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Memorandum

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to: Scott D. Holt
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Internal Revenue Agent
(Large & Mid-Size Business)

from: Deputy Area Counsel, Industry Programs
(Retailers, Food, Pharmaceuticals and Healthcare)
(Large & Mid-Size Business)

subject: Application of uniform capitalization rules of Section 263A to ending physical grain inventory held for resale

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether _____ (“_____” or Taxpayer) is required to capitalize costs to ending physical grain inventory under the uniform capitalization rules of Section 263A where _____ values ending physical grain inventory held for resale at replacement cost?

CONCLUSION

_____ must capitalize and allocate to ending physical grain inventory pursuant to Section 263A the direct costs of acquiring the grain for resale and the properly allocable share of indirect costs that directly benefit or are incurred in the resale of the grain.

FACTS

_____ is a licensed public grain warehouse. _____ operates two country grain elevators located in _____ and _____. _____ is primarily in the business of purchasing grain from farmers and producers and reselling the grain to larger grain

terminals and processors. also provides a full line of related agricultural services, including grain storage, supply of fertilizers and chemicals, financing activities and commodity trading services. Taxpayer operates on an overall accrual basis of accounting with a taxable period ending . Taxpayer is under examination for its taxable periods ended and .

The Chicago Board of Trade (“CBOT”) provides an open market for the purchase and sale of commodities, including corn, soybean and wheat grain. The CBOT establishes a “zero basis” futures price for each commodity traded on the exchange. Terminals and elevators generally use the “zero basis” futures price in calculating the price that it will purchase or sell the commodity. “Basis” is an amount that may be added or subtracted from the futures price to increase or decrease the volume of grain that is sold at a particular terminal or elevator. For example, if a terminal is experiencing increased demand for a commodity, the terminal may increase the “basis” amount to entice suppliers to sell the commodity to the terminal. Each day, terminals and elevators post a “bid” or “spot” price, which is the price that it is willing to purchase the commodity on that particular day. In calculating its “bid” price, the terminal or elevator typically takes a market futures price¹ for the commodity and adjusts for “basis,” overhead, destination freight and profit margin. The “bid” price is the price that the terminal or elevator is willing to purchase the commodity from a supplier.

maintains corn, soybean and wheat grain inventories for resale in the ordinary course of its business to larger grain elevators and processors. purports to value its grain inventory at market price. determines market price for its grain inventory based upon the month-end futures price for such grain,² plus or minus “basis,” less freight and profit margin. calculation arrives at the year-end cash price at which it would purchase grain from farmers and producers. This “bid” price is the replacement cost of grain inventory at month or year-end. uses the “bid” price to value its grain inventory. year-end physical grain inventory valuation is calculated from the year-end price it pays to its suppliers for the grain.

sells corn, soybean and wheat grain in a separate market from that in which it purchases. sells to larger grain elevators and processors. While establishes the price at which it purchases grain from farmers and producers, sells grain to the larger grain elevators and processors at prices established by the purchasers. Therefore, correct calculation of its “bid” price is critical to profitability.

For the taxable years at issue, did not capitalize or include any costs other than the “bid” price in its year-end physical grain inventory valuation. incurred

¹ The market futures price may derived from the CBOT “zero basis” futures price or a futures price established by another market.

² continuously monitors the prices offered by a variety of terminals and elevators in an effort to obtain the highest returns. During the periods at issue, utilized the futures price for corn and soybeans from the market and the futures price for wheat from the market.

compensation, retirement and employee benefit, payroll and property tax, contract labor, depreciation, interest, insurance, rent, repairs, utilities, supplies, telephone, dues, travel and miscellaneous expenses. also incurred purchasing, storage, and handling costs with respect to its grain inventory. did not capitalize any indirect costs to ending grain inventory under Section 263A for the taxable years at issue.

LAW AND ANALYSIS

Section 263A requires, in the case of inventory, the capitalization and inclusion in inventory of the direct costs of acquiring the property and the property's properly allocable share of indirect costs. I.R.C. § 263A(a); Treas. Reg. §§ 1.263A-1(a)(3), (c)(1), (e)(1). For inventory, capitalize means to include in inventory costs. Treas. Reg. § 1.263A-1(c)(3). Resellers must capitalize the acquisition costs of property acquired for resale. Treas. Reg. § 1.263A-1(e)(2)(ii). Resellers must also capitalize the indirect costs (such as officers' compensation, pension and employee benefits expense, storage, handling, insurance, utilities and repairs) that directly benefit or are incurred in the resale of property. Treas. Reg. § 1.263A-1(e)(3).

Generally, taxpayers that purchase and resell to others must compute the value of ending inventory under Section 263A. Section 263A applies to personal property acquired by a taxpayer primarily for resale to customers in the ordinary course of its trade or business. I.R.C. § 263A(b)(2)(A). acquires grain from farmers and producers for resale to grain elevators and processors in the ordinary course of its business. Accordingly, absent an exception, is required to capitalize the acquisition costs of the grain and the properly allocable share of indirect costs relating to the grain to inventory under Section 263A.

