CHAPTER 8011
DEPARTMENT OF REVENUE
INCOME TAX DIVISION
INVENTORIES

8011.0100 WHEN INVENTORIES ARE REQUIRED.

Inventories are necessary in order to properly reflect the net income in every case in which the production, purchase, or sale of merchandise is an income-producing factor. All raw materials and supplies which will physically become a part of merchandise intended for sale, and all finished or partly finished goods which have been produced or acquired for sale, should be included in the inventory. Supplies of the type which are consumed as an incident to the conduct of business should not be included with the other merchandise in the inventory. Only merchandise title to which is vested in the taxpayer should be included in the inventory. The seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract, and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which is passed to him although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should exclude goods ordered for future delivery, the title to which has not been transferred.

Statutory Authority: *MS s 290.52*

8011.0200 VALUATION OF INVENTORIES.

Subpart 1. **In general.** An inventory valued in accordance with the best accounting practice in the trade or business and used by the taxpayer to show his financial position, can usually be accepted for tax purposes. No inventory practice will be considered as clearly reflecting the taxable income which is not 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, provided that the method or basis used is substantially in accord with these rules.

Subp. 2. **Valuation bases; bona fide selling price.** The bases most commonly used in valuing inventories are (1) cost, and (2) cost or market, whichever is lower. When the inventory includes goods which are unsalable at normal prices or cannot be used for the purpose for which they were acquired, because of damage, imperfection, shop wear, change of style, odd or broken lots, or other similar causes, such goods should be valued at bona fide selling prices less costs. In the case of damage or imperfect raw materials or work in process, the basis of valuation must take into consideration the usability and condition of the goods, but in no case shall the value be less than scrap value. "Bona fide selling price" means the price at which the goods are offered for sale at or about the date of the inventory. The burden of proof will rest upon the taxpayer to show that the portions of the inventory in question were actually offered for sale at or about the date of the inventory, and to maintain adequate records of the disposition of the goods which will permit a verification of the inventory.

Subp. 3. **Basis.** Whether the cost, or cost or market whichever is lower, basis of valuing inventories is used, the basis adopted must be applied with reasonable consistency to the entire inventory, and no change from one basis to the other will be permitted without first obtaining permission from the commissioner.

Subp. 4. **Intermingled goods.** Goods included in the inventory which have become so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced and the cost thereof will be the actual cost of goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired.

Subp. 5. **Physical inventories.** When the system of accounting involves the keeping of perpetual inventory records, actual physical inventories must be taken at reasonable intervals and proper adjustments made to bring the books into accord with such physical inventories.

Subp. 6. **Records.** Inventories should be preserved as a part of the accounting records of the taxpayer in such a manner as to set forth clearly the number of units, prices and extensions. Suitable summaries should be preserved, showing the totals by classes or departments of the goods included in the inventory. The inventory records will be subject to investigation by the commissioner and the taxpayer must, therefore, preserve such data as will be necessary to substantiate the correctness of the quantities and prices included therein.

Statutory Authority: *MS s 290.52*

8011.0300 INVENTORY VALUATION METHODS NOT PERMITTED.

The following methods, among others, are sometimes used in the valuation of inventories, but are not permitted for income tax purposes:

A. deducting reserves for anticipated price changes or estimated depreciation from the gross inventory;

B. using a constant valuation from year to year for a so-called normal quantity of materials or goods on hand;

C. excluding goods out on consignment from the inventory;

D. including in the inventory goods ordered, but the title to which has not been acquired; and

E. valuing work in process at less than its proper value.

Statutory Authority: *MS s 290.52*

8011.0400 INVENTORIES AT COST.

Subpart 1. **Cost defined.** Within the meaning of Minnesota Statutes, section 290.11, "cost" means, in the case of merchandise on hand at the beginning of the taxable year or purchased during the taxable year, the invoice price less trade or other discounts, except cash discounts. Cash discounts are distinguished by being comparatively small in amount, usually approximating a fair interest rate and usually contingent upon prompt payment. Cash discounts may or may not be deducted from the invoice price, at the option of the taxpayer, provided a consistent practice is followed. Transportation or other necessary charges incurred in acquiring possession of the goods must be added to the net invoice price.

