INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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Taxpayer's Name:

Taxpayer's Address:

Taxpayer's TIN:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer

ISSUES:

1. Where Taxpayer's business is selling and leasing equipment, should leased equipment that is also held for sale be treated as "inventory" within the meaning of § 471 of the Internal Revenue Code?

2. Assuming the equipment is not inventory once placed in the leasing operation, under what circumstances must Taxpayer subsequently treat it as inventory?

CONCLUSIONS:

1. Under the particular facts presented, Taxpayer's leased equipment that is also held for sale should not be treated as inventory.

2. Leased equipment must be treated as inventory when it is permanently removed from Taxpayer's leasing operation.

FACTS:

The examining agent has requested technical advice in connection with the examination of Taxpayer's 1996 and 1997 tax returns. In these years, Taxpayer sold new heavy construction equipment, such as excavators, road pavers, backhoes, and earthmovers; leased new equipment; sold equipment that had been previously leased; sold parts and products; and provided equipment maintenance services. Taxpayer also sold used equipment, including equipment that it had acquired as trade-ins, at auction.[1] Taxpayer filed its tax returns on a calendar year basis.

Except for the rare situation where a sale or lease already had been arranged before Taxpayer acquired the new equipment, Taxpayer made all new equipment available to customers for either sale or lease. Taxpayer's ultimate goal was to sell all its equipment; however, because of the nature of its business and its competitive business environment, Taxpayer often leased its equipment prior to selling it.[2] While using equipment during a lease caused its value to decrease, Taxpayer received income from its leases that benefitted its business. Taxpayer normally reacquired the leased equipment upon the early termination or expiration of the lease and would hold it for varying periods of time before selling or re-leasing it.[3] Taxpayer never scrapped any equipment and eventually sold all of it. Taxpayer maintained title to all its equipment until it was sold.

Initially, Taxpayer treated the equipment as "inventory" as defined in § 471 unless the equipment had been already subject to an existing lease when Taxpayer acquired it. The examining agent has not questioned this initial classification of equipment as inventory.

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[1] Apparently, used equipment acquired by Taxpayer is not leased.

[2] The examining agent has not questioned whether the Taxpayer's leases are *bona fide* rental arrangements. For example, the agent has not alleged that Taxpayer's leases were conditional sale contracts.

[3] Infrequently, a lessee would purchase the equipment and Taxpayer sometimes did decrease the purchase price to reflect the rental payments previously made. However, Taxpayer's standard lease agreements do not provide its lessees with a purchase option.

Upon leasing equipment, Taxpayer moved the equipment from its inventory classification to the classification of "property used in its trade or business" and began depreciating it.[4] Since August 1997, Taxpayer claimed depreciation under § 168 on leased equipment it had reacquired and was holding for sale or re-lease. Before August 1997, Taxpayer used the "income forecast method" for depreciation. Under this method, Taxpayer did not claim depreciation on the reacquired equipment it was holding that was no longer out on lease.[5] Taxpayer included income it earned from a lease in its gross income in accordance with Taxpayer's overall accrual method of accounting. The examining agent has not questioned Taxpayer's treatment of this income. The examining agent has also not questioned the characterization (as ordinary income or loss) of the gains and losses the Taxpayer reported when it sold equipment that had been previously leased.

The following example illustrates Taxpayer's treatment of leased equipment depreciated under § 168:

Taxpayer acquired an earthmover for $300,000 on January 1, 1999 and treated it as inventory. After two months, Taxpayer leased the earthmover to lessee, M, for one month for $10,000 and began to claim depreciation on it. Taxpayer reacquired the earthmover from M after one month and held it for two months before it leased the earthmover to lessee, N, for three months for $25,000. After three months, Taxpayer reacquired the earthmover from N and held it until year end.

Taxpayer included $35,000 in gross income and deducted $60,000 as depreciation in 1999. The earthmover's basis on December 31, 1999 was $240,000 ($300,000-$60,000).

In the spring of 2000, Taxpayer leased the earthmover for seven months to lessee, O, for $60,000. Later that same year, Taxpayer reacquired the earthmover from O and on December 31, 2000, Taxpayer sold the earthmover to buyer, P, for $200,000. Depreciation on the earthmover computed for 2000 was $48,000.

