[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9688]

RIN 1545-BJ64

Retail Inventory Method

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the retail inventory method of accounting. The regulations restate and clarify the computation of ending inventory values under the retail inventory method and provide a special rule for certain taxpayers that receive margin protection payments or vendor allowances that are required to reduce only cost of goods sold. The regulations affect taxpayers that are retailers and use a retail inventory method.

DATES: <u>Effective Date</u>: These regulations are effective on [**INSERT THE DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

<u>Applicability Date</u>: For date of applicability, see §1.471-8(f).

FOR FURTHER INFORMATION CONTACT: Christopher Call, (202) 317-7007 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations that amend the Income Tax Regulations (26 CFR part 1) relating to the retail inventory method of accounting under §1.471-8 of the Income Tax Regulations. On October 7, 2011, a notice of proposed rulemaking (REG-125949-10) was published in the **Federal Register** (76 FR 62327). A public hearing was not requested or held. No comments were received during the comment period. Three comments were received after the end of the comment period and were considered, as discussed later in this preamble. The proposed regulations are adopted as amended by this Treasury decision.

Summary of Comments and Explanation of Revisions

Section 471 of the Internal Revenue Code provides that a taxpayer's method of accounting for inventories must clearly reflect income. Section 1.471-2(c) provides that the bases of inventory valuation most commonly used and meeting the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower (LCM). Section 1.471-3 provides rules for determining inventories at cost. Section 1.471-4 provides rules for determining inventories at lower of cost or market. Section 1.471-8 of the regulations contains rules specific to retailers, allowing them to approximate cost or LCM of the goods in their ending inventory by using the retail inventory method. Under the retail inventory method, a taxpayer computes the value of ending inventory by multiplying a cost complement by the retail selling prices of the goods on hand at the end of the taxable year. The numerator of the cost complement is the value of beginning inventory plus the cost of purchases during the taxable year, and the denominator is the retail selling prices of beginning inventory plus the initial retail selling prices of purchases. For taxpayers using the retail inventory method to value

inventories at cost (retail cost method), the denominator of the cost complement is adjusted for all permanent markups and markdowns. Taxpayers using the retail inventory method to value inventories at LCM (retail LCM method) generally do not make adjustments to the denominator for markdowns.

The proposed regulations provided that a taxpayer using the retail LCM method may not reduce the numerator of the cost complement by the amount of an allowance, discount, or price rebate that is related to or intended to compensate for a permanent reduction in the taxpayer's retail selling price of inventory, often called a margin protection payment or a markdown allowance. The proposed regulations also provided that a taxpayer using the retail inventory method (whether valuing inventories at LCM or at cost) may not reduce the numerator of the cost complement by the amount of a sales-based vendor allowance.

Commenters suggested that taxpayers using the retail LCM method to value inventories should reduce the numerator of the cost complement for all vendor allowances and discounts, including margin protection payments and sales-based vendor allowances (but should not be required to reduce the denominator by the related price reduction), because all allowances and discounts reduce the cost of inventory and allow retailers to achieve their margin goals. The commenters asserted that if the numerator of the cost complement is not reduced for margin protection payments and sales-based vendor allowances, taxpayers' income will not be clearly reflected, the economics of the underlying business transaction will be ignored, and small retailers would be adversely affected. The commenters suggested that small retailers have less bargaining power than large retailers and are less able to negotiate purchase-based

discounts from vendors.

The final regulations do not adopt these comments. A margin protection payment, unlike other types of allowances, is inherently related to a markdown that will be reflected in the retail selling prices of the items remaining in ending inventory. When a taxpayer using retail LCM reduces the numerator of the cost complement by the amount of a margin protection payment without reducing the denominator by the amount of the corresponding markdown, ending inventory value does not clearly reflect income, and does not reflect the economics of the underlying transaction. Taxpayers using the retail cost method to value inventories, as opposed to retail LCM, are allowed to reduce the numerator of the cost complement by the amount of a margin protection payment because these taxpayers also reduce the denominator of the cost complement by the amount of a related markdown, maintaining the relationship between cost and retail price.

