Demolition Losses in Leasing: Current or Deferred Federal Income Tax Deductions

Linda Kreer Witt

Follow this and additional works at: http://lawecommons.luc.edu/luclj

Part of the Taxation-Federal Commons

Recommended Citation
Available at: http://lawecommons.luc.edu/luclj/vol5/iss2/15
Demolition Losses in Leasing: Current or Deferred Federal Income Tax Deductions

INTRODUCTION

Under the Internal Revenue Code of 1954,1 a current income tax deduction for the remaining undepreciated basis of a demolished building used in a business is an ordinary loss offsetting ordinary income. Continued capitalization of the undepreciated basis would result in periodic amortization of the building and a lessened tax benefit by postponing the total deduction of the loss for a period of years. For example, if a taxpayer2 has $200,000 of unearned taxable income for a given year without any demolition loss deduction, he pays approximately $111,000 in taxes. A current deduction for a building with a remaining undepreciated basis of $75,000 will reduce his taxable income to $125,000 and his tax to $61,000. On the other hand, if the taxpayer must amortize the undepreciated basis over a 99-year lease,3 he is only amortizing $757.58 annually. This small deduction results in a negligible tax reduction.4 Planning for a current income tax deduction of the undepreciated basis of a demolished building involves a careful weighing of the conflicting positions of the Internal Revenue Service5 and the courts on the conditions required for such a deduction.

Conflict has developed in the circuits6 over the proper interpretation and application of the Income Tax Regulations7 on demolition losses. The split has involved the wording of regulation 1.165-3(b)(2) and

2. Using Table 1 for married taxpayers filing joint returns under INT. REV. CODE, § 1(a).
3. See CODE section 167 regarding methods of depreciation by the owner of depreciable property and CODE section 178 concerning depreciation or amortization of improvements made by the lessee on the lessor's property.
4. The taxpayer must pay $110,457 in taxes.
5. Hereinafter referred to as the Service or the IRS.
6. The district courts in the Fifth Circuit and the Eighth Circuit held for the taxpayer and allowed current demolition deductions; both district courts were reversed on the appellate level.
7. Hereinafter referred to as the regulations.
its literal or substantive application to demolition losses. The Ninth\(^8\) and Fifth\(^9\) Circuits have favored a literal application of the crucial words "pursuant to the requirements of a lease or the requirements of an agreement which resulted in a lease." They have interpreted this phrase to mean that the courts will disallow a current deduction for the remaining undepreciated basis of a building only if demolition is a specific requirement of the lease terms. The Seventh\(^10\) and Eighth\(^11\) Circuits and the United States Tax Court\(^12\) have not allowed particular words used in the lease to control the deductibility of demolition losses. Emphasizing all the facts and circumstances of the lease negotiations and the final lease terms, these courts have particularly looked to the underlying intent of the parties and any compensation for the demolition.

The courts have articulated certain standards to evaluate the taxpayer's claim to a current Code\(^13\) deduction in the context of the disputed regulation. These standards include three major issues: the wording problem; the question of intent; and the presence of compensation. The courts have split over the weight they should accord to the wording of the regulation vis-à-vis the wording of the lease.

The courts have also split over whether to consider the intent of the parties to demolish and whether forming the intent prior to or subsequent to the execution of the lease makes any difference. The inquiry into intent has included factors such as: the length of time between acquisition and demolition; pre-lease negotiations allocating the cost of demolition between the parties; the comparison of the lease term and the remaining useful life of the demolished buildings; the suitability of the building for the lessee's intended use at the time of

---

Treas. Reg. § 1.165-3(b)(2) (1960):
(2) If a lessor or lessee of real property demolishes the buildings situated thereon pursuant to the requirements of a lease or the requirements of an agreement which resulted in a lease, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. However, the adjusted basis of the demolished buildings, increased by the net cost of demolition and decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the term thereof.

11. Foltz v. United States, 458 F.2d 600 (8th Cir. 1972).
13. INT. REV. CODE § 165(a):
(a) GENERAL RULE—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
acquisition; the determination of the unfeasibility of planned alterations only after the execution of the lease; and the use of a demolition clause as merely a protective device for the lessee.

Finally, the courts have disagreed whether the execution of the lease resulted in compensation to the lessor for the demolition and thereby precluded a current deduction. In evaluating this issue of consideration, the courts have scrutinized: the propriety of arguing about economic consideration; rental rates before and after demolition; the party bearing the cost of demolition; the requirement to rebuild and any specifications by the lessor on the type of building erected; the presence of a reverter clause in the lease; the general or special usefulness of the building erected; and a real intent to sell versus an apparent intent to lease.