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[4] The propriety of Taxpayer's method of accounting for the basis of property transferred from inventory to the classification as property used in a trade or business has not been addressed in this memorandum because the examining agent has not questioned this matter.

[5] The 1997 depreciation change was implemented on a "cut-off" basis as a result of the enactment of § 167(g), which limited the use of the "income forecast method" to specific properties. The examining agent has not questioned this change.

On its 2000 tax return, Taxpayer included $60,000 in gross income and deducted $48,000 as depreciation. The gain of $8,000 on the sale of the earthmover to P [$200,000 - ($240,000 - $48,000)] was reflected on Taxpayer's return as ordinary income.

The examining agent questions whether Taxpayer's leased equipment that is also held for sale can be depreciated. The agent notes that even when the equipment is out on lease, Taxpayer simultaneously held the equipment for sale.[6]

An analysis of Taxpayer's equipment summary for the two years under examination shows that approximately 70 percent of Taxpayer's equipment was leased, for varying periods, at least once prior to sale. On average, equipment was leased about five times before being sold. The usual term of a lease ran between one to six months, and there was no fixed minimum lease period. On average, about 1½ years passed before Taxpayer was able to sell its equipment. However, when equipment that was never leased is disregarded, sales of previously leased equipment usually occurred within two to four years after Taxpayer had originally acquired the equipment.

For the two years under examination, approximately 45 percent of Taxpayer's gross revenue was derived from new and leased equipment sales. This revenue averaged about $ million a year. Of this $ million, about $ million was from new equipment sales and the remaining $ million was from the sale of previously leased equipment. Over this same period, lease income averaged about $ million, which was about 16 percent of Taxpayer's total gross revenue. Taxpayer's depreciation deduction was about $ million each year.

For the years under examination, on average Taxpayer had on hand about $ million of previously leased equipment and about $ million of new equipment. Each year, Taxpayer sold approximately 340 pieces of new and leased equipment and had about 3,700 leasing transactions.

For the years under examination, Taxpayer recovered approximately 81 percent of its cost of equipment through sales revenue, including revenue from the sale of equipment that had never been leased. When considering only previously leased equipment, Taxpayer recovered approximately 68 percent of its cost through sales revenue. Although leased equipment was usually sold for less than Taxpayer's original cost, Taxpayer was able to sell about 34 percent of previously leased equipment for more than its original cost. In contrast, about 94 percent of new equipment was sold for more than Taxpayer's original cost.

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[6] Specifically, one term and condition contained in Taxpayer's standard lease agreement states "

Taxpayer reacquires equipment about 30 times a year pursuant to this term and condition.

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 tax 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 should 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 1.167(a)-10(b) provides, in part, that the period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. An asset is placed in service when it is first placed in service by the taxpayer in a condition or state of readiness and availability for a specifically assigned function. See §§ 1.167(a)-11(e)(1)(i) and 1.46-3(d)(1)(ii).

Section 1.167(a)-8(a) provides that the term "retirement" means the permanent withdrawal from use of depreciable property used in the trade or business or from use in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by abandonment. In addition, the asset may be withdrawn from productive use without disposition as, for example, by being placed in a supplies or scrap account.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in § 168(a) and the other method is the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

The applicable recovery period for purposes of either § 168(a) or § 168(g) is determined by reference to class life. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer were an elector under that section. Prior to its revocation, § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) sets out the method for asset classification under former §167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities. Section 1.167(a)-11(e)(3)(iii) provides that in the case of a lessor of property, the asset guideline class in effect for lessors of such property is determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (for example, trucks or railroad cars) as distinguished from the activity in which used, the property is classified without regard to the activity of the lessee.

In Latimer-Looney Chevrolet, Inc. v. Commissioner, 19 T.C. 120 (1952), acq. 1953-1 C.B. 5, the Tax Court considered whether the taxpayer, a dealer in new and used cars, had properly claimed depreciation on certain "company cars" that it later sold. The court stated that "it is not the nature of the property itself [that] is determinative of [the question,] but rather the purpose for which the property is held" by the taxpayer. Id. at 125. Based on the facts of the case, the court found that the taxpayer's company cars were used in the taxpayer's business and, accordingly, were depreciable.

