

**Office of Chief Counsel
Internal Revenue Service
memorandum**

Number: **201025049**

Release Date: 6/25/2010

CC:ITA:6:
POSTN-153895-09

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 167.01-00, 471.01-00, 1031.02-00

date: March 12, 2010

to: James L. Gessford
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Large & Mid-Size Business

from: Kathleen Reed
Chief, Branch 7
Income Tax & Accounting

subject: Application of §§ 167 and 1031 to Equipment Held For Sale

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

LEGEND

Corporation X =

Year 1 =

ISSUE

Is Corporation X allowed depreciation deductions under § 167 of the Internal Revenue Code and like-kind exchange treatment under § 1031 for equipment that Corporation X simultaneously held for sale to customers and designated as rental equipment?

CONCLUSION

Under the particular facts presented, Corporation X has not demonstrated that the equipment in question was devoted to use in its trade or business and that Corporation X looked to such use of the equipment to recover the cost of the equipment. Instead, the facts show that Corporation X held the equipment primarily for sale. Accordingly, to the extent the facts provided are representative of Corporation X's designated rental equipment, Corporation X may not depreciate the equipment under § 167 and does not qualify for like-kind exchange treatment under § 1031.

FACTS

Corporation X distributes, sells, rents, services, and finances equipment from various business locations within the United States. Corporation X orders its equipment directly from the manufacturer and identifies certain equipment as rental property prior to receiving the equipment from the manufacturer. Upon receipt of the equipment, Corporation X capitalizes the cost of the equipment that has been designated as rental property and claims depreciation on this equipment under § 167 from the time the equipment is available for rent. Corporation X apparently capitalizes the cost of equipment other than this designated rental property as “inventory” (as defined in § 471) upon the receipt of the equipment from the manufacturer.

Corporation X’s rental agreements state that equipment is available for rent by the hour, week, or month, and reserves to Corporation X the right to withdraw the rented equipment during the rental period and substitute similar equipment. The rental agreements permit a renter of equipment to buy the rented equipment. The information provided does not indicate the amount of rent, if any, that would be applied against the purchase price in the event a renter purchases the equipment. However, Corporation X has indicated that the sales price would be the subject of further negotiation between it and the renter/purchaser.

Corporation X structures its sales of property designated as rental equipment as exchanges. It entered into a Master Exchange Agreement and named a qualified intermediary (QI) and a trustee, neither of which is related to Corporation X. Corporation X negotiates sales with customers and assigns the sales contracts to the QI. Corporation X orders replacement property from a manufacturer and assigns its rights to acquire the equipment to the QI. The trustee collects the proceeds from the sale of the relinquished property and makes disbursements for purchase of the replacement property on behalf of Corporation X. The replacement property is assigned an order number and is entered into Corporation X’s fixed asset depreciation system. Corporation X sends a monthly statement to the QI and the manufacturer informing them of the replacement property and includes the statement: “Under IRC § 1031, [Corporation X] has assigned its rights to acquire this equipment to [QI].”

An analysis of Corporation X’s Year 1 fiscal year results shows that 91 percent of its income was generated from “sales” while 9 percent was generated from its rental operation. Further, the information provided indicates that a substantial amount of the equipment designated as rental equipment was sold by Corporation X prior to the equipment generating any rental income.

The information provided also shows that the Examination Division sampled items of equipment received in exchange transactions and found that many were disposed of shortly after receipt and none of the items in the sample were rented by Corporation X

prior to the disposition. Of all of the replacement property acquired during Year 1, approximately 40 percent was disposed of in Year 1, with nearly half of the dispositions occurring within 90 days of receipt.

You ask whether it is appropriate to allow Corporation X to depreciate certain items of equipment but to disallow § 1031 nonrecognition treatment upon the disposition of such equipment. As discussed further below, it is our opinion based on the facts provided that the equipment in question is neither eligible for depreciation nor eligible for nonrecognition under § 1031.