Section 263A provides a number of exceptions from its treatment. See I.R.C. §§ 263A(b)(2)(B), (c), (d); Treas. Reg. § 1.263A-1(b). Four exceptions to the capitalization requirements under Section 263A may be applicable to a reseller such as . Section 263A(b)(2)(B) provides an exception from capitalization of costs under Section 263A for personal property acquired by the taxpayer for resale if the taxpayer's average annual gross receipts for the preceding three years do not exceed \$10 million. See also Treas. Reg. § 1.263A-3(a)(1); Treas. Reg. § 1.263A-3(b). A second exception from the capitalization of costs under Section 263A for personal property is contained in Treas. Reg. § 1.263A-3(a)(2)(ii), which excepts the *de minimis* production activities of resellers. See also Treas. Reg. § 1.263A-1(b)(1). A third exception from the capitalization of costs under Section 263A is provided for small resellers that have property produced under contract. Treas. Reg. § 1.263A-3(a)(3). Finally, an exception from the capitalization of costs under Section 263A is provided for a reseller valuing inventory at the property's fair market value. Treas. Reg. § 1.263A-1(a)(3)(iv). does not satisfy the first three exceptions to Section 263A identified above. At issue in this memorandum is whether satisfies the fourth exception under Treas. Reg. § 1.263A-1(a)(3)(iv) based upon a valuation of inventory at fair market value.

Section 471(a) requires the use of inventories when necessary to clearly determine the income of a taxpayer. Inventories at the beginning and end of each taxable year are necessary where the purchase or sale of merchandise is an income-producing factor. Treas. Reg. § 1.471-1. income arises primarily from its purchase and sale of grain. Therefore, is required to maintain grain inventories.

Treas. Reg. § 471-2(a) requires that inventories conform as nearly as may be to the best accounting practice in the trade or business and clearly reflect the income. Taxpayers may value inventories under the lower of cost or market method. Treas. Reg. § 1.471-2(c); but see Rev. Rul. 74-227, 1974-1 C.B. 119; Molsen v. Commissioner, 85 T.C. 485, 497 (1985)(grain dealers engaged in grain purchase, storage or resale permitted to value physical ending inventory at market value, even where it exceeds actual cost of inventory). “Cost” is generally defined as the invoice price less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession. Treas. Reg. § 1.471-3(b). “Market” generally refers to replacement or reproduction costs. Treas. Reg. § 1.471-4(a); Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 534 (1979). must value its grain inventory in accordance with Section 471 and, if applicable, Section 263A.

Section 263A does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property’s fair market value. Treas. Reg. § 1.263A-1(a)(3)(iv). For such purposes, fair market value means the price at which the taxpayer sells its inventory to its customers less, if applicable, the direct cost of disposing of the inventory. Id.

In defining fair market value, Treas. Reg. § 1.263A-1(a)(3)(iv) references Treas. Reg. § 1.471-4(b), which recognizes a situation in which inventories may be valued at fair market value. Id. Treas. Reg. § 1.471-4(b) provides an exception to the general rule that “market” is determined by reference to replacement or reproduction costs. The “inactive market” exception in Treas. Reg. § 1.471-4(b) states that where no open market exists or where quotations are nominal, a taxpayer must use evidence of a fair market price at the date nearest the inventory as may be available, such as specific sales in reasonable volume and made in good faith. Section 263A does not apply to inventories valued using the lower of cost or market method if market is determined under the “inactive market” exception. IRS TAM 199913037 (April 2, 1999). In contrast, a taxpayer must capitalize costs under Section 263A when market is determined with respect to replacement or reproduction cost. Id.; Treas. Reg. § 1.263A-1(a)(3)(iv); Treas. Reg. § 1.471-4(a). is not permitted to use the “inactive market” exception in Treas. Reg. § 1.471-4(b) because an open and active market exists on the CBOT for the sale of the grain.

valued its ending physical grain inventory at the price it paid to the farmers or producers for the grain, referred to as the “bid” or “spot” price. values its inventory based upon the price it would pay on the open market to replace its grain inventory.

does not value its grain inventories at the price (less direct costs of disposition) at which it sells grain to the grain elevators and processors. In fact, does not purchase and sell its grain inventories in the same market. purchases grain from farmers and producers at prices it establishes. sells grain to elevators or processors at prices set by the purchaser. profits by selling the grain to the elevators or processors at a price higher than it purchased the grain from farmers and producers. is appropriately valuing its inventory under the market method set forth in Treas. Reg. § 1.471-4(a). method of valuing its grain inventories results in a valuation at replacement or reproduction cost.

is required to capitalize and include in ending physical grain inventory, under Section 263A, the direct costs of acquiring the grain for resale and the properly allocable share of indirect costs that directly benefit or are incurred in the resale of the grain. does not satisfy the exception to Section 263A provided in Treas. Reg. § 1.263A-1(a)(3)(iv) for inventory valued at the price (i.e., fair market value) sold to its customers. Instead, appropriately values its grain inventories at the price it purchases grain from farmers and producers at year-end. Therefore, is subject to the capitalization rules of Section 263A.

This advice has been coordinated with Branch 7 of the Office of Associate Chief Counsel (Income Tax and Accounting). This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views. Please call me at (312) 368-8387 or Rogelio Villageliu at (312) 368-8728 if you have any further questions.

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