In Duval Motor Co. v. Commissioner, 264 F.2d 548 (5th Cir. 1959), aff'g. 28 T.C. 42 (1957), the court dealt with automobiles removed from inventory by a car dealer and provided to company officials and salesmen for the purpose of stimulating interest in all the dealer's cars. The court found that these cars were only temporarily assigned for use in the car dealer's business and that there was no general or indefinite commitment to use the cars in the business. Thus, the court concluded that, on these facts, at all times the cars were held primarily for sale to customers in the ordinary course of the car dealer's business. However, the court noted that if a car dealer "takes [cars] out of inventory and puts them to the use for which [a car] is intended in the hands of its ultimate consumer, that is, transporting personnel, and commits them . . . to that purpose in the operation of [the] business," the car dealer is entitled to depreciate the cars. Id. at 551.

I. Leased Equipment in Inventory

The principal question presented is whether Taxpayer properly accounted for its leased equipment that was also held for sale. The examining agent argues that Taxpayer was required to account for this leased equipment as inventory and not as property used in its trade or business. Accordingly, the agent concludes that Taxpayer was not entitled to any deduction for depreciation. Section 1.167(a)-2. The examining agent reasons that the equipment was always inventory because Taxpayer's foremost goal was to sell it and the equipment was always being held by Taxpayer for sale even when it was being leased. On the other hand, Taxpayer argues that its leased equipment need not be included in inventory because the equipment was being used in its leasing operation. Accordingly, Taxpayer concludes that it was entitled to deductions for depreciation. Section 167(a). To establish that it was legally entitled to depreciate leased equipment, Taxpayer must show that it primarily intended to use this leased equipment in its leasing operation. Latimer-Looney Chevrolet. Determining Taxpayer's primary intent with respect to the equipment is a question of fact.

This case does not involve a situation where property is acquired for resale and is temporarily used by the taxpayer in its business. In that situation the property properly remains as inventory because the use of property temporarily in a business does not support recharacterizing the property as property used in a trade or business. Duval Motor Co. In the present case, the leased equipment was not being used temporarily in Taxpayer's business. Except for rare situations, Taxpayer made all equipment it acquired available for use in its leasing operation until it sold the equipment. Once leased, Taxpayer expected to re-lease the equipment multiple times before sale. Taxpayer derived substantial income from its leasing operation, which constituted a substantial percentage of its gross revenue. The leased equipment was subjected to significant wear and tear while it was being leased. Moreover, on average, Taxpayer sold its previously leased equipment between two and four years after acquiring it.

It is not unusual for taxpayers to be simultaneously engaged in multiple business activities. See, Recordak v. USA, 163 Ct. Cl. 294 (1963) (taxpayer engaged in selling and leasing microfilming equipment) and Rev. Rul. 80-37, 1980-1 C.B. 51 (taxpayer engaged in manufacturing, leasing, and selling of electronic data processing equipment). Here, Taxpayer had multiple business activities, which included the selling and leasing of equipment. For the two years under examination, these two activities were a significant part of Taxpayer's overall business.

The examining agent has not questioned Taxpayer's initial classification of all new equipment as inventory. This inventory was made available for both sale and lease. Ordinarily, Taxpayer did not know whether an individual piece of equipment would be leased prior to sale, but from its prior experience Taxpayer did know that about 70 percent of its equipment would be leased at least once. When it initially leased equipment, Taxpayer removed the equipment from inventory to reflect the fact it was being used in its leasing operation.

Taxpayer's leases in these two years were *bona fide* leases. For example, they were with unrelated parties, in arms-length transactions, and generally were not with subsequent equipment purchasers. Further, they were for significant amounts of money and periods of time. The examining agent has not questioned the nature or validity of Taxpayer's leases.

Taxpayer generally reacquired its leased equipment upon the early termination or expiration of a lease. When it did, Taxpayer again made the equipment available for lease. While not certain with respect to any specific piece of equipment, Taxpayer knew that once a piece of equipment was leased, it would likely be leased again about four more times prior to its ultimate sale.