LAW AND ANALYSIS

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 1.471-1 of the Income Tax Regulations provides that in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. See also ' 1.446-1(a)(4)(i).

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.

Section 1.167(a)-2 provides that no depreciation deduction may be taken with respect to inventories or stock in trade.

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is held either for productive use in a trade or business or for investment.

Section 1031(a)(2)(A) provides that § 1031 nonrecognition treatment is not allowed for any exchange of property that is stock in trade or other property held primarily for sale. The phrase "property held primarily for sale," appears in a number of Code sections and has been the subject of considerable litigation. In Malat v. Riddell, 383 U.S. 569, 572 (1966), the Supreme Court held that the term "primarily," as used in § 1221(1), means "of first importance" or "principally."

The facts indicate that Corporation X makes equipment available to customers for sale or for rent. If an asset can function as both merchandise held for sale and as an asset used in a trade or business, the taxpayer's primary purpose for holding that asset

determines whether that asset is inventoriable. Latimer-Looney Chevrolet, Inc. v. Commissioner, 19 T.C. 120 (1952) (presumption that motor vehicles held by a car dealer are stock-in-trade overcome by evidence that vehicles were actually used in business operations), *acq.* 1953-1 C.B. 5.

In Rev. Rul. 75-538, 1975-2 C.B. 35, the Internal Revenue Service ruled that a car dealer that used certain motor vehicles temporarily as “demonstrators” in its business could not claim depreciation deductions on those vehicles. The ruling states that, to overcome the presumption that motor vehicles are held for sale to customers in the ordinary course of business, the evidence must clearly show that the dealer has actually devoted a vehicle to use in its business operations and that the dealer looks to consumption through use of the vehicle in the ordinary course of its business to recover the vehicle’s cost. See also Johnson-McReynolds Chevrolet Corporation v. Commissioner, 27 T.C. 300 (1956).

Temporarily withdrawing property from inventory for business use is not sufficient to constitute using the property in the ordinary course of business operations. See Rev. Rul. 89-25, 1989-1 C.B. 79 (taxpayer that builds and sells residential houses may not depreciate those houses set aside, temporarily, as models and/or sales offices because the houses set aside were not property used in the taxpayer’s business); Duval Motor Co. v. Commissioner, 264 F.2d 548 (5th Cir. 1959), *aff’g* 28 T.C. 42 (1957) (car dealer may not depreciate motor vehicles provided to company officials and salesmen for the purpose of stimulating interest in the dealer’s cars because the vehicles were primarily held for sale to customers and there was no “general or indefinite commitment to use the cars in the business”).

The facts you have presented about Corporation X’s rental practice, including the results of the Examination Division’s equipment sampling, lead to the conclusion that the equipment should be treated as inventory held primarily for sale to customers in the ordinary course of business. While Corporation X does rent or hold some equipment for rent, it has not shown that the equipment was actually devoted to use in its business and that it looked to consumption through this use to recover the cost of the equipment. A significant fact leading to our conclusion is that a substantial amount of the equipment designated as rental equipment was sold by Corporation X relatively soon after acquisition and prior to the equipment generating any rental income. Based on the available facts, the best that can be said is that for a relatively short period, Corporation X rents or holds for rent some of its equipment pending the sale of that equipment. The facts do not support the conclusion that Corporation X had a “general or indefinite commitment” to use the equipment in its trade or business. Accordingly, Corporation X may not depreciate its equipment under § 167.

Because Corporation X holds the equipment primarily for sale, we conclude that exchanges of the equipment are ineligible for § 1031 treatment by reason of § 1031(a)(2)(A).

We note that the issues raised in your request for advice are heavily dependent on the particular facts and circumstances. The determination of whether a particular piece of equipment may be eligible for depreciation, or whether an exchange of equipment qualifies for § 1031 nonrecognition treatment, must be made on a property-by-property basis. While we have concluded based on the facts presented that Corporation X may not depreciate the described rental equipment, additional or different facts could change that conclusion.

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 contact us at 202-622-4970 if you have any further questions.