

ILM 201025049 (June 2010). No 1031 Treatment for Equipment Held Primarily for Sale.

In this ruling, the IRS found that the taxpayer, and equipment renter and seller, was holding equipment primarily for sale and thus did not qualify for Section 1031 treatment, and could not depreciate the equipment. The taxpayer bought equipment directly from the manufacturer and identified it as rental property for tax purposes. However, 91 percent of the taxpayer's income was generated from "sales" while 9 percent was generated from its rental operation. Further, a substantial amount of the equipment designated as rental equipment was sold by the taxpayer prior to the equipment generating any rental income. The IRS looked at a sample number of exchange transactions and found that many of the items received in the sample exchanges were disposed of shortly after receipt and none of the items were rented by taxpayer prior to the disposition. Of all of the replacement property acquired during one year, approximately 40 percent was disposed of in the same year, with nearly half of the dispositions occurring within 90 days of receipt. Based on these facts, the IRS found that the equipment was held primarily for sale and not rental.

The ruling reasoned that 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 inventory. 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.

The ruling further cited Rev. Rul. 75-538, 1975-2 C.B. 35, in which the IRS 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).