

Rev. Proc. 77-12

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, Section 334; 1.334-1.)

January, 1977

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SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to set forth guidelines for use by taxpayers and Service personnel in making fair market value determinations in situations where a corporation purchases the assets of a business containing inventory items for a lump sum or where a corporation acquires assets including inventory items by the liquidation of a subsidiary pursuant to the provisions of section 332 of the Internal Revenue Code of 1954 and the basis of the inventory received in liquidation is determined under section 334(b)(2). These guidelines are designed to assist taxpayers and Service personnel in assigning a fair market value to such assets.

SEC. 2. BACKGROUND.

If the assets of a business are purchased for a lump sum, or if the stock of a corporation is purchased and that corporation is liquidated under section 332 of the Code and the basis is determined under section 334(b)(2), the purchase price must be allocated among the assets acquired to determine the basis of each of such assets. In making such determinations, it is necessary to determine the fair market value of any inventory items involved. This Revenue Procedure describes methods that [*2] may be used to determine the fair market value of inventory items.

In determining the fair market value of inventory under the situations set forth in this Revenue Procedure, the amount of inventory generally would be different from the amounts usually purchased. In addition, the goods in process and finished goods on hand must be considered 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.

SEC. 3. PROCEDURES FOR DETERMINATION OF FAIR MARKET VALUE.

Three basic methods an appraiser may use to determine the fair market value of inventory are the cost of reproduction method, the comparative sales method, and the income method. All methods of valuation are based on one or a combination of these three methods.

.01 The cost of reproduction 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 [*3] value of the finished goods of a manufacturing concern. In valuing a particular inventory under this method, however, 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 reproduction because it provides a continuity of business, whereas an inventory containing obsolete merchandise unsuitable for customers might have a fair market value of less than the cost of reproduction.

.02 The comparative sales method utilizes the actual or expected selling prices of finished goods to customers as a basis of determining fair market values of those finished goods. When the expected selling price is used as a basis for valuing finished goods inventory, consideration should be given to the time that would be required to dispose of this inventory, the expenses that would be expected to be incurred in such disposition, for example, all costs of disposition, applicable discounts (including those for quantity), sales commissions, and freight and shipping charges, and a profit commensurate with the amount of investment and degree of risk. It should also [*4] be recognized that the inventory to be valued may represent a larger quantity than the normal trading volume and the expected selling price can be a valid starting point only if customers' orders are filled in the ordinary course of business.

.03 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. Since 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 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 [*5] reduced by the expected costs of completion, including a reasonable profit allowance for the completion and selling effort of the acquiring corporation. In determining the fair market value of raw materials, the current costs of replacing the inventory in the quantities to be valued generally provides the most reliable standard.

SEC. 4.CONCLUSION.

Because valuing inventory is an inherently factual determination, no rigid formulas can be applied. Consequently, the methods outlined above can only serve as guidelines for determining the fair market value of inventories.