INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 29, 2004

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200445026**
Release Date: 11/5/04
Index (UIL) No.: 471.08-00, 471.08-01, 471.08-02
CASE-MIS No.: TAM-123258-03 (CC:ITA:6)

Director
LMSB:CTM Area 11

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year Involved:
Date of Conference: July 28, 2003

LEGEND:

Taxpayer=
A=
B=
C=
D=
E=
F=
G=
H=
I=
Date 1=
$Amount 1=
Date 2=
$Amount 2=
$Amount 3=
Software 1=
Accounting Firm=

Software 2=
Quantity 1=
PRICE
Quantity 2=
Quantity 3

ISSUES:

(1) What retail selling prices must a merchant use to ensure that the retail method of accounting sanctioned in §1.471-8 clearly reflects income?

(2) Given the revenue agent's determination that Taxpayer did not apply the retail method properly and did not maintain the inventory records required by §1.471-8, should the national office revoke Taxpayer's ruling retroactively?

CONCLUSIONS:

(1) For the retail method to clearly reflect income, the merchant must use contemporaneous retail selling prices when computing cost complements and the retail value of ending inventories. To establish this fact, the merchant must maintain contemporaneous, purchase-related records, and if using computer software to apply the retail method, the merchant must maintain software-related records.

(2) Taxpayer's ruling is hereby revoked as of the beginning of the year of change because Taxpayer did not comply with the terms and conditions of the ruling.

FACTS:

Taxpayer is a publicly owned corporation and merchant that operates retail stores in A, B, C, D, E, F, G, H, and I. Specifically, Taxpayer sells consumer electronics, such as television sets, stereophonic equipment, and related accessories. Thus, Taxpayer actually maintains, and must account for, inventories. Until the year under examination, Taxpayer valued its inventories at the lower of cost or market ("LCM") for both financial reporting and federal income tax purposes, but these two values generally were different. For financial reporting purposes, Taxpayer followed generally accepted accounting principles ("GAAP"). For federal income tax purposes, Taxpayer followed tax principles[1] and the first-in, first-out ("FIFO") method.[2]

Taxpayer timely filed a Form 3115, Application for Change in Accounting Method, for the taxable year ending Date 1 ("year of change"). In the Form 3115, Taxpayer

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1 *See* §1.471-4.

2 *See* §1.471-2(d).

sought permission to use the retail method under §1.471-8 to value its inventories at *approximate* LCM ("Retail LCM"). Taxpayer continues to value its inventories at LCM for financial reporting purposes.

The Commissioner issued a ruling (*i.e.*, ruling letter and Consent Agreement) that granted consent for Taxpayer to value its inventories at Retail LCM "in accordance with" the provisions of §1.471-8. The ruling states that Taxpayer's method change requires Taxpayer to decrease taxable income by $Amount 1 ("§ 481(a) adjustment"). In addition, the ruling contains the following terms and conditions:

(1) the taxpayer takes one-fourth of the § 481(a) adjustment into account in computing taxable income each taxable year of the adjustment period beginning with the year of change. See section 5.02(3) of Rev. Proc. 97-27.

(2) if the taxpayer ceases to engage in the trade or business or terminates its existence, the taxpayer must take the remaining balance of any § 481(a) adjustment relating to the trade or business into account in computing taxable income in the year of cessation or termination. For purposes of this condition the provisions in section 7.03(3) of Rev. Proc. 97-27 will apply in determining whether the taxpayer is treated as ceasing to engage in a trade or business.

(3) the taxpayer keeps its books and records for the year of change and for subsequent taxable years (provided they are not closed on the date it receives this letter) on the method of accounting granted in this letter. This condition is considered satisfied if the taxpayer reconciles the results obtained under the method used in keeping its books and records and the method used for federal income tax purposes and maintains sufficient records to support such reconciliation.

(4) the basis of the taxpayer's inventory at the beginning of the year of change be restated to reflect the change in method of accounting granted herein.

Finally, under EFFECT OF THIS ACCOUNTING METHOD CHANGE, the ruling contains the following statement:

> The district director must apply the ruling in determining the taxpayer's liability unless the district director recommends that the ruling should be modified or revoked. The district director will ascertain whether (1) the representations upon which this ruling was based reflect an accurate statement of the material facts, (2) the amount of the § 481(a) adjustment was properly determined, (3) the change in method of accounting was implemented as proposed in accordance with the terms and conditions of the Consent Agreement and Rev. Proc. 97-27,

> (4) there has been any change in the material facts upon which the ruling was based during the period the method of accounting was used, and (5) there has been any change in the applicable law during the period the method of accounting was used. If the district director recommends that the ruling (other than the amount of the § 481(a) adjustment) should be modified or revoked, the district director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 98-2, 1998-1 I.R.B. 74, (or any successor) will be followed. See section 11.01 of Rev. Proc. 97-27.

On Date 2, Taxpayer's vice president signed the Consent Agreement on Taxpayer's behalf. Subsequently, Taxpayer's return for the year of change was selected for examination. During this examination, the revenue agent reviewed Taxpayer's §481(a) adjustment and determined that Taxpayer, by valuing ending inventories at Retail LCM instead of LCM, reduced its gross income for the year of change and first succeeding taxable year by $Amount 2 and $Amount 3, respectively.

After inquiring about Taxpayer's inventory-accounting and record-keeping systems, the revenue agent learned that Taxpayer uses a mainframe computer and integrated, point-of-sale and inventory-accounting software known as "Software 1" to account for over Quantity 1 thousand different inventory items or "stock-keeping units" ("SKUs"). Software 1 maintains the following data for each SKU within separate database fields: (1) SKU number that identifies the product, (2) product type, (3) department, (4) retail selling price ("retail price"), and (5) cost. The database field for retail price is named PRICE. Whenever Taxpayer assigns a new permanent retail price to a SKU, that retail price goes into PRICE, and the old permanent retail price, if any, is automatically expunged from PRICE. Only a small group of Taxpayer's employees (*i.e.*, executives and merchandise-buying group) are authorized and able to change the retail price maintained in PRICE.