HISTORICAL DEVELOPMENT

Understanding the current issues in the demolition deduction controversy involves a careful review of the standards enunciated in the early precedent. Until 1959 the IRS had not proposed regulations dealing with demolition losses in the leasing context. The Code section concerning losses, enacted in the Revenue Act of 1918, has never specifically mentioned demolition losses. Without any statutory or regulatory rule-making, the courts freely formulated their own rules and generally applied a “substitution of assets” theory. If the demolition resulted in the substitution of one asset (the lease) for another asset (the old building) of equal value, they disallowed current deductions for the remaining undepreciated basis of the demolished building. These courts required continued capitalization and amortization of the remaining basis over the lease period. The courts treated the demolition loss merely as a cost of the acquisition of the lease. The early judicial inquiry into demolition losses looked to the financial implications of each factual situation:

The determination of the controversy seems to depend altogether on the solution of the question as to whether, by the acquisition

   (d) Buildings demolished to obtain lease. If, pursuant to the terms of a lease, the lessor of real property demolishes buildings situated thereon, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the buildings. Likewise, if, pursuant to the terms of a lease, the lessee of real property demolishes the buildings, no deduction shall be allowed to the lessor. However, the adjusted basis of the demolished buildings shall be considered as a part of the cost of the lease to be amortized over the term thereof.
of the long-term lease, the lessors added to their assets, or substituted property for another form of capital assets.\textsuperscript{16}

If the answer to this judicial inquiry was yes, the taxpayer did not get a present deduction for his undepreciated basis in the demolished building. Instead, he had to amortize the basis over the life of the lease. If the lease required the lessee to demolish the existing buildings and replace them with new structures, the early precedent found grounds for invoking a "substitution of assets" rationale. In \textit{Young v. Commissioner}\textsuperscript{17} and \textit{Spinks Realty Co. v. Burnet},\textsuperscript{18} the lease required the lessees to erect buildings on the leased premises. The \textit{Spinks} lease required demolition, and although the \textit{Young} lease did not mention demolition, destruction of the existing buildings was necessary for the new buildings required under the lease. In both cases the courts found that the value of the demolished buildings was an investment in and a contribution to the cost of the lessor in obtaining the lease.\textsuperscript{19} Since the lessors still received the total value of the tax benefits of the demolished buildings by the end of the lease term, amortization of the undepreciated basis of the old buildings over the life of the lease was no detriment to the lessors.

The \textit{Young} court used a pure "substitution of assets" theory and did not enunciate specific standards for measuring compensation. The court indicated that the "substitution of assets" theory particularly applied since the demolished buildings were relatively new.

There can be no question that, where a landowner finds it necessary to remove structures unsuitable for further use, he may have a reduction from gross income for the loss. On the other hand, where he finds it advantageous to remove substantial buildings in order to secure a lease which will result in his having erected on his property a new building, without money outlay on his part for its construction, and to have assured a large rental income for a long term of years, it would seem just and reasonable that the value of the buildings removed be charged as a contribution to the cost of securing his lease, and as a part of the investment then made for that purpose.\textsuperscript{20}

The court in \textit{Spinks} followed the rationale in \textit{Young}.\textsuperscript{21} The \textit{Spinks} court stated that the lessor had no uncompensated loss from the de-

\begin{footnotesize}
\begin{enumerate}
\item[16.] Young v. Commissioner, 59 F.2d 691, 692 (9th Cir.), \textit{cert. denied}, 287 U.S. 652 (1932).
\item[17.] 59 F.2d 691 (9th Cir.), \textit{cert. denied}, 287 U.S. 652 (1932).
\item[18.] 62 F.2d 860 (D.C. Cir. 1932), \textit{cert. denied}, 290 U.S. 636 (1933).
\item[19.] 59 F.2d at 693.
\item[20.] \textit{Id.} at 692-93.
\item[21.] \textit{See also} Anahma Realty Corporation v. Commissioner, 42 F.2d 128 (2d Cir.), \textit{cert. denied}, 282 U.S. 854 (1930).
\end{enumerate}
\end{footnotesize}
molation because he obtained valuable lease rights for a long term, a new building erected at no cost to himself and title to the building upon termination of the lease by a reverter clause.

*Blumenfield Enterprises, Inc. v. Commissioner*\(^2\) extended the "substitution of assets" theory. Unlike *Young* and *Spinks*, the parties in *Blumenfield* did not contemplate demolition of the existing building before or after the signing of the lease. The lessee of a 25-year lease contemplated remodeling the building for use as a multi-story parking garage. The lease specifically stated that before any remodeling took place, the lessor had to approve the remodeling plans. Conditions later imposed by the city and county authorities made the remodeling plans of the lessee impossible; the lessee and the lessor then executed an agreement with an option to buy which permitted demolition by the lessee.