With regard to sales-based vendor allowances, the final regulations adopt, with a modification, the proposed rule that the numerator of the cost complement is not reduced for sales-based vendor allowances. Proposed regulations under §1.471-3(e) provided that sales-based vendor allowances (the amount of an allowance, discount, or price rebate that a taxpayer earns by selling specific merchandise) reduce cost of goods sold and do not reduce ending inventory value. Because the retail inventory method produces an ending inventory value and sales-based vendor allowances could not be allocated to ending inventory, the proposed regulations under §1.471-8 provided that sales-based vendor allowances do not reduce the numerator of the cost complement. The final regulations under §1.471-3(e) (TD 9652, 79 FR 2094) apply specifically to only

one type of sales-based vendor allowance, a sales-based vendor chargeback, and reserve rules for other types of sales-based vendor allowances. To conform to this modification, these final regulations under §1.471-8 provide that sales-based vendor allowances that are required to reduce only cost of goods sold under §1.471-3(e) do not reduce the numerator of the cost complement. This rule will apply only to sales-based vendor chargebacks until further guidance is issued under §1.471-3(e).

Commenters also requested that the final regulations allow retail LCM taxpayers to reduce the numerator of the cost complement by margin protection payments and sales-based vendor allowances because requiring taxpayers to track margin protection payments and sales-based vendor allowances separately from other types of allowances would create burdensome recordkeeping requirements. This comment is not adopted because, as discussed earlier in this preamble, allowing a retail LCM taxpayer to reduce the numerator of the cost complement by the amount of a margin protection payment without reducing the denominator by the amount of the corresponding markdown would not clearly reflect income and would not reflect the economics of the underlying transaction. Nonetheless, as discussed later in this preamble, to ease taxpayers' compliance burden, the final regulations provide alternative methods and procedures for computing the cost complement for retail LCM taxpayers.

The preamble to the proposed regulations requested comments on an alternative method for retail LCM taxpayers to account for margin protection payments when computing the cost complement. The method described in that preamble would have permitted retail LCM taxpayers to reduce the numerator of the cost complement for all

non-sales-based allowances, discounts, or price rebates, including margin protection

payments or markdown allowances, and also would have required a reduction of the

denominator of the cost complement for permanent markdowns to which the margin

protection payments or markdown allowances relate (related markdowns). Although

commenters did not address this proposal explicitly, they stated that in some cases,

based on the nature of their business dealings with vendors and the variety of

allowances offered, taxpayers have difficulty distinguishing between the different types

of vendor allowances their vendors provide. For example, commenters contend that it

might be difficult for a taxpayer to distinguish the amount of a margin protection

payment or markdown allowance received from a vendor from the amounts of other

types of allowances received from that vendor, thus making it difficult to determine the

amount by which they were required to reduce the numerator of the cost complement

under the proposed regulations.

The final regulations address these comments and ease taxpayers' compliance

with the regulations by allowing retail LCM taxpayers to use a method similar to the

method described in the preamble to the proposed regulations that does not require

taxpayers to distinguish the amounts of margin protection payments from the amounts

of other vendor allowances (except for vendor allowances required to be allocated to

cost of goods sold under §1.471-3(e)). Under the alternative method provided in the

final regulations, retail LCM taxpayers reduce the numerator for margin protection

payments and must quantify and reduce the denominator for the related markdowns.

This alternative method results in a reduction of the numerator of the cost complement

by all vendor allowances other than those required to reduce cost of goods sold under

§1.471-3(e). This alternative method accordingly reduces the compliance burden for taxpayers that cannot distinguish margin protection payments from other allowances, but that can identify the markdowns related to those margin protection payments.