At year end, Taxpayer uses a spreadsheet created by Accounting Firm, the "Software 2," to calculate Retail LCM for Taxpayer's entire business. To perform this calculation, the Software 2 utilizes some of the data stored in Software 1 and some additional data that must be inputted manually by Taxpayer's employees (*e.g.*, freight charges and vendor discounts). Taxpayer represents that the Software 2 uses the retail prices "maintained in [Software 1] for the same quantities of goods in the opening inventory and purchased during the year . . . ." Employees in Taxpayer's information technology department download data from Software 1 and give that data to Taxpayer's tax department, whose employees manually input the additional data into the Software 2. For each SKU, the retail value of ending inventory is computed by multiplying the end-of-year quantity by the end-of-year retail price maintained in PRICE, and Retail LCM is computed by multiplying the retail value of ending inventory by the cost complement. The Software 2 produces a written report showing Retail LCM for each SKU and for Taxpayer's entire business.

Taxpayer purchases products throughout the year from various suppliers. Most of these products have a manufacturer's suggested retail price ("MSRP"). The cost of these products usually remains constant when the economy is good, but can decline when market conditions are less robust or when a manufacturer overproduces. Taxpayer contends that its retail prices tend to remain constant even when its costs decline. Taxpayer acknowledges, however, that a product's MSRP sometimes declines. In any event, these products have a limited life cycle. For example, approximately Quantity 2 percent of Taxpayer's inventory items are new each year. New models of an established product can be introduced by their manufacturers at any time of the year, but manufacturers of car stereos, home audio equipment, and camcorders, which represent approximately Quantity 3 percent of Taxpayer's total inventory, generally introduce their new models in January.

For most products, Taxpayer's retail price is the MSRP because manufacturers encourage merchants to keep retail prices high. Thus, the first retail price entered into PRICE generally is the product's MSRP. Of course, Taxpayer reduces its retail prices to accommodate changing inventory levels and special buying opportunities. Taxpayer represents, however, that its business policy is to avoid permanently reducing the retail price of any product below its MSRP, so all of its retail price reductions ("markdowns") are "temporary" markdowns. Because temporary retail prices are not entered into PRICE, no SKU's Ending Inventories at Retail is reduced by temporary markdowns. Despite these representations, it appears that whenever a SKU's end-of-year MSRP is lower than its beginning-of-year MSRP, Taxpayer's method of computing the retail value of ending inventories ("ending inventories (at retail)") will reflect a permanent markdown equal to the quantity of goods still priced at the higher MSRP multiplied by the difference in the beginning-of-year MSRP and end-of-year MSRP.

The revenue agent was unable to examine Taxpayer's contemporaneous, purchase-related records for the year of change because Taxpayer did not maintain them. Were these records to exist, for each shipment of merchandise, they would contain both the cost of the unit(s) received and the permanent retail price prevailing when the unit or units are first offered for sale ("contemporaneous retail price"). In addition, they would show (or permit the computation of) the merchant's permanent markdowns for the taxable year. Though Taxpayer produced a large sample of sales tickets, which recorded the actual retail price(s) of the product(s) being sold, the revenue agent was unable to satisfy himself that the retail prices recorded on these sales tickets were used by the Software 2 to compute each SKU's cost complement and Retail LCM. Furthermore, the Software 2 user manual, which includes examples of the retail method being applied properly, also contains the following statement:

> The retail value of the ending inventory is multiplied by its cost complement (the ratio of an item's cost to its highest retail value during the current fiscal year) to approximate the value of ending inventory at cost (emphasis added).

The revenue agent stated parenthetically that Accounting Firm has misplaced the software-related workpapers that might have been used to interpret this statement. The user manual does not specify that adjustments are needed for temporary markdowns existing at year end and markup cancellations.

LAW AND ANALYSIS:

Section 446(a) of the Internal Revenue Code provides generally that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 446(c) provides that subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting -- (1) the cash receipts and disbursements method; (2) an accrual method; (3) any other method permitted by this chapter; or (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

Section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-2(a) of the Income Tax Regulations provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect the income.

Section 1.471-2(b) provides that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§1.471-1 through 1.471-11.

Section 1.471-2(c) provides that the bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower.

Section 1.471-2(e) provides that 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.

Section 1.471-3(a) provides that in the case of merchandise on hand at the beginning of the taxable year, “cost” means the inventory price of such goods.

Section 1.471-3(b) provides that in the case of merchandise purchased since the beginning of the taxable year, “cost” means 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.

Section 1.471-3(d) provides that 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.

Section 1.471-4(a)(1) provides that 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.

Section 1.471-4(c) provides that where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Section 1.471-8(a) provides that retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that method, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in paragraph (e) of §1.446-1. Under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as --

(1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs, less

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit. See §§1.263A-1 and 1.263A-3 for rules regarding the computation of costs with respect to property acquired for resale.

Section 1.471-8(d) provides that a taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories in accordance with the retail method, except that, to obtain a basis of approximate cost or market, whichever is lower, has consistently and uniformly followed the practice of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the taxable year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

Section 1.471-8(e) provides that in no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

Section 1.471-8(f) provides that a taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices may

adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, paragraph (e) of §1.446-1. A taxpayer filing a first return of income may adopt such practice subject to approval by the district director upon examination of the return.

Rev. Rul. 79-115, 1979-1 C.B. 185, holds that promotional markdowns should not be used when computing cost complements under the retail LIFO method because the retail price of the inventory does not reflect promotional markdowns.

Section 10.01 of Rev. Proc. 97-27, 1997-1 C.B. 680, provides that a taxpayer that changes to a method of accounting pursuant to this revenue procedure may be required to change or modify that method of accounting for the following reasons: (1) the enactment of legislation; (2) a decision of the United States Supreme Court; (3) the issuance of temporary or final regulations; (4) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin; (5) the issuance of written notice to the taxpayer that the change in method of accounting was granted in error or is not in accord with the current views of the Service; or (6) a change in the material facts on which the consent was based.

Section 10.02 of Rev. Proc. 97-27 provides that except in rare or unusual circumstances, if a taxpayer that changes its method of accounting under this revenue procedure is subsequently required under this section 10 to change or modify that method of accounting, the required change or modification will not be applied retroactively provided that: (1) the taxpayer complied with all the applicable provisions of the Consent Agreement and this revenue procedure; (2) there has been no misstatement or omission of material facts; (3) there has been no change in the material facts on which the consent was based; (4) there has been no change in the applicable law; and (5) the taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change or modification retroactively would be to the taxpayer's detriment.

