

FACTS:

During 1988, Honest John's Auto Sales, a dealer in new and used cars, sold some new cars, some used cars, some demonstrators and some company cars that had been used to run errands.

ISSUES:

1. Were the company cars sold by Honest John's Auto Sales "used in a trade or business"?
2. Were they eligible for depreciation under Section 167?
3. Were they inventory?

ANALYSIS:

Despite the fact that Section 1221(2) excludes depreciable personal property used in a trade or business from the definition of capital assets, Section 1231 generally permits a taxpayer to obtain capital gain treatment from the sale, exchange, or involuntary conversion of these types of assets which are held for more than six months. It does, however, specifically exclude any property that would be properly included in the inventory of the taxpayer if it was on hand at the end of the year.

The operative provision under Section 1231 is Section 1231(b) which sets forth the definition of property used in a trade or business. The general rule is that to constitute Section 1231 "trade or business" property, the property must be business use property of a character which is depreciable, and it must be held for more than six months prior to disposition (This is the length of the long term capital gains holding period, which means it would change to one year in 1988). It is not necessary that the property actually be depreciated, only that it be of a character which is subject to the allowance for depreciation. It could, for instance, be fully depreciated and still be considered for Section 1231 treatment.

Revenue Ruling 75-538, 1975-2 C.B. 34 provides some specific guidelines about what is inventory to automobile dealers. It states:

"A motor vehicle dealer is presumed to hold all vehicles, including those temporarily withdrawn from inventory for business use or for demonstrations, primarily for sale to customers unless it is clearly shown that the vehicles were actually devoted to use in the dealer's business and that the dealer looks to such use to recover their cost."

To overcome this presumption, it must be clearly shown that the motor vehicle was actually devoted to use in the business of the dealer and that the dealer looks to consumption through use

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of the vehicle in the ordinary course of the business operation to recover the dealer's cost. 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."

This makes it clear that all of the new cars, used cars and demonstrators that Honest John's Auto Sales sold in 1988 will be considered to be inventory sold in the normal course of business and not Section 1231 assets. The only issues concern the sale of the company cars which had been used to run errands. Can the gains be considered Section 1231 gains?

There are many court cases that consider whether company cars belonging to automobile dealers are 1231 assets. R.E. Moorhead & Son, Inc., Dec 26,210, 40 T.C. 704, explains that merely being a car dealer does not deprive a business of Section 1231 treatment for their cars, if the dealership commits the cars over their reasonable life to the purposes of the business. This case applied considerations of time, distance, and the primary concern used to determine when the cars are to be sold. In this case, Section 1231 treatment was disallowed because the primary determinate of when to sell the cars was their marketable condition.

John P. Wagner, et al., 58,112 P-H Memo TC,aff'd Geomans v. Comm., (7 Cir; 1960), 5 AFTR 2d 1566, 279 F.2d 12, allowed 1231 treatment for the sale of cars used to carry spare parts and used for other business purposes. Massey Motors, Inc. v. U.S., (DC Fla 1957), 156 F.Supp. 516, 52 AFTR 933, aff'd (5 Cir; 1959), 3 AFTR 787, 264 F.2d 1780, 364 U.S. 92, 4 L.Ed.2d 1592, 80 S.Ct. 1411, allowed Section 1231 treatment for cars used in the business by the officials of their wholly owned subsidiary. These cars were insured for the dealer's exclusive benefit and had regular license plates. They were used by the dealership in the course of their everyday business.

Section 1231 treatment was allowed in Latimer-Looney Chevrolet, Inc., 19 T.C. 120, dis (6 Cir;5-7-53). In this case, the cars were used immediately on acquisition and sold after between 8,000 and 12,000 miles. Shortly after acquisition, the taxpayer paid cash for the cars, insured them and purchased license tags. The fact that the cars were originally entered on the taxpayer's books as "New Cars available for sale" was immaterial since the manufacturer's system required such an entry and it was not a reflection of the dealership's intent.

A similar decision was reached in Fields v. Granguist (D.C. Ore; 1955), 134 F.Supp. 624, 48 AFTR 186. Section 1231 Treatment was allowed to the dealership on the new cars it assigned to employees for their business use, and on the cars it loaned to schools as training cars, even though these cars were later sold at new car prices. The fact that the manufacturer's manual

listed the cars as inventory was not controlling. However, if the dealership listed the cars as demonstrators on their return, it could not later change its own classification and these cars would be treated as held for sale to the public.

Section 1231 treatment was allowed in Bruce-Flournoy Motor Corp. v. U.S., (DC Va;1962), 10 AFTR2d 5473 on new cars used by the management that were later resold after 10,000 miles of service. The court decided that the cars were used substantially for the ultimate purpose of conducting the taxpayer's business and were therefore not held for sale.