Commenters also stated that some accounting systems cannot sufficiently track the related markdowns. Accordingly, a second alternative provided in the final regulations allows taxpayers that are able to determine the amount of their margin protection payments to reduce the numerator of the cost complement for the margin protection payments and adjust the denominator by the amount that, in conjunction with the reduction of the numerator, maintains what would have been the cost complement percentage before taking into account the margin protection payments and related markdowns. This second alternative method assumes that a margin protection payment maintains the taxpayer's profit margin after a related markdown in retail selling price. Thus, if before taking into account the margin protection payment and the related markdown the cost complement is 50 percent ($10/$20), and the taxpayer receives a margin protection payment of $2, the taxpayer must reduce the denominator by $4 to maintain a cost complement of 50 percent ($8/$16) under this second alternative method.

A retail LCM taxpayer must use one of these three methods (the general method and the two alternative methods) for computing all of its cost complements. A change from one to another of these methods is a change in method of accounting.

The final regulations further facilitate identifying margin protection payments and related markdowns by allowing retail LCM taxpayers to use statistical sampling in accordance with Rev. Proc. 2011-42 (2011-37 IRB 318), see §601.601(d), in

conjunction with any of the three methods. A retail LCM taxpayer using statistical sampling must use it for all margin protection payments and related markdowns associated with the inventory items valued by a particular cost complement. However, a retail LCM taxpayer that calculates more than one cost complement is not required to use statistical sampling for all cost complements. A change from using to not using statistical sampling, or from not using to using statistical sampling, to identify margin protection payments and related markdowns is not a change in method of accounting.

The proposed regulations provided that a taxpayer may apply the retail inventory method to a department, a class of goods, or a stock-keeping unit. A commenter suggested that the final regulations specify that a taxpayer may use the retail inventory method to value ending inventory for a sub-class of goods, style of goods, or other similar category of goods to avoid the implication that the scope of the retail inventory method is limited to those groupings specifically identified in the proposed regulations. The categories suggested by the commenter are already encompassed by the terms department, class of goods, or stock-keeping unit. Accordingly, the final regulations do not adopt this comment.

A commenter suggested that the final regulations should allow taxpayers to calculate their cost complements using a measurement period shorter than the entire taxable year and should clarify whether beginning inventory may or must be eliminated from the cost complement of a last-in, first-out (LIFO) taxpayer using the retail inventory method. These issues were not addressed in the proposed regulations and therefore are not addressed in the final regulations. However, the final regulations do not reflect a

change in established administrative practice regarding whether LIFO taxpayers using the retail inventory method may exclude beginning inventory from the cost complement.

Effective/Applicability Date

These regulations apply to taxable years beginning after December 31, 2014. For taxable years beginning before January 1, 2015, see §1.471-8 as contained in 26 CFR part 1, revised April 1, 2014.

Special Analyses

This Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received from the Small Business Administration.

Drafting Information

The principal author of these regulations is Natasha M. Mulleneaux of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.471-8 is revised to read as follows:

§1.471-8 Inventories of retail merchants.

(a) In general. A taxpayer that is a retail merchant may use the retail inventory method of accounting described in this section. The retail inventory method uses a formula to convert the retail selling price of ending inventory to an approximation of cost (retail cost method) or an approximation of lower of cost or market (retail LCM method). A taxpayer may use the retail inventory method instead of valuing inventory at cost under §1.471-3 or lower of cost or market under §1.471-4.

(b) Computation--(1) In general. A taxpayer computes the value of ending inventory under the retail inventory method by multiplying a cost complement by the retail selling prices of the goods on hand at the end of the taxable year.

(2) Cost complement--(i) In general. The cost complement is a ratio computed as follows:

(A) The numerator is the value of beginning inventory plus the cost (as determined under §1.471-3, except as otherwise provided in this section) of goods purchased during the taxable year.

