



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSISTANT CHIEF COUNSEL
CC:DOM:FS

SUBJECT: Depreciation of Display Room Furniture

This Field Service Advice responds to your memorandum dated June 14, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corporation: =

ISSUE:

Whether furniture displayed by Corporation should be treated for tax purposes as inventory or depreciable property used in its trade or business?

CONCLUSION:

Corporation has not clearly demonstrated that the display furniture is devoted to use in Corporation's business operations and that Corporation looks to consumption through use

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of the furniture in the business operation to recover its cost. Thus, Corporation is considered to hold the display furniture primarily for sale to customers in the ordinary course of business and cannot depreciate the display furniture.

FACTS:

Corporation is a high-end furniture manufacturer that uses showrooms and outlet stores to market its furniture. The showrooms contain 20 to 40 display suites for the various types of furniture manufactured by the taxpayer. Generally, only designers, retailers, architects, dealers and wholesalers are allowed to place orders through the showrooms. Generally, the furniture is not for sale to the public, unless returned to the factory or sold at an outlet store. The general public may enter the showrooms unattended and look at the furniture samples on display.

Many of the facts in this case are in dispute. While Corporation avers that its display furniture is sold off the showroom floor only if it is damaged, unproductive, or discontinued, the examiner states that furniture in excellent condition is frequently sold off the floor. Also in dispute is the length of time an item of furniture remains in a showroom. Corporation claims that the period of time furniture remains on the floor varies from one month to ten years, with an average duration of three years. The examiner states that Corporation's records indicate the furniture is on display for much shorter periods.

Display items to be sold off the floor are offered for sale at gradually reduced prices. Items remaining unsold are shipped to the factory and offered for sale to employees and the general public. Corporation recognizes a profit from the sale of display items, although there is disagreement as to the calculation and the resulting amount of the gross profit percentage.

Currently, Corporation depreciates its display furniture under Modified Accelerated Cost Recovery System (MACRS) using a 5 year recovery period. Corporation stops depreciating the display furniture when it is sold or placed back into inventory.

LAW AND ANALYSIS

Section 167 of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business or held for the production of income. However, in the case of tangible property, the depreciation allowance applies only to that part of the property that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence, and does not apply to inventories or stock in trade. Treas. Reg. ' 1.167(a)-2.

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Whether Corporation's display furniture should be treated as inventory held primarily for sale to customers in the ordinary course of business or as property used in Corporation's trade or business is a question of fact. The nature of the property itself is not determinative. Instead, the central inquiry is the primary purpose for which the property is held, as determined by all the facts and circumstances. Latimer-Looney Chevrolet, Inc. v. Commissioner, 19 T.C. 120, 125 (1952), acq. 1953-1 C.B. 5.

The instant case presents a situation where Corporation seeks to depreciate items of furniture which are identical to the items of furniture that Corporation is engaged in the business of selling. A similar situation was presented in Rev. Rul. 75-538, 1975-2 C.B. 35, where the taxpayer was a car dealer seeking to depreciate certain motor vehicles which were temporarily used as Ademonstrators.@ The revenue ruling states that a taxpayer engaged in such a business is presumed to hold all vehicles for sale to customers in the ordinary course of the taxpayer's business. The ruling provides that to overcome this presumption it must be clearly shown that the vehicle was actually devoted to use in the business of the dealer and that the dealer looks to consumption through use of the vehicle in the ordinary course of business operations to recover the dealer's cost. The ruling also provides that a vehicle is not property used in the business if it is merely used for demonstration purposes, or temporarily withdrawn from stock-in-trade or inventory for business use.

A similar issue was addressed in Rev. Rul. 89-25, 1989-1 C.B. 79, where a taxpayer in the business of building and selling residential houses sought to depreciate certain houses used as models and/or sales offices. Taxpayer used such houses to assist in its sales activity for a particular development and, during the period of that use, the taxpayer would make no effort to sell such houses. However, the taxpayer expected to sell all houses within the development, including those used as models and/or sales offices, within a few years. The revenue ruling concludes that such houses were property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business rather than property used in the trade or business, even though the houses were used temporarily as models and/or sales offices, and even though the taxpayer may have been reluctant or unwilling to sell the houses while they were being used in this way. The ruling holds that the houses are not depreciable.

Duval Motor Co. v. Commissioner, 264 F.2d 548 (5th Cir. 1959), aff-g 28 T.C. 42 (1957), is cited by both of the revenue rulings discussed above. Duval concerns automobiles removed from inventory by a car dealer and provided to company officials and salesmen for the purpose of stimulating interest in all of the dealer's cars. The court concluded that at all times these demonstrator cars were held primarily for sale to customers in the ordinary course of the car dealer's business and, therefore, were not depreciable. However, the

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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.

The revenue rulings and Duval are analogous to the present case. In each case assets are used as demonstrators or models to stimulate the sale of other assets, and in each case after such use the assets are invariably sold. While demonstrator cars may be more available for sale and more quickly sold than Corporation's display furniture, Duval and Rev. Rul. 75-538 set forth principles applicable to the present case. In accordance with these authorities, a taxpayer engaged in the trade or business of manufacturing and selling furniture is presumed to hold all such furniture with the primary purpose of selling to customers in the ordinary course of business. To overcome this presumption it must be shown that the furniture was actually devoted to use in the business of the manufacturer and that the manufacturer looks to consumption through use of the furniture in the ordinary course of business operations to recover its cost in the furniture.