Section 11.01 of Rev. Proc. 97-27 provides that the district director must apply a ruling obtained under this revenue procedure in determining the taxpayer's liability unless the district director recommends that the ruling should be modified or revoked. The district director will ascertain if: (1) the representations on which the ruling was based reflect an accurate statement of the material facts; (2) the amount of the § 481(a) adjustment was properly determined; (3) the change in method of accounting was implemented as proposed in accordance with the terms and conditions of the Consent Agreement and this revenue procedure; (4) there has been any change in the material facts on which the ruling was based during the period the method of accounting was used; and (5) there has been any change in the applicable law during the period the method of accounting was used.

Section 11.02 of Rev. Proc. 97-27 provides that if the district director recommends that the ruling (other than the amount of the § 481(a) adjustment) should

be modified or revoked, the district director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 97-2 (or any successor) will be followed.

ISSUE (1): What retail price must a merchant use to ensure that the retail method of accounting sanctioned in §1.471-8 clearly reflects income?

In general, a permissible method of accounting clearly reflects income[3] when properly applied by a qualified taxpayer. Under §1.471-8, the retail method is a permissible method for merchants, so Taxpayer is qualified to use the retail method. Thus, Taxpayer may use the retail method for the taxable year under examination if it can show that it properly applied the method.

To apply the retail method properly, a merchant must satisfy the computational and record-keeping requirements of §1.471-8.

1. Computational Requirements

a. Introduction

Section 1.471-8 provides two versions of the retail method for merchants not also using the LIFO method. Under §1.471-8(a), the merchant reduces the retail prices of goods in ending inventories to approximate cost ("Retail Cost") by deducting an amount, adjusted for markups and markdowns, that represents the merchant's expected profit. Alternatively, under §1.471-8(d), the merchant reduces those retail prices to approximate LCM (Retail LCM) by deducting an amount that is adjusted for markups but not for markdowns. Under LCM,[4] "market" is replacement cost.[5] Thus, when computing Retail LCM, the merchant is computing the approximate replacement cost of ending inventories.

Though §1.471-8 neither defines "retail price" nor provides a detailed example of properly adjusting retail prices for markups and markdowns, the first sentence of §1.471-8(a) refers to the method "known as" the retail method. Thus, because of the critical role played by retail prices and markdowns under the retail method, an examination of both the retail method used for book and financial-reporting purposes[6] and the history of §1.471-8 is useful.

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[3] Section 446(b).

[4] *See* §1.471-4.

[5] *See, e.g., Thor Power Tool, Inc. v. Commissioner*, 439 U.S. 522, 534 (1979).

[6] Section 1.446-1(a)(2) provides in relevant part that a method of accounting that reflects the consistent application of GAAP in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily

b. Origin of retail method

As the size of merchandising businesses grew during the 19th Century, larger merchants often had to account for inventories containing tens of thousands or even hundreds of thousands of items (SKUs). Though counting, and assigning a unit cost to, all the units of each SKU was feasible with a sufficiently large staff of accountants, the expense of computing the value of ending inventories for book purposes would have been prohibitive and would have outweighed any benefit obtained from knowing that value. Thus, larger merchants began using a new method, which became known as the retail method. Under the retail method, the merchant maintains detailed records showing the cost and retail price of goods purchased for resale, permanent markdowns, and sales. By reviewing these detailed records, the merchant can determine ending inventories (at retail).

Though price-based inventories worked well for inventory-management purposes, such as evaluating a staff of buyers, the merchant had to convert them into cost-based inventories to compute net income. This conversion was accomplished by multiplying ending inventories (at retail) by the cost complement, which produced either Retail Cost or Retail LCM.[7] To prevent ending inventories from being overvalued (and thus from overstating the value of the merchant's business), the typical merchant valued ending inventories at Retail LCM.

c. Relevant retail prices for book and financial reporting purposes

Any determination regarding the retail prices that are relevant for book and financial reporting purposes requires an examination of GAAP. At the outset, we acknowledge the so-called hierarchy of GAAP. The most authoritative pronouncements are found in FASB (Financial Accounting Standards Board) Standards and Interpretations, APB (Accounting Principles Board) Opinions, and AICPA Accounting

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be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

[7] For a discussion regarding the financial accounting principles applicable to the retail method, see MALCOLM P. MCNAIR & ANITA C. HERSUM, THE RETAIL INVENTORY METHOD AND LIFO (1952) at 43; ROBERT M. ZIMMERMAN ET AL, RETAIL ACCOUNTING AND FINANCIAL CONTROL 215 (5th Ed. 1990); PAUL W. WILSON AND KENNETH E. CHRISTENSEN, LIFO FOR RETAILERS 11 (1985); RAYMOND A. HOFFMAN, INVENTORIES, A GUIDE TO THEIR CONTROL, COSTING, AND EFFECT UPON INCOME AND TAXES 119 (1962); DONALD E. KIESO AND JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 462 (9th Ed. 1998); GLENN A. WELSCH AND CHARLES T. ZLATKOVICH, INTERMEDIATE ACCOUNTING 379 (1989); MICHAEL H. GRANOF, FINANCIAL ACCOUNTING 302-03 (2nd Ed. 1980). For a discussion regarding the tax-accounting principles applicable to the retail method, see LESLIE J. SCHNEIDER, FEDERAL INCOME TAXATION OF INVENTORIES §8.04[2] at 60 (2003).

Research Bulletins ("ARBs").[8] The least authoritative pronouncements are found in AICPA Accounting Interpretations, FASB Implementation Guides (Q&A), and "widely recognized and prevalent industry practices." When even the least authoritative pronouncements do not provide guidance, support can be found in other accounting literature.