Taxpayer acknowledges that all its equipment was always available for sale and eventually would be sold. Taxpayer acknowledges that its standard lease agreement gave it the right to sell equipment that was out on lease to a customer, but notes that this right was only exercised in about one percent of its leases. Taxpayer also acknowledges that selling equipment was always its ultimate goal.

While we recognize Taxpayer's equipment was always held for sale, we also recognize that Taxpayer had an active, sizeable leasing operation, and that it devoted a significant amount of equipment to that leasing operation. In our view, Taxpayer had a *bona fide*, ongoing leasing operation, and was using equipment in that operation. Therefore, based on all the facts presented, we believe Taxpayer's leased equipment qualifies as property used in a trade or business for purposes of § 167(a) and thus, Taxpayer is entitled to depreciation deductions for such equipment. Latimer-Looney Chevrolet. These deductions offset the income that Taxpayer earned from its leasing operation.

Key factors in this case are that Taxpayer usually sold its leased equipment for substantially less than its original cost and that it only recovered an average of about 68 percent of its cost through sales revenue. The majority of Taxpayer's equipment was leased multiple times and was offered to customers for lease for a substantial period of time. Taxpayer obtained a substantial amount of revenues from its leases, and recovered a substantial portion of its equipment costs through leasing. We also note that the value of Taxpayer's equipment decreased with use and that Taxpayer was entitled to cost recovery in connection therewith. Section 167(a).

Accordingly, we believe that close consideration of the specific facts presented leads to the conclusion that Taxpayer's leased equipment that is also held for sale should not be treated as inventory. This conclusion is wholly consistent with the viewpoint of the courts concerning the dual use of property produced by manufacturers. For example, in Honeywell v. Commissioner, the Tax Court stated:

> The concept of "dual purpose property" has been recognized in a series of cases . . . . International Shoe Machine Corp. v. United States, 491 F.2d 157 (1st Cir. 1974); [Hollywood Baseball] Association v. Commissioner, 423 F.2d 494 (9th Cir. 1970); Continental Can Co. v. United States, 190 Ct. Cl. 811, 422 F.2d 405; Recordak Corp. v. United States, 163 Ct. Cl. 294, 325 F.2d 460. *These cases stand for the proposition that a manufacturer regularly engaged in the dual business of selling and renting equipment it manufactures can claim depreciation on property that is at all times available for sale.* Proceeds from the sale, however, are treated as ordinary income even though the property might otherwise qualify for capital gain treatment under section 1231.

87 T.C. 624, 633 (1986) (Emphasis added), acq., 1988-1 C.B. 1.

II. Equipment Return to Inventory

Under § 167(a), Taxpayer is entitled to claim depreciation with respect to the equipment used in its leasing operation. Section 1.167(a)-10(b) provides that depreciation begins when the asset is placed in service (assuming the "ready and available" test of § 1.167(a)-11(e)(1)(i) is satisfied) and ends when the asset is retired from service. An asset is retired from service when it is permanently withdrawn from use in the taxpayer's trade or business or in the production of income. Section 1.167(a)-8(a). The withdrawal may be made by selling or exchanging the asset, by abandonment, or by placing the asset in a supplies or scrap account. Applying these principles to the present case, Taxpayer's equipment, once properly removed from inventory, does not revert back to inventory until the equipment is permanently withdrawn from Taxpayer's leasing operation. Such withdrawal would happen, for example, when the equipment was identified by Taxpayer as no longer to be offered for lease. In that case, once Taxpayer determined that certain equipment was held only for sale to customers, Taxpayer would be required to reclassify that equipment as inventory and would not be entitled to claim depreciation. Section 1.167(a)-2.

The fact that equipment in Taxpayer's leasing operation was not continually subject to a lease for significant periods of time does not change the conclusion reached in the preceding paragraph. In Twentieth Century-Fox Film Corp. v. Commissioner, 45 T.C. 137, 143 (1965), the Tax Court stated that "[t]he law is well established that deductions (including depreciation) are allowable with regard to property held for the production of income or for use in a trade or business even though no income is currently being received or accrued therefrom and even though the asset is currently idle." Accordingly, Taxpayer's equipment continued to be depreciable after Taxpayer had reacquired the equipment upon the early termination or expiration of a lease.

CAVEAT:

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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