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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director

Taxpayer's name:

Taxpayer's address:

Taxpayer's EIN:

Date of conference:

LEGEND: taxpayer =

ISSUES:

1. May the taxpayer value its inventory at zero using the cost or market, whichever is lower, method (hereinafter referred to as "the LCM method") when the taxpayer either gives away its finished goods at no charge or sells these goods for a nominal amount?

2. Is the taxpayer required to capitalize costs under § 263A of the Internal Revenue Code to its inventory?

CONCLUSIONS:

1. The taxpayer may not value its inventory at zero using the LCM method even though the taxpayer either gives away its finished goods at no charge or sells these goods for a nominal amount.

2. The taxpayer is required to capitalize costs under § 263A to its inventory.

FACTS: The taxpayer publishes trade periodicals. These periodicals are published either monthly, bimonthly, quarterly, or annually. Most of the publishing work is performed by the taxpayer but the taxpayer always has the printing, binding, and mailing of its periodicals done by others. Publishing work is usually done by others when the taxpayer is not able to perform the required work, for example, when the taxpayer lacks the expertise required.

Each of the taxpayer's periodicals include articles pertaining to the trade covered by that periodical as well as advertisements. Ordinarily, these advertisements are directly related to the trade being covered by the periodical. For example, a periodical that discusses restaurant management will include articles pertaining to that trade as well as advertisements from food companies that sell to restaurants and from uniform companies that sell uniforms suitable for restaurant employees.

The taxpayer publishes two types of periodicals. One type consists of periodicals that are sold by the taxpayer. The other type consists of periodicals that are given away by the taxpayer without charge. The majority of the taxpayer's periodicals are given away without charge.

The taxpayer receives revenue from the sale of advertising space in its periodicals, and for those periodicals that are sold by the taxpayer, from subscriptions to the periodicals. With respect to sold periodicals, the taxpayer claims that revenue from subscriptions is "nominal" when compared with the costs of publishing and distributing of these periodicals. For the years presently under examination, the taxpayer received approximately four percent of its total revenue from subscription sales.

In regard to the periodicals that it gives away without charge, the taxpayer controls who receives its periodicals by means of circulation lists. By such lists, the taxpayer, as well as its advertisers, attempt to guarantee that each periodical is delivered to only those involved in the relevant trade. For example, if the taxpayer is publishing a periodical discussing the airport limousine business, the taxpayer's circulation list for that periodical will be limited to businesses and individuals involved in that business. These circulation lists may be created by the taxpayer but some lists are given to the taxpayer by industry organizations. In regard to periodicals that are sold, the taxpayer's circulation lists will reflect the names of whoever purchased a subscription. Usually, only those involved in an industry purchase a subscription to a periodical devoted to that industry. Excess periodicals are destroyed by the taxpayer, except for reference copies. When asked, the taxpayer will sell reference copies.

The taxpayer uses an overall accrual method of accounting. Its current practice is to recognize revenue when the periodicals are shipped by the printer to the taxpayer's customers. The taxpayer has valued its raw materials inventory at cost and valued its work in process and finished goods inventory at cost or market, whichever is lower. The taxpayer's right to use the LCM method to value inventory is not currently being challenged. At issue is the taxpayer's application of this method. Also at issue is whether the taxpayer is required to capitalize costs under § 263A.

The taxpayer believes that since most of the periodicals are given away without charge the use of the LCM method causes the periodicals in the work in process and finished goods inventories to be valued at zero. The taxpayer concedes that publishers of periodicals are not specifically exempt from having to capitalize costs under § 263A. However, the taxpayer believes there are no § 263A costs to capitalize in its situation. In fact, the taxpayer claims "that there are specific magazine industry attributes that would cause the [§] 263A adjustment to be zero for at least monthly magazine publishers." The taxpayer explains that this is because publishers are allowed to use the LCM method to value inventories. Since magazines are either given away without charge or the cost of publication and distribution exceeds the subscription price, the taxpayer believes that the market value of magazines is zero. Because it is valuing its inventories at this market value, which it claims approximates fair market value, the taxpayer does not believe § 263A applies.

The examiner disagrees with the taxpayer's position. Basically, the examiner believes that the taxpayer is not applying the provisions of § 471 and §§ 1.471-1 and 1.471-4 of the Income Tax Regulations correctly and that § 263A does apply to its inventories.

LAW and ANALYSIS: Section 471(a) requires the use of inventories whenever the Secretary determines that inventories are necessary in order clearly to determine the income of the taxpayer. Inventories are to be taken on the basis the Secretary prescribes so as to conform as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-1 specifies that in order to reflect taxable income correctly, inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory includes all finished or partly finished goods and, appropriate raw materials.

As required by § 471, and the regulations thereunder, the taxpayer uses inventories in order to clearly determine its income. As explained by § 1.471-1, inventories are necessary in every situation where the production of merchandise results in income. The taxpayer publishes periodicals and all of its income, that is, either advertising or subscription sales revenue, arises from this activity. The need for the taxpayer to use inventories is not affected by the fact that the taxpayer's revenues are primarily received from entities other than those who receive the taxpayer's periodicals. See, for example, Knight-Ridder Newspaper, Inc. v. United States, 743 F.2d 781, 790 (11^{th} Cir. 1984), Rev. Rul. 81-272, 1981-2 C.B. 116 (situation 5). As further explained in § 1.471-1, the taxpayer's inventories consist of raw materials, work in process, and finished goods. The taxpayer must value this inventory in accordance with §§ 263A and 471 and the regulations thereunder.