An asset temporarily used for demonstration purposes is not considered to be used in the trade or business for depreciation purposes and, therefore, is not depreciable. This is because in such a case a taxpayer looks to recover the cost of the asset through the sale of the asset rather than through the consumption of the asset in the trade or business. Duval indicates that a car dealer who takes a car out of inventory and uses it for its intended function in the business (as a transportation vehicle) can depreciate the car. In the present case the taxpayer's assets are used as display furniture rather than office furniture or some other type of furniture actually used as furniture in the taxpayer's business. Although the exact amount of profit percentage is in dispute, Corporation earns a profit on virtually every piece of display furniture when it is eventually sold. The furniture is not sold as scrap. The facts indicate that Corporation looks to the sale of its display furniture to recover its cost.

Corporation contends its display furniture is not analogous to demonstrator cars because of the longer time period in which the furniture is on display in a showroom and because the cars, unlike the furniture, are more available for sale. Corporation argues that the operative phrase in Rev. Rul. 75-538 is "temporarily withdrawn" from inventory. According to Corporation, furniture is on display in its showrooms an average of three years, while demonstrator cars are used as demonstrators for less than a year. However, the complete sentence from the revenue ruling includes the phrase "[a] vehicle is not property used in the business if it is merely used for demonstration purposes. . . ." Certainly Corporation's display furniture is demonstrator-type property. Further, the facts in Rev. Rul. 89-25 indicate that the mere passage of years does not render model homes depreciable. In addition, the model homes in the revenue ruling were not generally available for sale. Thus,

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even if we accept Corporation's assertion in the present case that its display furniture is not held out for sale, this fact would not compel the conclusion that the furniture is depreciable. The important fact in Rev. Rul. 89-25 is, like here, the expectation to sell the assets at issue.

Corporation cites several cases for the proposition that a taxpayer who maintains inventories for items that it is in the business of selling does not have to include in inventory similar items if they are used primarily in its trade or business. We agree with this proposition and it is consistent with the preceding discussion. However, the facts in those cases are easily distinguished from the facts in the present case. Hewlett-Packard Co. and Subsidiaries v. United States, 71 F.3d 398 (Fed. Cir. 1995), concerns a computer manufacturer that also serviced and repaired computers. The taxpayer maintained a pool of rotatable spare parts obtained from its manufacturing facility and used these parts to service and repair computers. The court held that the pool of parts was depreciable. However, we note that these parts were actually devoted to use in the taxpayer's service business (they were used as computer parts to repair computers) and were not ultimately sold to customers. In other words, these parts were consumed in the business and the manufacturer did not look to recover its cost in the parts through sales. As discussed previously, in the present case the display furniture is not used as furniture in the Corporation's business and the Corporation's cost in the furniture is recovered through sales.

The farm and livestock cases cited by Corporation are also inapposite. Cedarburg Fox Farms v. Commissioner, 283 F.2d 711 (7th Cir. 1960); United States v. Bennett, 186 F.2d 407 (5th Cir. 1951); Albright v. United States, 173 F.2d 339 (8th Cir. 1949). These cases hold that various types of breeding animals are depreciable even though they are eventually sold along with inventory animals. Some of these cases were cited by the taxpayer in Duval in support of its contention that demonstrator cars are depreciable. In rejecting this argument the court in Duval stated that the breeding of animals is a separate business from the selling of animals and that animals dedicated to the breeding business are not held primarily for sale to customers. Duval, 264 F.2d at 552. With respect to the demonstrator cars at issue in the case the court concluded that there was no separate business in connection with which the demonstrator cars were used. In the present case the Corporation's display furniture is used only in connection with its furniture sales business. Because the furniture is used only for display purposes it is not considered to be property used in Corporation's trade or business and thus, is not depreciable. Corporation has not clearly established that the display furniture is devoted to use in Corporation's business and that Corporation looks to consumption through use of the furniture in the business operation to recover their cost. If Corporation can conclusively establish that certain of its furniture or product lines are on display for ten years, or a length of time approaching the actual useful life of the furniture, this is a factor indicating that Corporation

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looks to recover its cost through use of the furniture in the operation of Corporation's business. Similarly, if after holding the furniture for ten years, Corporation sells the item at or below cost, this is another factor indicating that Corporation looks to recover its cost through use of the furniture in the business operation. Corporation has not clearly established any such facts to support the conclusion that the furniture is held primarily for use in Corporation's trade or business. We therefore conclude, based on the facts not in dispute, that Corporation holds the display furniture primarily for sale to customers in the ordinary course of business.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As indicated above, if Corporation can establish that the furniture remains on the floor for display purposes for ten years or an amount of time approaching the useful life of the furniture, the argument that the display furniture is inventory would probably not prevail with respect to such assets. So too it is with the gross profit percentage. If Corporation can establish that they barely recover their cost on the ultimate sale of the display furniture, the inventory argument would probably not prevail. Corporation bears the burden of establishing such facts.

Please call if you have any further questions

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