ARB 43 sanctions the retail method for financial reporting purposes, but does not describe the retail method.[9] Other, less authoritative pronouncements of GAAP do not exist. But the accounting treatises and textbooks ("authoritative texts") cited in note 7 (not an all-inclusive list) describe the retail method ("textbook approach"). As shown in these authoritative texts and applied in *Examples 1* through *4*, *infra*, the textbook approach is a multi-step formula for computing the cost complement, ending inventories (at retail), and Retail LCM. Even if not actually used by merchants to compute Retail LCM, the textbook approach reveals the arithmetic relationship between the cost complement and ending inventories (at retail).

According to the cited authoritative texts, the relevant retail price of a unit is its original retail price (*i.e.*, the first retail price).[10] But only one of these authoritative texts provides guidance that might help a merchant apply "first" to several units purchased at different times. This guidance consists primarily of reproductions and descriptions of the inventory records used by merchants during the first half of the 20th Century:

> For the operation of the retail method, only a few comparatively simple forms are required. The key device is the so-called Department Stock Ledger, on which are summarized, for each department or dissection separately, monthly and for the season to date or year to date, the cost and retail of inventory and purchases, the retail reductions, and the miscellaneous merchandising data which eventually are reflected in the gross margin computations. The other essential forms are a Purchase Record, <u>for recording the necessary details relating to each lot of merchandise coming into the department</u>, a Merchandise Transfer form for recording interdepartmental transfers, and a Price Change Report for recording additional markups, markdowns, and cancellations of additional markups and markdowns.[11]

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[8] *See, e.g.*, KIESO & WEYGANDT, *supra* note 7 at 13-14. This hierarchy of GAAP may change because of §108 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. A. § 7218 (West 1998 and Supp. 2004).

[9] Accounting Research Bulletin No. 43, ch. 4, ¶10 (Committee on Accounting Procedure, June 1953).

[10] *See, e.g.*, ZIMMERMAN, *supra* note 7 at 214; WELSH AND ZLATKOVICH, *supra* note 7 at 378. For example, in traditional retail clothing stores, the original will be the first price shown on the price tag. Reduced prices result from markdowns.

[11] MCNAIR AND HERSUM, note 7 *supra* at 79-81 (underscoring added).

Regarding the purchase record,[12] the authors write:

> Here, besides spaces for identifying entries, including dates and invoice numbers, there are columns for Invoice Cost, Transportation, Discount, Retail, and Percentage Markon. For each lot of merchandise received, invoice cost, discount, and retail are recorded, this last figure being transcribed from the notations of retail made by the buyer for marketing purposes.[13]

The above-quoted description of the purchase record suggests that a merchant using the retail method should be recording inventory costs and retail prices on a lot-by-lot basis. However, this description does not expressly provide that the merchant should record only contemporaneous retail prices on the purchase record.

Finally, the authors write that "[t]he Price Change Report[14] is the source also of the figure for the net total of markdowns which appears in the Retail Deductions section of the stock ledger."[15]

In summary, the authoritative texts clarify the importance of using original retail prices under the textbook approach, but they do not explain how a merchant determines the original retail price of units purchased at different times. Fortunately, as will be shown, the operation of the textbook approach (specifically, the arithmetic relationship between the cost complement and ending inventories (at retail)) provides the answer.

d. Moving-average phenomenon

Except by chance, Retail LCM will not equal LCM computed under the FIFO method because of a moving-average phenomenon. This moving-average phenomenon has two causes. First, a merchant may compute one cost complement for all the inventories of an entire department. Unless every type of merchandise has the same ratio of profit to cost, the expected profit reflected in ending inventories (at retail) will be an average that varies depending on the mix of low-cost, high-profit units and high-cost, low-profit units. Thus, using one cost complement for all the inventories of an entire department removes a *weighted-average* expected profit per dollar of value from ending inventories (at retail). Second, at the end of the year, the merchant computes the cost complement using beginning inventories as well as current-year purchases. Stated differently, when computing Retail LCM, the merchant does not use the FIFO

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12 *Id*. at 81 (Exhibit 10).

13 *Id*. at 82 (underscoring added).

14 *Id*. at 84 (Exhibit 12) (footnote added).

15 *Id*. at 83.

method to determine which units are in ending inventories.[16] Thus, this weighted-average expected profit is a *moving* average.[17] The effect of this moving-average phenomenon is shown in *Example 1.*

Example 1. At the beginning of the taxable year ending December 31, 2003, Merchant has 2 widgets whose cost is $5.00 ($10.00 total) and whose retail price is $10.00 ($20.00 total). During January and February of 2003, Merchant sells these 2 widgets @ $10.00 ($20.00 total). Subsequently, Merchant purchases 15 additional widgets. The dates of receipt, unit costs, and retail prices are shown below:

Date Received	No. of Units	Unit Cost	Total Cost	Original Retail Price	Total Retail Price
3/01/03	10	$5.00	$50.00	$10.00	$100.00
11/01/03	5	$4.50	22.50	$8.00	40.00
Total	15		$72.50		$140.00

Between March 1, 2003, and October 31, 2003, Merchant sells 7 additional widgets @ $10 ($70 total). On November 1, 2003, Merchant reduces the retail price to $8.00 because of changed market conditions and the reduced replacement cost. Because 3 of the widgets purchased on March 1 still are marked at $10.00, Merchant reduces the retail price of each of those widgets from $10.00 to $8.00. Thus, Merchant's markdowns for 2003 total $6.00 (3 widgets @ $(2.00)). Assume that these widgets are offered for sale on the date received. During 2003, Merchant does not mark up the retail price of any units, receive any vendor discounts, provide any employee discounts, or experience any inventory shrinkage. Using these data and the textbook approach, Merchant computes Retail LCM:

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16 *But see* GLENN A. WELSCH AND CHARLES T. ZLATKOVICH, *supra* note 7, which shows how to use the retail method to estimate the FIFO cost of ending inventories.

17 Some treatises distinguish "periodic averages," which are calculated annually using beginning amounts and current-year additions, from "moving averages," which are calculated more frequently. *See, e.g.*, SCHNEIDER, *supra* note 7 at §2.02[4] at 33. Though the formula used to compute Retail LCM is a periodic average under this criterion, "moving" is a better description of the phenomenon shown in *Example 1*.