The *Blumenfield* court found that the lessor had not suffered any demolition loss and disallowed a current deduction. The demolition did not curtail the lessee's obligations. The period of the new lease extended beyond the useful life of the building. The permission to demolish looked primarily toward the sale of the property. Since the building no longer had any economic usefulness to the lessor, its razing and replacement by an advantageous lease benefited the lessor.\(^2\) The lessor, however, did not require a new building for the razed structure, but the *Blumenfield* court did not consider this fact strong enough to warrant a current deduction. Thus the *Blumenfield* court had no difficulty extending the "substitution of assets" rationale to a case that did not involve the replacement of a demolished building.

If the demolition resulted in the substitution of one asset (the lease) for another asset (the old building) of equal value, the pre-regulation cases like *Young*, *Spinks* and *Blumenfield*\(^2\) denied a current tax de-

---

\(^2\) 23 T.C. 665 (1955), aff'd, 232 F.2d 396 (9th Cir. 1956).

\(^2\) Nickoll's Estate v. Commissioner, 282 F.2d 895 (7th Cir. 1960), was decided by the district court before the regulation was adopted. On appeal, the Seventh Circuit affirmed a denial of the current deduction. The court applied a "substitution of assets" rationale but stated that the decision was consonant with the then newly adopted regulation:

> The old building was substantially demolished as a necessary condition precedent to the execution of a remunerative lease under which taxpayers became the owner of a remodeled building. The value of the old building which was partially demolished is properly charged as a cost of acquiring valuable lease rights and is to be amortized over the life of the lease.

*Id.* at 897.

\(^2\) See also Smith Real Estate Co. v. Page, 67 F.2d 462 (1st Cir. 1933); Myer Dana v. Commissioner, 30 B.T.A. 83 (1934); and Manning v. Commissioner, 7 B.T.A. 286, 289 (1927), where the court states that a substitution of the lease for the demolished building provides a *quid pro quo.*
duction to the lessor for the undepreciated basis of the demolished building. These cases concentrated on real economic losses and did not emphasize the initial intent of the parties regarding a later demolition. Whether the lease required or permitted demolition was also an irrelevant fact to these courts. The *Blumenfield* court extended the "substitution of assets" argument by denying a current tax deduction to the lessor when the sum of the periodic lease payments had compensated the lessor for not only the fair rental value of the property but also for the value of the demolished building.

**IRS Position**

In its first proposed regulation on demolition losses, the IRS followed prior case law and disallowed a current deduction for demolished buildings if demolition was "pursuant to the terms of a lease." \(^{25}\) This phrase, crucial to the holdings of prior case law, virtually forestalled any current deduction regardless of intent at the time of the execution of the lease. The finalized regulation, promulgated in 1960, changed the wording and gave rise to the current disagreement among the circuits in its interpretation. This final regulation is basically a Service relaxation of the "substitution of assets" theory, and it changed the crucial language noted above to "pursuant to the requirements of a lease or the requirements of an agreement which resulted in a lease. . . ." \(^{26}\)

At the December 4, 1959 hearings on the regulation as originally proposed, a taxpayer's representative argued that even the precise phrase "pursuant to the terms of a lease" could apply unfairly to a situation in which a lessor began demolition with the general intention of leasing but before he had reached any understanding with a specific lessee. After an appeal that the regulation should reach only cases in which the lease negotiations included the issue of demolition, the discussion centered around the drafting of language to counter any inequitable result without providing unintended tax loopholes. \(^{27}\) The final wording apparently restricted disallowance of current tax deductions to situations in which the parties bargained for the later demolition in the lease negotiations.

This posture of the IRS is consonant with the long-standing rule requiring capitalization of demolition expenses incident to replacement.

---

25. See note 14 *supra*.
26. See note 7 *supra* (emphasis added).
or removal of existing structures if the intent to demolish existed at the time of acquisition.\textsuperscript{28} If the intent to demolish existed at the date of purchase, no portion of the purchase price is attributable to the old structure or later added to the basis of a replacement building. The entire purchase price is the cost of the land. By analogy, if demolition is a bargained-for right of the lease or incident to a contractual duty to erect a new building, the remaining undepreciated basis of the demolished building should also be capitalized and attributed to the lease through amortization over the life of the lease.

