Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, § 338; 1.338-1.)

Rev. Proc. 2003-51

SECTION 1. PURPOSE

This revenue procedure sets forth guidelines for use by taxpayers and Internal Revenue Service personnel in making fair market value determinations for inventory items acquired when a taxpayer purchases the assets of a business for a lump sum or a corporation acquires the stock of another corporation and makes an election pursuant to § 338 of the Internal Revenue Code with respect to the acquisition. The Service invites public comment on issues relating to the inventory valuation methods discussed herein and to whether additional valuation methods are appropriate. This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 77-12, 1977-1 C.B. 569.

SECTION 2. BACKGROUND

If the assets of a business are purchased for a lump sum or if a corporation acquires the stock of another corporation and makes an election pursuant to § 338 with respect to the acquisition, the purchase price (actual or deemed) must be allocated among the assets acquired to determine the basis of each of the assets. In making the allocation, a taxpayer must determine the fair market value of any inventory items acquired. This revenue procedure describes methods that may be used to determine the fair market value of inventory items for purposes of the purchase price allocation.

In the situations set forth in this revenue procedure, the quantity of inventory to be valued generally would be different from the quantity usually purchased. In addition, the fair market value of the goods in process and finished goods on hand must be determined in light of what a willing purchaser would pay and a willing seller would accept for the inventory at the various stages of completion, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. In making the inventory valuation determination, it is necessary to allow for a fair division between the buyer and the seller of the profit on the inventory, taking into account that the quantity of inventory purchased may be greater than the quantity of inventory usually purchased. *See Knapp King-Size Corp. v. United States*, 527 F.2d 1392 (Ct. Cl. 1975).

SECTION 3. PROCEDURES FOR DETERMINATION OF FAIR MARKET VALUE.

Three basic methods a taxpayer may use to determine the fair market value of inventory are the replacement cost method, the comparative sales method, and the income method.

.01 *Replacement Cost Method*. The replacement cost method generally provides a good indication of fair market value if inventory is readily replaceable in a wholesale or retail business, but generally should not be used in establishing the fair market value of the work in process or finished goods of a manufacturing concern. In valuing a bulk inventory of raw materials or goods purchased for resale under this method, the determination of the replacement cost of the individual items should be only a base or starting point. This base amount must be adjusted for factors that are generally relevant. For example, a willing purchaser might be expected to pay (and a willing seller might be expected to demand) a price for inventory that would compensate the seller not only for the current replacement cost, but also for a fair return on expenditures in accumulating and preparing the inventory for distribution. Thus, an amount equal to the fair value of the related costs that the taxpayer would have incurred in acquiring and accumulating the same quantity of goods had the goods been purchased separately (*e.g.,* purchasing, handling, transportation, and off-site storage costs) should be added to the base amount. Additionally, in valuing a particular inventory under this method, other factors may be relevant. For example, a well balanced inventory available to fill customers' orders in the ordinary course of business may have a fair market value in excess of its cost of replacement because it provides a continuity of business, whereas an inventory containing obsolete merchandise unsuitable for customers may have a fair market value of less than the cost of replacement.

.02 *Comparative Sales Method*. The comparative sales method utilizes the actual or expected selling prices of finished goods to customers in the ordinary course of business as the base amount that must be adjusted for factors that are generally relevant in determining the fair market value of the inventory. The inventory to be valued may represent a larger quantity than the normal trading volume. The expected selling price is a valid starting point only if the inventory is expected to be used to fill customers' orders in the ordinary course of business. If the expected selling price is used as a basis for valuing finished goods inventory, the base amount must be adjusted for relevant factors, including:

(1) the time that would be required to dispose of this inventory;

(2) the expenses that would be expected to be incurred in the disposition, for example, all costs of disposition, applicable discounts (including those for quantity), sales commissions, and freight and shipping charges; and

(3) a profit commensurate with the amount of investment in the assets and the degree of risk. (This analysis should include (but is not limited to) an evaluation of risks of possible changes in style/design, changes in price levels, increased competition, possible adverse economic conditions, the fact that the inventory to be valued may represent a larger quantity than the normal trading volume, *etc*.).

.03 *Income Method*. The income method, when applied to fair market value determinations for finished goods, recognizes that finished goods must generally be valued in a profit motivated business. As the amount of inventory may be large in relation to normal trading volume, the highest and best use of the inventory will be to provide for a continuity of the marketing operation of the going business. Additionally, the finished goods inventory will usually provide the only source of revenue of an acquired business during the period it is being used to fill customers' orders. The historical financial data of an acquired company can be used to determine the amount that could be attributed to finished goods in order to pay all costs of disposition and provide a return on the investment during the period of disposition.