	(a) At Cost	(b) At Retail	(a) / (b) Cost Complement
Beginning Inventories	$10.00	$ 20.00	
Purchases (15 widgets)	72.50	140.00	
Markups[18]	-	0.00	
Total Goods Handled	$82.50	160.00	0.51563
Markdowns[19]		(6.00)	
Sales (9 widgets @ $10.00)		(90.00)	
Ending Inventories -- At Retail (8 units @ $8.00)		64.00	
Cost Complement		0.51563	
Ending Inventories -- At Retail LCM		$ 33.00	

In *Example 1*, the moving-average phenomenon affects the cost complement because the cost-to-retail ratio of beginning inventories, 0.50 ($10.00 {cost} ÷ $20.00 {retail}), is different from the cost-to-retail ratio of purchases, 0.5179 ($72.50 ÷ $140.00). Stated differently, because the cost complement of beginning inventories (*i.e.*, prior year's cost complement) is different from the cost complement of purchases, the cost complement computed for the current year is affected by the relative weight (total expected profit {retail price - cost}) of these two components of Total Goods Handled. More importantly, Retail LCM, $33.00, is $3.00 less than LCM, $36.00, which is the lesser of cost, $37.50 (5 widgets @ $4.50 {unit cost of November 1 purchases} + 3 widgets @ $5.00 {unit cost of March 1 purchases}), or replacement cost, $36.00 (8 widgets @ $4.50 {unit cost of November 1 purchases}).

e. History of §1.471-8

At first, merchants employing the retail method for book purposes were unable to employ this method for tax purposes.[20] Though section 203 of the Revenue Act of 1918[21] authorized the Treasury Department to prescribe inventory methods that

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[18] If a merchant increases the price of a unit above the original price, that increase is a "markup." If the merchant later reduces the price of that unit, the reduction is either a "markup cancellation" or a "markdown." As long as the reduced price equals or exceeds the original price, the reduction is a markup cancellation, and the merchant's net markups will be positive. Once the reduced price falls below the original price, the reduction is a markdown, and the merchant's net markups will equal zero.

[19] If goods are sold at a temporarily reduced retail price, the merchant must subtract the corresponding temporary markdowns from total goods handled (at retail), so ending inventories (at retail) will not be overstated. But, as discussed in note 30 *infra*, temporary markdowns on *unsold* merchandise are not subtracted from total goods handled (at retail).

[20] MCNAIR & HERSUM, *supra* note 7 at 60.

[21] Pub. L. 65-254, 40 Stat. 1060.

conform as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income,[22] the Treasury Department did not sanction the retail method for federal income tax purposes. Instead, the Treasury Department promulgated Art. 1582 of Regulations 45 (1919), which required taxpayers to value inventories on an item-by-item basis and at (1) cost or (2) cost or market, whichever is lower. The retail method fails both requirements because it treats all the goods sold in a department as a single item and because it only approximates cost or LCM.[23]

During the following year, the Treasury Department promulgated Art. 1588 of Regulations 45 (1920) as a relief provision for merchants who employ the retail method.[24] However, this regulation did not provide complete relief because merchants were not permitted to value their inventories at Retail LCM. To ensure that merchants valued their inventories at cost, this regulation prohibited them from deducting any markdown related to *unsold* merchandise from total goods handled (at retail) when computing ending inventories (at retail).[25] As amended in 1922,[26] this regulation permitted merchants, for each department or class of goods, to reduce ending inventories (at retail) to Retail Cost by reducing the denominator of the cost complement, and thus total goods handled (at retail), by all markdowns recorded during the year (including markdowns related to unsold merchandise). Finally, in 1941, the Treasury Department permitted merchants using the retail method to value inventories at either (1) Retail Cost or (2) Retail LCM.[27] Section 1.471-8 continues this policy.

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22 At the first annual convention of the Controllers' Congress of the National Retail Dry Goods Association in June of 1920, the delegates were informed that their organization was instrumental in having this language inserted into section 203. *See* MCNAIR AND HERSUM, *supra* note 7 at 64.

23 Moreover, the moving-average phenomenon inherent in the cost complements used to compute Retail LCM arguably conflicts with the Service's position regarding the use of average-cost methods for inventory valuation. *See, e.g.,* T.B.R. 48, 1 C.B. 47. *See also* Rev. Rul. 71-234, 1971-1 C.B. 148 (updating and restating T.B.R. 48).

24 T.D. 3058, 3 C.B. 72 (1920).

25 But for the moving-average phenomenon, the textbook approach shown in *Example 1* will compute Retail Cost if all markdowns related to unsold merchandise are added back to ending inventories (at retail) before the combined amount is multiplied by the cost complement. Determining the amount of markdowns related to unsold merchandise is impractical, however, without the use of physical flow assumptions, which defeats the purpose of using the retail method.

26 T.D. 3296, 1922-1 C.B. 40 (1922).

27 T.D. 5048, 1941-1 C.B. 200.

f. Retail LCM equals LCM under limited conditions

For the reasons discussed previously, Retail LCM usually will not equal LCM computed under the FIFO method.[28] But under the limited conditions of *Example 2*, Retail LCM is the actual replacement cost of the merchant's ending inventories.

Example 2. At the beginning of the taxable year ending December 31, 2003, Merchant has 10 widgets whose cost is $4.00 ($40.00 total) and whose retail price is $6.00 ($60.00 total). During January and February of 2003, Merchant sells 7 of these widgets @ $6.00 ($42.00 total). Subsequently, Merchant purchases 6 additional widgets. The dates of receipt, unit costs, and retail prices are shown below:

Date Received	No. of Units	Unit Cost	Total Cost	Original Retail Price	Total Retail Price
3/01/03	1	$4.00	$ 4.00	$6.00	$ 6.00
7/01/03	2	3.00	6.00	4.50	9.00
9/01/03	2	3.00	6.00	4.50	9.00
11/01/03	1	3.00	3.00	4.50	4.50
Total	6		$19.00		$28.50

Assume that these widgets are offered for sale on the date received. On July 1, 2003, Merchant permanently reduces the retail price of the widgets from $6.00 to $4.50. Because Merchant's inventory includes 4 widgets priced at $6.00, Merchant records markdowns totaling $6.00 (4 widgets x [$6.00 {March retail price} - $4.50 {July retail price}]). During 2003, Merchant does not mark up the retail price of any units, receive any vendor discounts, provide any employee discounts, temporarily reduce any retail price, or experience any inventory shrinkage.