In the case of merchandise produced by the taxpayer since the beginning of the taxable year, "cost" means:

A. the cost of raw materials and supplies entering into or consumed in connection with the product;

B. expenditures for direct labor; and

C. indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

Subp. 2. **Exceptions to usual rules for computing cost.** 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 the established trade practice in the particular industry. Among such are:

A. farmers and raisers of livestock;

B. miners and manufacturers, who, by a single process or series of processes, derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike; and

C. retail merchants who use what is known as the "retail method" in ascertaining approximate cost.

Statutory Authority: *MS s 290.52*

8011.0500 INVENTORIES AT COST OR MARKET, WHICHEVER IS LOWER.

Subpart 1. **Market goods.** Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the following cases of (1) goods purchased and on hand, and (2) basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contract (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost.

Subp. 2. **Nonmarket goods.** Where no open market exists or where quotations are nominal, due to stagnant 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 such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less proper allowance for selling expense, and the correctness of such prices will be determined by reference to the actual sale of the taxpayer for a reasonable period before and after the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

Subp. 3. **Values compared.** 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.

Statutory Authority: *MS s 290.52*

8011.0600 INVENTORIES BY DEALERS IN SECURITIES.

A dealer in securities who in his books of account regularly inventories unsold securities on hand (1) at cost, (2) at cost or market, whichever is lower, or (3) at market value, may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the commissioner pursuant to a written application therefor filed with the taxpayer's return. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purpose of this part, as regularly inventorying his securities at cost. For the purpose of this part a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this part.

Statutory Authority: *MS s 290.52*

8011.0700 INVENTORIES OF MINERS AND MANUFACTURERS.

A taxpayer engaged in mining or manufacturing who, by a single process or uniform series of processes, derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production may, with the consent of the commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of different kinds of products.

Statutory Authority: *MS s 290.52*

8011.0800 INVENTORIES OF RETAIL MERCHANTS.

Subpart 1. **Retail method.** Retail merchants who employ what is known as the "retail method" of pricing inventories may make their return upon that basis, 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. Under this method the goods in the inventory are ordinarily priced at the selling prices, and the total retail value of the goods in each department or of each class of goods is reduced to approximate cost by deducting the percentage which represents the difference between the retail selling value and the purchase price. This percentage is determined by departments of a store or by classes of goods, and should represent as accurately as possible the amounts added to the cost prices of the goods to cover selling and other expenses of doing business and the margin of profit. In computing the percentage above mentioned, proper adjustment must be made for all markups and markdowns.

Subp. 2. **Inventory valuation.** A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentage for the respective departments or classes of goods.

Subp. 3. **Physical inventory required.** A physical inventory at retail selling price, reduced by markups, must be taken at the close of each year and the book inventory must be adjusted to agree with the physical inventory. If the markup in the opening inventory is different from the markup of current purchases, the latter markup should be used in closing inventory, unless substantial quantities of year-old merchandise appear in the closing inventory.

Subp. 4. **Records.** The books and records must be fully departmentalized so that merchandise with a similar percentage of markup is accounted for separately in the inventory.

Subp. 5. **Differences; gross discrepancies.** The difference between the inventory taken on the old basis and the inventory taken on the basis of the "retail method" will constitute taxable income or deductible expense for the year in which the change is made. Any gross discrepancies between the new and old basis will be taken as an indication either that the inventory was improperly taken on the old basis or that the inventory upon the basis of the "retail method" does not reflect values which will properly account for the true taxable income.

Statutory Authority: *MS s 290.52*

8011.0900 INVENTORIES OF DEALERS IN REAL ESTATE.

Real estate held by dealers in real estate must be carried at cost value and, therefore, cannot be included in inventories which are subject to valuation at cost or market, whichever is lower. Any increase or decrease in the market value of real estate held will not constitute a taxable gain or deductible loss until realized or sustained through sale or other disposition.

Statutory Authority: *MS s 290.52*

8011.1000 INVENTORIES OF LUMBER COMPANIES.

The inventories of lumber companies shall be valued according to the general rules of cost or cost or market, whichever is lower. In order to determine the market value of goods in process and finished goods, such inventories must be analyzed as to their basic elements of cost, which include material, labor, and overhead. The purchase market of each of the basic elements of cost should be determined and the total thereof taken as the market. If the market thus determined is less than cost, the inventory should be valued upon that basis.

Statutory Authority: *MS s 290.52*