themselves in the midst of the aftermath of the housing crisis and government bailouts, accompanied by an on-going credit crunch with unprecedented unemployment rates, plunging state revenues and incomprehensive budget deficits, they are forced to reconsider and restructure their traditional ways of doing business. Inventory write-downs could be one way for companies to raise extra revenue. This paper evaluates the issue of valuing inventory using the lower of cost or market method.

I. *Inventory Write-downs*

For US tax purposes, there are certain circumstances in which taxpayers are permitted to deduct a decline in value of their inventory from cost to a lower market value. The adjustment to the inventory value must be taken in the year in which the decline occurs even though the goods have not been sold. Section 471 of the Internal Revenue Code and the regulations thereunder, provide for two basic methods of inventory valuation- cost and lower of cost or market. If a taxpayer has elected to value inventories under a lowerofcostormarket method, the write-downs should be taken in the year in which the reduction in value has occurred.

There are different rules relative to the valuation of normal and subnormal goods:

Subnormal goods- are defined as inventory items which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, wear, change in style, broken lots or similar causes. Subnormal goods should be valued at bona fide selling prices less direct cost of disposition. Bona fide selling price means actual offering of the goods during a period ending not later than thirty days after the inventory date. As always, the burden of proof rests with the taxpayer to demonstrate and justify their valuation method and is required to keep the appropriate records.

For a taxpayer to utilize the special valuation methods related to subnormal goods, the goods have to be defective in some manner as outlined above. The fact that goods are not being sold due to market downturns does not justify the use of the above method.

Normal goods- in determining the inventory value under the lower of cost or market for normal goods, market is defined as the current bid price prevailing at the year-end date for the quantity usually purchased by the taxpayer. The use of a bid price is applicable in the case of (a) of goods purchased and on hand and (b) determining the basic elements of cost, such as materials, labor, and overhead burden, included in the computation of work-in-process and finished goods.

A. Market for Purchased Goods

Assuming there is an existing active market for the goods at issue, market for a non-manufacturer of inventory is the current bid price of the inventory. Specifically, it is the price that the taxpayer would have to pay vendors on the open market to purchase the inventory in question. Such price would include the invoice price of the goods plus freight-in as well as all the purchasing, handling, storage, and associated general and administrative costs incurred by the taxpayer.

B. Market for Manufactured Goods

For manufacturers, the initial question is whether market for finished goods and goods-in-process should be determined on the basis of reproduction cost or replacement cost. Under the Treasury's regulations, reproduction cost method is the proper method for determining market for the manufactured goods.

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Under this method the value of the manufactured goods is computed using the current market bid price for the labor, materials, and overhead used in the production. The Internal Revenue Service, however, has also allowed the replacement cost method, which is computed by reference to the price at which the taxpayer can replace its inventory through purchase. Such conflict has been noted by the Tax Court, but has not been conclusively resolved. As such, the Service appears to allow either the reproduction or the replacement cost method depending upon the taxpayer's circumstances.

C. No Open Market or Nominal Quotations

Where an active replacement market does not exist or where quotations are nominal, the taxpayer must use all available evidence of the fair market value at the year-end date. This approach must be based on all the relevant facts and circumstances.Write-downs will not be permitted if they are based on speculation and mere estimates.

If the taxpayer has offered merchandise for sale at prices lower than the prices determined under the reproduction or replacement cost method, the inventory should be valued at the lower offering prices less direct cost of disposition. Such offer to sell the goods at the reduced prices must occur near year-end. The taxpayer must maintain records of the ultimate disposition of the written-down goods. It is also important to note that if the offering prices used as market vary materially from actual sales prices, offering prices will not be accepted.

II. Other Considerations

A. Item-by-item analysis

When determining the market value of the inventory based upon any of the above methods, the determination must be made on an item-by-item basis. This does not necessarily mean that each inventory item needs to be identical and price separately. Rather, products which are very similar and possess similar properties can be grouped in determining the bid price.

B. Maintenance of records

It is critical for a taxpayer to be able to justify its markdown. In that regard, the Company needs to retain the appropriate records that would support the bid prices, or alternative market prices based on offering goods for sale to customers.

As such, companies in the current economic environment may use any one of these inventory valuation methods to potential write-down their inventory from the original cost basis to the current fair market value. Therefore, inventory write-downs could be one way for companies to raise extra revenue.

C. Change in Accounting Method

If the Company currently using the cost method to valuate its inventory, the company will routinely add back the inventory reserve computed for financial statement purposes in determining taxable income. If the Company were to utilize a different method, the lower of cost or market method for valuing the inventory, it would need to file Form 3115, Change In Accounting Method Form. Such accounting method change would be automatic and is normally accepted by the Internal Revenue Service. Change In Accounting Method Form would be filed with the corporate income tax return.

References

I.R.C. §471, generally
Treasury Regulation §1.471-2(c).
CBIZ, May 2010. *Monetize Your Inventory Through Tax Deductible Write-downs*
IRA Federal Tax Coordinator, 2d, generally.