The value of Merchant's ending inventories at LCM computed under the FIFO method is $27.00. The actual cost of Merchant's ending inventories is $31.00 [1 widget @ $3.00 {November 1 purchase} + 2 widgets @ $3.00 {unit cost of September 1 purchase} + 2 widgets @ $3.00 {unit cost of July 1 purchase} + 1 widget @ $4.00 {March 1 purchase} + 3 widgets @ $4.00 {unit cost of beginning inventories}]. But the replacement cost of Merchant's ending inventories is only $27.00 [9 widgets @ $3.00 {unit cost of November 1 purchase}]).

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[28] The moving-average phenomenon is not the only reason that Retail LCM will differ from LCM. Losses on subnormal goods (*e.g.*, scratched tables) are recognized differently for book and tax purposes. A permanent markdown on a subnormal good reduces ending inventories (at retail) and, thus, Retail LCM. In contrast, LCM is not reduced except to the extent that the reduced price of the subnormal good is less than the replacement cost of a similar normal good. But for simplicity's sake, none of the examples involves subnormal goods.

Using these data and the textbook approach, Merchant properly computes the cost complement, ending inventories (at retail), and Retail LCM:

	(a) At Cost	(b) At Retail	(a) / (b) Cost Complement
Beginning Inventories	$40.00	$60.00	
Purchases[29]	19.00	28.50	
Total Goods Handled	$59.00	88.50	0.66667
Markdowns		(6.00)	
Sales (7 widgets @ $6.00)		(42.00)	
Ending Inventories -- At Retail (9 widgets @ $4.50)		40.50	
Cost Complement		0.66667	
Ending Inventories -- At Retail LCM		$27.00	

Finally, Merchant computes gross income for 2003:

Sales	$42.00
Cost of Goods Sold:	
Beginning Inventories	$40.00
Purchases	19.00
Cost of Goods Available	59.00
Less Ending Inventories	27.00
Less Cost of Goods Sold	32.00
Gross Income	$10.00

In *Example 2*, Retail LCM is the actual replacement cost of Merchant's inventories for three reasons. First, the moving-average phenomenon does not affect Merchant's cost complement. Second, when computing the denominator of the cost complement, Merchant uses only contemporaneous retail prices. Specifically, the contemporaneous retail prices of the 2003 purchases are $6.00 for the unit purchased on 3/01/03, $4.50 for the units purchased on 7/01/03, $4.50 for the units purchased on 9/01/03, and $4.50 for the unit purchased on 11/01/03. Third, the goods in Merchant's

[29] A merchant sometimes needs to lower prices in a way that is not properly classified as a markdown because the reductions are not chargeable to the merchant's buyer (*e.g.*, when the merchant decides to hold a special sale after purchasing merchandise at a special, low cost). In these cases, the merchant records the special purchase at the original price and subtracts a "special adjustment" when computing net purchases (at retail). *See, e.g.*, RAY A. HOFFMAN, *supra* note 7, at 117-18. But for this accounting treatment, a temporary price reduction following a special, low-cost purchase would activate the moving-average phenomenon and artificially lower the merchant's cost complement.

ending inventories are recorded at the lesser of their contemporaneous retail price or their permanently reduced retail price and not at a temporarily reduced retail price.[30]

g. Conclusions drawn from the operation of the textbook approach

Because Retail LCM equals the actual replacement cost of ending inventories under the limited conditions of *Example 2*, the retail method clearly reflects income when properly applied by a merchant. But properly applying the retail method means properly completing each intermediate step in the computation of Retail LCM (*i.e.*, the computations of the cost complement, permanent markdowns, and ending inventories (at retail)).

Under the textbook approach, the denominator of the cost complement is related arithmetically to ending inventories (at retail). As shown in *Example 2*, Merchant adds beginning inventories (at retail) and purchases (at retail) to obtain total goods handled (at retail), which also is the denominator of the cost complement. Then, subtracting markdowns (at retail) and sales (at retail) from total goods handled (at retail), Merchant obtains ending inventories (at retail). Thus, beginning inventories (at retail) and purchases (at retail) are common to the denominator of the cost complement and to ending inventories (at retail). Given this arithmetic relationship, the computations of ending inventories (at retail) ($40.50) and the denominator of the cost complement ($88.50) cannot be correct unless Merchant uses the same beginning inventories (at retail) ($60.00) and purchases (at retail) ($28.50), respectively, for both computations. Thus, Merchant is not allowed to assign one set of retail prices to purchases (at retail) when computing ending inventories (at retail) and to assign a different set of retail prices to purchases (at retail) when computing the denominator of the cost complement.

Because of the arithmetic relationship between the denominator of the cost complement and ending inventories (at retail), the textbook approach provides an objective test for determining whether a merchant has used original retail prices when computing beginning inventories (at retail) and purchases (at retail). Specifically, when a merchant has assigned only original retail prices to beginning inventories (at retail) and purchases (at retail) and thereafter has computed only bona fide permanent

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[30] When sanctioning the retail method, the Treasury Department modified it to prevent merchants from obtaining artificial tax losses on the last day of the taxable year. *See* §§1.471-8(a) and (e). As shown in *Example 2*, ending inventories (at retail) is reduced when a merchant reduces the price of unsold goods. Thus, if a merchant were permitted to reduce ending inventories (at retail) when it temporarily reduces the price of unsold goods for promotional purposes, Retail LCM will be significantly lower than replacement cost (*i.e.*, LCM), which is what the retail method is supposed to approximate. Thus, under §1.471-8, temporary markdowns on *unsold* goods are not permitted. *See* Rev. Rul. 79-115. Moreover, unlike permanent markdowns, which acknowledge inventory-related losses, temporary markdowns function as a marketing tool.

markdowns, the computation of ending inventories (at retail) will be correct. Of course, few merchants actually use the textbook approach to compute ending inventories (at retail). But if a merchant uses the physical inventory approach[31] or some other approach for this purpose, the retail prices will be original only when the value actually computed by the merchant is the same as the value that the merchant would have computed under the textbook approach.[32] The truth of these propositions can be seen by comparing and contrasting *Examples 2* through *4*. In *Example 2*, whenever required to use an original retail price, Merchant always selects the unit's contemporaneous retail price. Furthermore, Merchant always computes bona fide permanent markdowns that equal the difference between the unit's former permanent retail price and the unit's current permanent retail price. In contrast, *Examples 3* and *4* show how using an artificially high retail price as the original retail price distorts ending inventories (at retail).

