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Reg. Section 1.471-3

Inventories at cost

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, 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.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§1.263A-1 and 1.263A-2 for more specific rules regarding the treatment of production costs.

(d) 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).

(e) Sales-based vendor allowances.

(1) Treatment of sales-based vendor chargebacks.

(i) In general. A sales-based vendor chargeback is an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor. A sales-based vendor chargeback decreases cost of goods sold and does not reduce the cost of goods on hand at the end of the taxable year.

(ii) Example. The following example illustrates the provisions of this paragraph (e)(1).

Example.

(i) W is a wholesaler of pharmaceuticals. W purchases Drug X from the manufacturer, M, for \$10x per unit. M has agreements with specific customers that allow those customers to acquire Drug X from M's wholesalers for \$6x per unit. Under an agreement between W and M, W is required to sell Drug X to specific customers at the prices M has negotiated with such customers (\$6x per unit) and, in exchange, M agrees to provide a price rebate to W equal to the difference between W's cost for Drug X and the price W is required to charge specific customers under the agreement (a difference of \$4x per unit). W sells Drug X to specific customer Y for \$6x. Under the agreement between W and M, the price rebate can be paid to W, credited against M's invoice to W for W's purchase of Drug X, or it can be credited to W's future purchases of drugs from M.

(ii) Under the terms of the agreement, W is unconditionally entitled to the price rebate of Drug X when it sells Drug X to specific customer Y, a specifically identified customer of M. The price rebate received by W for the sale of Drug X to Y is a sales-based vendor chargeback. Therefore, the amount of the sales-based vendor charge back, \$4x per unit for Drug X, whether paid to W, credited against M's invoice to W for W's purchase of Drug X or credited against a future purchase, decreases cost of goods sold and does not reduce the cost of Drug X on hand at the end of the taxable year.

(2) Treatment of other sales-based vendor allowances. [Reserved]

(f) 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.

(g) Effective/applicability date. Paragraph (f) of this section applies to taxable years ending on or after January 13, 2014.