.04 *Work in Process.* The fair market value of work in process should be based on the same factors used to determine the fair market value of finished goods reduced by the expected costs of completion, including a reasonable profit allowance for the completion and selling effort of the acquiring corporation.

SECTION 4. EXAMPLE OF REPLACEMENT COST AND COMPARATIVE SALES COST METHODS

On Date 1, Manufacturer A purchased all the assets of Manufacturer B for a lump-sum payment of $31,000,000. The assets of Manufacturer B included quantities of finished goods and raw material inventory that were larger than the normal trading volume. The inventories are in good condition and the raw materials include minimal obsolete or subnormal goods. On the date of sale, Manufacturer B's books reflected finished goods inventory having a book value of $4,000,000 and raw materials having a book value of $300,000.

Manufacturer A expects to sell the acquired finished goods inventory to customers in the ordinary course of business. An appraiser hired by Manufacturer A determined that under the circumstances the expected retail selling price of the acquired finished goods inventory to customers was $6,000,000. It was also determined that the cost of disposing of the finished goods inventory, including sales commissions, freight and shipping charges, was $1,000,000. Manufacturer A calculated that it would incur a holding cost of $50,000 based on the average amount invested in holding the inventory, the period of time that would reasonably be expected to be necessary to dispose of the inventory, and the available established finance rate for the period. After taking into consideration Manufacturer A's investment in the assets of Manufacturer B, the risks Manufacturer A would incur during the time it took to dispose, in the ordinary course of its business, of the quantity of acquired inventory, and a fair division of the profit on the finished goods inventory between Manufacturer A and Manufacturer B, it was determined that the allocation of profit to Manufacturer A should be $450,000.

The appraiser determined that the replacement cost of the raw materials was $310,000. The appraiser computed a fair value of approximately $4,100 for purchasing, handling, and storage costs to acquire and accumulate the raw materials. Finally, the appraiser determined that there were minimal obsolete and subnormal goods, which would decrease the value of the inventories by approximately $100. In the ordinary course of business, Manufacturer B did not resell the raw materials without further processing. Manufacturer A also does not expect to resell in the ordinary course of business the raw materials without further processing.

Using the comparative sales method for finished goods and replacement cost method for raw materials, the fair market value of inventory for purposes of allocating the lump sum payment is computed as follows:

Gross expected selling price	$6,000,000
Disposition costs	(1,000,000)
Holding costs	(50,000)
Corporation A's profit	(450,000)
Fair Market Value of finished goods nventory	4,500,000
Current replacement cost of raw materials	310,000
Purchasing, storage, and handling costs	4,100
Obsolete and subnormal goods	(100)
Fair Market Value of raw materials inventory	314,000
Fair Market Value of acquired inventories	$ 4,814,000

SECTION 5. CONCLUSION

Valuing inventory is an inherently factual determination. No rigid formulas should be applied. Consequently, the three valuation methods outlined above serve only as guidelines for determining the fair market value of inventories. Similarly, the example serves only as a guideline for applying the methods.

SECTION 6. REQUEST FOR COMMENTS

The Service invites comments from the public on issues relating to this revenue procedure, including the current valuation methods provided herein and whether the Service should consider any additional valuation methods (for example, whether manufacturers should be permitted to apply a replacement cost method to value work in process and finished goods). Comments should be submitted by September 23, 2003, either to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044
Attn: CC:PA:RU (CC:ITA:6)
Room 5525

or electronically via: notice.comments@.irscounsel.treas.gov (the Service comments e-mail address). All comments will be available for public inspection and copying.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 77-12 is amplified, modified, and superseded.

SECTION 8. EFFECTIVE DATE

Generally, this revenue procedure is effective for taxable years ending on or after April 25, 1977. However, references in this revenue procedure to § 338 are effective for: (1) certain acquisitions occurring before September 1, 1982, if: (a) the acquisition date with regard to an acquired corporation was after August 31, 1980, and before September 1, 1982; (b) the acquired corporation was not liquidated before September 1, 1982; and (c) the acquiring corporation made an election pursuant to § 338; and (2) acquisitions occurring after August 31, 1982.

DRAFTING INFORMATION

The principal author of this revenue procedure is Willie E. Armstrong, Jr., of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this Revenue Procedure, contact Mr. Armstrong on (202) 622-4970 (not a toll-free call).