Example 3. Assume that the facts are the same as in *Example 2*, except that when computing the denominator of the cost complement, Merchant uses the first permanent retail price charged during the year, $6.00, as the original retail price of every unit purchased during the year:

Date Received	No. of Units	Unit Cost	Total Cost	Original Retail Price	Total Retail Price
3/01/03	1	$4.00	$ 4.00	$6.00	$ 6.00
7/01/03	2	3.00	6.00	6.00	12.00
9/01/03	2	3.00	6.00	6.00	12.00
11/01/03	1	3.00	3.00	6.00	6.00
Total	6		$19.00		$36.00

Using these data and the textbook approach, Merchant computes the cost complement, ending inventories (at retail), and Retail LCM as follows:

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31 To determine ending inventories (at retail) for widget A, the merchant counts the units of widget A and multiplies that sum by widget A's end-of-year price.

32 For this purpose, we may ignore the fact that ending inventories (at retail) is likely to be different under the textbook and physical inventory approaches because a merchant estimates shrinkage under textbook approach but determines actual shrinkage under the physical inventory approach.

	(a) At Cost	(b) At Retail	(a) / (b) Cost Complement
Beginning Inventories	$40.00	$60.00	
Purchases	19.00	36.00	
Total Goods Handled	$59.00	96.00	0.61458
Markdowns		(6.00)	
Sales (7 widgets @ $6.00)		(42.00)	
Ending Inventories -- At Retail		48.00	
Cost Complement		0.61458	
Ending Inventories -- At Retail LCM		$29.50	

Finally, Merchant computes gross income for 2003:

Sales	$42.00
Cost of Goods Sold:	
Beginning Inventories	$40.00
Purchases	19.00
Cost of Goods Available	59.00
Less Ending Inventories	29.50
Less Cost of Goods Sold	29.50
Gross Income	$12.50

Using the artificially high original retail price when computing the cost complement causes a series of errors in Merchant's computations of Retail LCM, which ultimately affect Merchant's computation of gross income. First, the cost complement is understated compared to *Example 2* (0.61458 versus 0.66667) because the denominator is overstated compared to *Example 2* ($96.00 versus $88.50). Second, ending inventories (at retail) is overstated by the same $7.50. In other words, though the 9 widgets in ending inventories have a retail value of $40.50 (9 widgets @ $4.50), Merchant has computed an artificially high retail value of $48.00 using the textbook approach. Third, overstating ending inventories (at retail) overstates Retail LCM compared to *Example 2* ($29.50 versus $27.00). Fourth, overstating Retail LCM overstates gross income compared to *Example 2* ($12.50 versus $10.00).

In summary, using an artificially high retail price under the textbook approach affects the computation of Retail LCM in two ways. The understatement of the cost complement reduces Retail LCM, and the overstatement of ending inventories (at retail) increases Retail LCM. On balance, they increase Retail LCM and, thus, increase gross income. Because each intermediate step in the computation of Retail LCM is not being completed properly, Merchant is not applying the retail method properly.

Example 4. After understating the cost complement as shown in *Example 3*, Merchant computes ending inventories (at retail) using either the physical inventory approach or the textbook approach with both permanent markdowns of $6.00

{*Examples 2* and *3*} and artificial markdowns of $7.50, the amount required to correct ending inventories (at retail) in *Example 3*. In either case, Merchant will compute a revised Retail LCM as follows:

Ending Inventories -- At Retail (correct value)	$40.50
Cost Complement (*Example 3*)	0.61458
Ending Inventories -- At Retail LCM	$24.89

Finally, Merchant will compute the revised gross income for 2003:

Sales	$42.00
Cost of Goods Sold:	
Beginning Inventories	$40.00
Purchases	19.00
Cost of Goods Available	59.00
Less Ending Inventories	24.89
Less Cost of Goods Sold	34.11
Gross Income	$ 7.89

Using the actual ending inventories (at retail) does not compensate for the fact that using an artificially high retail price understates the cost complement. When Merchant multiplies the actual ending inventories (at retail), $40.50, by the understated cost complement, 0.61458, Retail LCM is understated compared to *Example 2* ($24.89 versus $27.00), which causes Merchant's gross income to be understated compared to *Example 2* ($7.89 versus $10.00).

h. Conclusion

The retail method will correctly compute Retail LCM only if the merchant uses contemporaneous retail prices when computing the cost complement and ending inventories (at retail). Thus, the retail method will not correctly compute Retail LCM if the merchant computes the cost complement or ending inventories (at retail), or both, using any of the following: (1) an artificially high or nominal retail price (with or without an artificial markdown[33]); (2) the permanent retail price of identical units prevailing on the first day of the taxable year (with or without an artificial markdown); (3) an artificially low retail price; or (4) a temporarily reduced retail price.[34]

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[33] "Artificial markdown" means the amount needed to offset the excess of (1) the price used when computing the cost complement and (2) the taxpayer's contemporaneous price.

[34] In contrast, the retail method will correctly compute Retail Cost even if a merchant uses artificially high prices and artificially high markdowns because the latter offset the former when the merchant computes the cost complement.

2. Record-keeping Requirements

A merchant must satisfy the following record-keeping requirements. First, the merchant must maintain records that document the cost and retail value of beginning inventories, the unit cost and original retail price of all purchases (as well as their respective totals), and the merchant's markups, markdowns, vendor discounts, etc.[35] Second, the merchant must be able to show that it used these data properly when computing the cost complement, ending inventories (at retail), and Retail LCM (or Retail Cost).

If the merchant used software to apply the retail method, the merchant must satisfy additional record-keeping and computational requirements because a revenue agent is not required to accept software-generated tax data at face value. First, the merchant must establish audit trails between the retained electronic records and the taxpayer's books and between the retained electronic records and the tax return.[36] Second, the merchant must show that its software properly used all the relevant data when computing the cost complement, ending inventories (at retail), and Retail LCM (or Retail Cost).