However, Section 1231 treatment was denied in Johnson-McReynolds Chevrolet Corp., 27 T.C. 300. This dealership assigned cars to salesmen and company officials who used them for business and as demonstrators for approximately one year. Then they were sold. Section 1231 treatment was also denied in Luhring Motor Co, Inc., 42 T.C. 732 dis (4 Cir;4-5-65). In this case, the cars assigned for company use were available for sale while they were assigned. The cars were used for less than one year before they were sold and were sold at a price that exceeded cost.

These two cases do seem to differ from the others in that in Johnson-McReynolds Chevrolet Corp. the automobiles were also used at least part of the time as demonstrators, and demonstrators are clearly not Section 1231 assets. In Luhring Motor Co, Inc., the cars were always for sale, so the dealership had to be considering them always as inventory.

In Duval Motor Co., 28 T.C. 42, aff'd (5 cir;1959), 3 AFTR2d 799, 264 F.2d 548, Section 1231 treatment was denied for cars assigned to company personnel for personal use and display, demonstration, parades, and loans during repairs. The cars were sold on the introduction of the new models or when the mileage reached 15,000 miles. Here again we have the court deciding against a car that was used occasionally as demonstrators. In this same case, Section 1231 treatment was allowed for the cars owned by the dealership which were used for deliveries and for the parts and service departments. These cars were sold after 2 1/2 to 4 years. Section 1231 treatment was also allowed for "Welcome Wagons" assigned to a good will organization and for cars loaned to a high school.

One of the clearest pair of cases is W.R. Stephens & Co. 51,231 P-H Memo TC, aff'd (8 Cir;1952) 199 F.2d 665, 42 AFTR 752 and W.R. Stephens Co v. Kelm, (DC Minn; 1956), 140 F.Supp. 12, 49 AFTR 1038. In 1952, Section 1231 treatment was denied because a car acquired by a dealer for resale does not become property used in business when it is merely used for a temporary period as a demonstrator. In 1956, the same company was allowed Section 1231 treatment for their company cars because they changed their procedures. In this case, the company was allowed Section 1231 treatment on the cars it assigned to employees for business use

even though they were later sold at new car prices. In 1956, the cars were used for between 8,000 and 13,000 miles and were sold when they were no longer current models, and the court decided that the number of cars claimed was reasonable for a business of that size.

Malat v. Riddell 1966, 383 US 569, 86 S.Ct. 1030, 16 L.Ed.2d 102, provides two important guidelines that have been used to make decisions in subsequent cases. The court defined the term "primarily" as it is used in Section 1221(1) to mean "of first importance" or "principally" as opposed to the "substantial", which was the definition the lower court had used. The court also explained that the underlying purpose of Section 1231 is to differentiate the profits arising from the everyday operation of a business on the one hand, and the realization of appreciation in value accrued over a substantial period of time on the other.

CONCLUSION:

New cars, used cars, and demonstrators sold by an automobile dealership are considered to be inventory held for sale and therefore do not qualify for 1231 treatment. However, company cars used for business purposes may qualify if it is determined that their primary purpose is use in a "trade or business" and if they are held for more than the holding period for long term capital gains. If this is true, then they also qualify for depreciation. However, it must be apparent that this is the intent for the purchase of the automobile from the outset and the automobile must not also be used as a demonstrator and it should not be for sale.

The most efficient way to record this is to keep books and records that expressly state that these cars were acquired for and were actually devoted to use in the business of the dealer other than for demonstration. The records should also state that the dealership looks to depreciation to recover his costs. The records should from the outset treat the cars as company cars and charge them to a fixed asset account.

If the cars do not fit these qualifications and instead are merely temporarily withdrawn from inventory and used, then even the company cars are inventory and not depreciable Section 1231 assets.

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FROM

TO

P-H Finding List

Rev. Rul. 75-738

"More Assets May be Eligible
for Capital Gains on
Disposition Than is Apparent at
First"

Ralph W. Simmers & Son, Inc.

P-H Current Monthly Supplement-
Court Decisions

W.R. Stephens

& Co, 51,231

P-H Memo TC, aff'd (8 Cir;
1952) 199 F.2d 665, 42 AFTR 752

W.R. Stephens Co. v. Kelm (DC
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Moorhead & Son, Inc., Dec
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North Florida Motor Co. v.
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Ralph W. Simmers & Son, Inc.,
TCM 1968-150

Howell, 57 T.C. 546 (1972)

Estate of Walter K. Dean, TCM
1975-137

Bynum, 46 T.C. 295 (1966)

Joseph A. Harrah, 30 T.C, 1236

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Malat v. Riddell, 1966, 383
U.S. 569, 86 S.Ct. 1030, 16
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Corn Products Refining Co. v.
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Cir., 1959, 264 F.2d 548

Duval Motor Co. v. Comm.

Latimer-Looney Chevrolet, Inc.
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Johnson-McReynolds Chevrolet
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59-1 USTC 9281, 264 F.2d 552