(B) The denominator is the retail selling prices of beginning inventory plus the retail selling prices of goods purchased during the year (that is, the bona fide retail

selling prices of the items at the time acquired), adjusted for all permanent markups and markdowns, including markup and markdown cancellations and corrections. The denominator is not adjusted for temporary markups or markdowns.

(ii) <u>Vendor allowances required to reduce only cost of goods sold</u>. A taxpayer may not reduce the numerator of the cost complement by the amount of an allowance, discount, or price rebate that is required under §1.471-3(e) to reduce only cost of goods sold.

(3) <u>Additional rules for cost complement for retail LCM method</u>--(i) <u>In general</u>— (A) <u>Margin protection payments</u>. A taxpayer using the retail LCM method may not reduce the numerator of the cost complement by the amount of an allowance, discount, or price rebate that is related to or intended to compensate for a permanent reduction in the taxpayer's retail selling price of inventory (a margin protection payment).

(B) <u>Markdowns</u>. A taxpayer using the retail LCM method does not adjust the denominator of the cost complement for markdowns (and markdown cancellations or corrections). Markups must be reduced by the markdowns made to cancel or correct them.

(ii) <u>Alternative methods for computing cost complement</u>--(A) <u>In general</u>. In lieu of the method described in paragraph (b)(3)(i) of this section, a taxpayer using the retail LCM method may compute the cost complement using one of the alternative methods described in this paragraph (b)(3)(ii). A taxpayer using an alternative method under this paragraph (b)(3)(ii) must use that method for all cost complements.

(B) <u>Adjust numerator and denominator</u>. A taxpayer using the retail LCM method may reduce the numerator of the cost complement by the amount of all margin protection payments if the taxpayer also reduces the denominator of the cost complement by the amount of the permanent reduction in retail selling price to which the margin protection payments relate (related markdowns).

(C) <u>Deemed adjustment to denominator</u>. A taxpayer using the retail LCM method that is able to determine the amount of all margin protection payments but cannot determine the amount of the related markdowns may reduce the numerator of the cost complement by the amount of all margin protection payments if the taxpayer also reduces the denominator by the amount that, in conjunction with the reduction of the numerator for the margin protection payments, maintains what would have been the cost complement percentage before taking into account the margin protection payment and the related markdown. A taxpayer that can determine the amount of a related markdown but not the associated margin protection payments may not use this method to compute an adjustment to the numerator.

(iii) <u>Statistical sampling</u>. A taxpayer using the retail LCM method may use statistical sampling in accordance with Rev. Proc. 2011-42 or any successor (see §601.601(d) of this chapter), in conjunction with any method of computing the cost complement described in this paragraph (b)(3), to determine the amount of margin protection payments and related markdowns. A taxpayer using statistical sampling must use it for all margin protection payments and related markdowns associated with the inventory items valued by a particular cost complement, but is not required to use it for every cost complement.

(4) <u>Ending inventory retail selling prices</u>. A taxpayer must include all permanent markups and markdowns but may not include temporary markups or markdowns in determining the retail selling prices of goods on hand at the end of the taxable year. A taxpayer may not include a markdown that is not an actual reduction of retail selling price.

(c) <u>Special rules for LIFO taxpayers</u>. A taxpayer using the last-in, first-out (LIFO) inventory method with the retail inventory method uses the retail cost method. See §1.472-1(k) for additional adjustments for a taxpayer using the LIFO inventory method with the retail cost method.

(d) <u>Scope of retail inventory method</u>. A taxpayer may use the retail inventory method to value ending inventory for a department, a class of goods, or a stock-keeping unit. A taxpayer maintaining more than one department or dealing in classes of goods with different percentages of gross profit must compute cost complements separately for each department or class of goods.

(e) <u>Examples</u>. The following examples illustrate the rules of this section:

<u>Example 1</u>. (i) R, a retail merchant who uses the retail LCM method and uses a calendar taxable year, has no beginning inventory in 2012. R purchases 40 tables during 2012 for $60 each for a total of $2,400. R offers the tables for sale at $100 each for an aggregate retail selling price of $4,000. R does not sell any tables at a price of $100, so R permanently marks down the retail selling price of its tables to $90 each. As a result of the $10 markdown, R's supplier provides R a $6 per table margin protection payment. R sells 25 tables during 2012 and has 15 tables in ending inventory at the end of 2012.