ISSUE (2): Given the revenue agent's determination that Taxpayer did not apply the retail method properly and did not maintain the inventory records required by §1.471-8, should the national office revoke Taxpayer's ruling retroactively?

This request for technical advice arose under section 11.01 of Rev. Proc. 97-27. In relevant part, section 11.01 of Rev. Proc. 97-27 requires the district director (*i.e.*, revenue agent) to ascertain whether the taxpayer implemented the proposed change in method of accounting according to the terms and conditions of the Consent Agreement. The revenue procedure also explains that if the revenue agent recommends modifying or revoking the ruling, the revenue agent will forward the matter to the national office for consideration before any further action is taken, and the national office will treat this referral as a request for technical advice.

Taxpayer's ruling granted consent to value inventories at Retail LCM under §1.471-8, which includes a requirement to keep accurate accounts. Taxpayer's ruling also contains terms and conditions. Among these is the requirement that Taxpayer keeps its books and records for the year of change and for subsequent taxable years on the method of accounting granted in the ruling. The ruling then provides that this condition is considered satisfied if the taxpayer reconciles the results obtained under the method used in keeping its books and records and the method used for federal income tax purposes and maintains sufficient records to support this reconciliation.

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35 *See* §§1.471-2(e) and 1.471-8(a).

36 *See* section 5.03(2) of Rev. Proc. 98-25, 1998-1 C.B. 689.

During the examination of Taxpayer's tax return for the year of change, the revenue agent determined that Taxpayer failed to implement the retail method according to the terms and conditions of the Consent Agreement. First, citing the statement contained in the user manual supplied with the Software 2, the revenue agent believes that Taxpayer used artificially high retail prices when computing the cost complements of the SKUs. Specifically, the revenue agent believes that when computing the cost complements, the Software 2 always used the retail price that was prevailing at the beginning of Taxpayer's taxable year. Second, the revenue agent contends that Taxpayer failed to maintain the accurate accounts required by §1.471-8(a), particularly, the contemporaneous, purchase-related records so critical to the computation of correct cost complements. In the revenue agent's view, Taxpayer's large sample of sales receipts does not satisfy this requirement. Finally, the revenue agent believes that the cost-based inventory method that Taxpayer used in the taxable year immediately preceding the year of change clearly reflects Taxpayer's income. Thus, the revenue agent has asked the national office to revoke Taxpayer's ruling retroactively under section 11.01(3) of Rev. Proc. 97-27.

In contrast, Taxpayer argues that the revenue agent's request is unreasonable because Taxpayer properly applied the retail method. Taxpayer contends that §1.471-8(a) does not expressly require a merchant to use contemporaneous retail prices when computing cost complements. Thus, §1.471-8(a) cannot require a merchant to maintain the contemporaneous, purchase-related records that the revenue agent would like to examine. Moreover, Taxpayer argues that its retail prices generally do not decrease, if ever, until near the end of the taxable year when its suppliers lower their MSRPs. Thus, Taxpayer contends that it has implemented the retail method according to the terms and conditions of the Consent Agreement. Finally, Taxpayer contends that the revenue agent should propose adjustments to correct Taxpayer's computational errors, if any actually exist, rather than request the national office to revoke the ruling so the revenue agent may require Taxpayer to cease using the retail method altogether.[37]

We believe that the revocation of Taxpayer's ruling is warranted. First, for the reasons discussed under ISSUE (1), we reject Taxpayer's argument that a merchant using the retail method is not required to use contemporaneous retail prices when computing cost complements. Thus, we concur in the revenue agent's inference that Taxpayer did not properly implement the retail method for the year of change. Second, for the reasons discussed under ISSUE (1), we reject Taxpayer's implicit argument that a merchant using the retail method is not required to maintain contemporaneous, purchase-related records for the revenue agent to examine. Third, Taxpayer's failure to maintain these records effectively nullified its reconciliation of book income and taxable

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[37] *But see Bank One Corp., et al. v. Commissioner*; 120 T.C. No. 11 (May 2, 2003), quoting *Am. Fletcher Corp. v. United States*, 832 F.2d 436, 442 (7th Cir. 1987) (Cudahy, J., concurring) ("Taxpayers are required to keep adequate records to support their declaration of taxable income, and have no grounds for protest if the Commissioner imposes a workable accounting method when confronted with inadequate records.").

income, which is required by the ruling. Whatever reconciliation Taxpayer offered is unverifiable because Taxpayer failed to show that it correctly computed its taxable income for the year of change.

Moreover, Taxpayer's failure to maintain contemporaneous, purchase-related records effectively prevents the revenue agent from proposing corrective adjustments as an alternative to requesting the national office to revoke Taxpayer's ruling. When a revenue agent determines under section 446(b) that a taxpayer has improperly applied a *permissible* method of accounting, the revenue agent generally will require the taxpayer to correct its application of the method for the year(s) under examination rather than require the taxpayer to change to some other permissible method.[38] In this case, however, because Taxpayer has not maintained sufficient records to support its application of the retail method for the year of change, neither Taxpayer nor the revenue agent is able to correct Taxpayer's application of the retail method for the year of change. In fact, if the revenue agent were to propose adjustments to Taxpayer's retail prices without having data to support those adjustments, his action could be construed as requiring Taxpayer to change from one method that does not clearly reflect income to another method that does not clearly reflect income.[39]

Under these circumstances, we hereby revoke Taxpayer's ruling as of the beginning of the year of change. Notwithstanding our retroactive revocation of Taxpayer's ruling, Taxpayer may request consent to return to the retail method in the taxable year that Taxpayer establishes to the Commissioner's satisfaction that it is able to comply with all the computational and record-keeping requirements attendant to using the retail method.

CAVEAT(S):

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

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38 *See, e.g.*, *Kohler Co. v. United States*, 34 Fed. Cl. 379 (1995).

39 *See, e.g.*, *Golden Gate Litho v. Commissioner*, T.C. Memo. 1998-184 (taxpayer permitted to continue using cash method, which did not clearly reflect income, because revenue agent's application of accrual method did not clearly reflect income either).