Section 1.471-2(c) permits taxpayers to value their inventories using the LCM method. Section 1.471-4(c) specifies that when inventory is valued using the LCM method the market value of each article on hand at the inventory date must be compared with the cost of the article, and the lower of these values must be taken as the inventory value of the article. Section 1.471-3 defines "cost" for various types of merchandise. Section 1.471-4 defines "market." Section 1.471-2(f)(2) specifically forbids the taking of work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

Section 1.471-4(a) provides that under ordinary circumstances and for normal goods in an inventory, “market” is determined with reference to replacement or reproduction costs. Specifically, § 1.471-4(a) provides that 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 in ordinary circumstances and for normal goods in an inventory. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (for example, § 263A). For taxpayers to which § 263A applies, 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 costs of purchasing, handling, and storage activities conducted by the taxpayer, both prior to and subsequent to 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 incurred by the taxpayer.

Section 1.471-4(b) provides an exception to the general rule of § 1.471-4(a). The “inactive market” exception set forth in §1.471-4(b) provides that if no open market exists or when quotations are nominal due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer, in the regular course of business has offered for sale merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct costs of disposition and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory.

As noted above, the taxpayer valued its raw materials inventory at cost and the work in process and finished goods inventories using the LCM method. With respect to the work in process and finished goods inventories, the taxpayer did not determine market value with reference to replacement or reproduction costs under § 1.471-1(a). Rather, the taxpayer determined market value under the inactive market exception of § 1.471-4(b). The taxpayer’s position is that because, in most instances, the taxpayer does not charge its subscribers for the periodicals, there is no market for the periodicals and their value is zero. This zero market value is lower than the cost of producing the periodicals. Accordingly, the taxpayer valued its work in process and finished goods inventory at zero.

The effect of this method is to assign a cost value to raw materials until such time as they enter the work in process inventory. Once the raw materials enter into the production process, their value is reduced from cost to zero.[1] The raw materials costs are, thus, deducted upon the

[1] In hindsight, the taxpayer believes that it should have also used the LCM method to value its raw materials and that the use of this method would have resulted in a valuation of the raw materials at zero.

entry of the raw materials into the production process. All of the other costs of producing the periodicals are deducted as incurred because, in the taxpayer's view, they are incurred to produce a product that has no value.

Taxpayers are permitted to value inventories under § 1.471-4(b) only when no open market exists or where the market is inactive. Section 1.471-4(b) is not available for the taxpayer's use because an active, open market does exist for its periodicals. The taxpayer is a profitable and an ongoing company. The reason why the taxpayer can give away almost all of its merchandise yet remain in business is because the profit from the merchandise is derived primarily through advertising sales. In effect, the advertisers are paying for the periodicals. Further, the periodicals themselves are normal goods. Thus, the taxpayer must determine market with reference to replacement or reproduction cost as required by § 1.471-4(a).

Section 263A does not apply to inventories valued using the LCM method if market is determined under the inactive market exception of § 1.471-4(b). Section 1.263A-1(a)(3)(iv). However, when market is determined with reference to replacement or reproduction cost, under § 1.471-4(a), a taxpayer is required to capitalize costs under § 263A. Sections 1.263A-1(a)(3)(iv) and 1.471-4(a). Since the taxpayer took the position that it could determine market value under § 1.471-4(b), it did not apply § 263A to its work in process and finished goods inventories. However, since the taxpayer is required to determine market value under § 1.471-4(a), it must apply § 263A to these inventories.

Section 263A(a) generally requires that the direct costs and all indirect costs that directly benefit or are incurred by reason of the production of tangible personal property be capitalized. Tangible personal property includes a film, sound recording, video tape, book, or similar property. See § 263A(b). Production, for purposes of § 263A , includes construct, build, install, manufacture, develop, or improve. See § 263A(g)(1); See also, § 1.263A-2(a)(1). A taxpayer must capitalize all of the direct costs and the appropriate portion of the indirect costs of producing tangible personal property, regardless of whether the property is sold or used in the taxpayer's trade or business. See § 1.263A-1(a)(3)(ii). To capitalize means, in the case of property that is inventory in the hands of the taxpayer, to include in inventory costs. See § 1.263A-1(c)(3).   Section 263A(g)(2) specifies that a taxpayer will be treated as producing property even when that property is produced for the taxpayer under contract by another party. See also, § 1.263A-2(a).

The taxpayer is producing property within the meaning of § 263A when it publishes its periodicals. The periodicals are tangible personal property and the taxpayer creates them. Sections 263A(b) and (g)(1). There is no specific exemption listed in either the Code or the regulations that exempts magazines publishers, such as the taxpayer, from having to capitalize costs under § 263A. Treating the taxpayer as one who produces property is not affected by the fact that others perform some of the production work, for example, others physically print the taxpayer's periodicals. Section 263A(g)(2). Accordingly, the taxpayer is required to capitalize the direct costs and the appropriate indirect costs that directly benefit or are incurred by reason of the production of the periodicals.

In summary, the taxpayer is producing its periodicals in its trade or business and undoubtedly, its publishing activity is being conducted for profit. The taxpayer must determine "market" under the rules of § 1.471-4(a), that is, at replacement or reproduction costs. Because it must use one of these two costs to determine "market," the taxpayer is subject to the rules of § 263A. Section 1.263A-1(a)(3)(iv).

CAVEAT: A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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