(ii) Under paragraph (b)(2)(i)(A) of this section, the numerator of the cost complement is the aggregate cost of the tables, $2,400. Under paragraph (b)(3)(i)(A) of this section, R may not reduce the numerator of the cost complement by the amount of the margin protection payment. Under paragraph (b)(2)(i)(B) of this section, the denominator of the cost complement is the aggregate of the bona fide retail selling prices of all the tables at the time acquired, $4,000. Under paragraph (b)(3)(i)(B) of this

section, R does not adjust the denominator of the cost complement for the markdown. Therefore, R's cost complement is $2,400/$4,000, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdown in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending table inventory is $1,350 (15 * $90). Approximating LCM under the retail method, the value of R's ending table inventory is $810 (60% * $1,350).

Example 2. (i) The facts are the same as in Example 1, except that R permanently reduces the retail selling price of all 40 tables to $50 per unit and the 15 tables on hand at the end of the year are marked for sale at that price. The additional $40 markdown is unrelated to a margin protection payment or other allowance.

(ii) Under paragraph (b)(3)(i)(B) of this section, R does not adjust the denominator of the cost complement for the markdown. Therefore, R's cost complement is $2,400/$4,000, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdowns in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending inventory is $750 (15 * $50). Approximating LCM under the retail method, the value of R's ending inventory is $450 (60% * $750).

Example 3. (i) The facts are the same as in Example 1, except that R computes the cost complement using the alternative method under paragraph (b)(3)(ii)(B) of this section.

(ii) R reduces the numerator of the cost complement by the margin protection payments of $240 ($6 * 40) and reduces the denominator of the cost complement by the related markdowns of $400 ($10 * 40). Therefore, R's cost complement is $2,160/$3,600, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdown in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending table inventory is $1,350 (15 * $90). Approximating LCM under the retail method, the value of R's ending table inventory is $810 (60% * $1,350).

Example 4. (i) The facts are the same as in Example 1, except that R cannot determine the amount of its related markdowns and computes the cost complement using the alternative method under paragraph (b)(3)(ii)(C) of this section.

(ii) R reduces the numerator of the cost complement by the margin protection payments of $240 ($6 * 40). R reduces the denominator of the cost complement by the amount that, in conjunction with the reduction in the numerator, maintains the cost complement percentage before taking into account the margin protection payments and the related markdowns. R's original cost complement was 60% ($2,400/$4,000). The numerator of R's new cost complement is $2,160 ($2,400 - $240). Therefore, R

reduces the denominator by $400, which maintains the cost complement of 60% ($2,160/$3,600).

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdowns in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending table inventory is $1,350 (15 * $90). Approximating LCM under the retail method, the value of R's ending table inventory is $810 (60% * $1,350).

Example 5. (i) The facts are the same as in Example 1, except that R uses the LIFO inventory method. R must value inventories at cost and, under paragraph (c) of this section, uses the retail cost method.

(ii) Under paragraph (b)(2)(i)(A) of this section, R reduces the numerator of the cost complement by the amount of the margin protection payment. Under paragraph (b)(2)(i)(B) of this section, R includes the permanent markdown in the denominator of the cost complement. Therefore, R's cost complement is $2,160/$3,600, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdown in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending inventory is $1,350 (15 * $90). Approximating cost under the retail method, the value of R's ending inventory is $810 (60% * $1,350).

(f) Effective/applicability date. This section applies to taxable years beginning

after December 31, 2014. For taxable years beginning before January 1, 2015, see

§1.471-8 as contained in 26 CFR part 1, revised April 1, 2014.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved: July 30, 2014

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

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