Since the adoption of the 1960 regulation, the Service has gradually rejected the arguments advanced against the wording of the regulation as originally proposed. The Commissioner has stated that the Service will not follow the cases\textsuperscript{29} which allow current deductions for demolition losses regardless of whether the wording in the specific lease grants permission to demolish or requires demolition. In a 1967 Revenue Ruling, the Service stated that the regulation merely reiterated prior case law:

Such section of the regulations reflects the position established by prior case law and was not intended to liberalize the position by allowing the loss where the demolition is permitted (as opposed to required) by the terms of the lease.\textsuperscript{30}

To avoid any discrepancy between its Revenue Ruling and the regulations and to prevent any claim of detrimental reliance by taxpayers on the 1960 regulation, the IRS proposed an amended regulation in 1972 that returns to the language “pursuant to the terms of a lease” found in the 1959 proposed regulation. The new regulation attempts to avoid the heavy reliance of some courts on the wording of the lease “requiring” demolition before disallowing a current tax deduction for the undepreciated basis of the demolished property.\textsuperscript{31}

\textbf{Regulation—Lease Wording}

The problem that has arisen in the courts involves the interpretation of the word “requirement” in the regulation. Both sides agree

\begin{itemize}
\item 28. Treas. Reg. \textsection 1.165-3(a)(3) (1960):
\begin{itemize}
\item (a) Intent to demolish formed at time of purchase.
\item (3) The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property originally purchased even though such part was, at the time of purchase, allocated to the buildings to be demolished for purposes of determining allowable depreciation for the period before demolition.
\end{itemize}
\item 29. Feldman v. Wood, 335 F.2d 264 (9th Cir. 1964); Hightower v. United States, 463 F.2d 182 (5th Cir. 1972).
\item 31. See note 14 \textit{supra}.
\end{itemize}
Deductibility of Demolition Losses

that prior case law holds that the regulations must be upheld unless unreasonable and plainly inconsistent with the revenue statutes.\textsuperscript{32} A legislative regulation has the “force and effect of law”;\textsuperscript{33} an interpretive regulation does not bind a court in its construction of the Code. An interpretive regulation, however, unless plainly at variance with the Code, is persuasive. The regulations often supply the definitions that Congress omitted:

Where the act uses ambiguous terms, or is of doubtful construction, a clarifying regulation or one indicating the method of its application to specific cases not only is permissible but is to be given great weight by the courts. And the same principle governs where the statute merely expresses a general rule and invests the Secretary of the Treasury with authority to promulgate regulations appropriate to its enforcement.\textsuperscript{34}

Surprisingly, both sides claim that their irreconcilable positions do not conflict with the tenor of the interpretive regulation on demolition losses.

In \textit{Feldman v. Wood}\textsuperscript{35} the Ninth Circuit followed the “plain-meaning” rule and allowed a current demolition loss deduction by a strict construction of the term “requirement.” The government, arguing for a “substitution of assets” theory, asked the court to construe the term “requirement” to include “permission.” The court rejected the government’s view: “A right to do an act is far different from a requirement to do it.”\textsuperscript{36}

The Seventh Circuit in \textit{Landerman v. Commissioner}\textsuperscript{37} has taken a contrary position on the construction of the term “requirement.”\textsuperscript{38} In \textit{Landerman} the court disallowed the immediate demolition deduction. If the demolition was an underlying condition of the lease, the court of appeals agreed with the contention that amortization of the underpreciated basis was necessary whether the demolition was pursuant to permission granted or required by the lease.

\begin{footnotesize}
\textsuperscript{33} Maryland Casualty Co. v. United States, 251 U.S. 342, 349 (1920).
\textsuperscript{34} Koshland v. Helvering, 298 U.S. 441, 446-47 (1935); INT. REV. CODE § 7805 (a).
\textsuperscript{35} 335 F.2d 264 (9th Cir. 1964).
\textsuperscript{36} Id. at 265.
\textsuperscript{37} 454 F.2d 338 (7th Cir. 1971), \textit{cert. denied}, 406 U.S. 967 (1972).
\textsuperscript{38} “Requirement” is defined as “something required, wanted, needed, called for or demanded; a requisite or essential condition.” Since the definition includes something which is wanted, needed or called for, only a restrictive interpretation of the word requirement would demand the presence of a formal mandatory undertaking.
\textsuperscript{Id.} at 340.
\end{footnotesize}
Against the background of . . . the regulations it appears to us that the present regulation was designed to narrow, but not alter, the focal point of determination to the contemplation and bargaining stances of the parties at the time the lease arrangements were made. In so doing, the vexatious problem of assessing the economic ramification of demolition by a lessee at a later period of the lease would be obviated. In this context, the replacement of the word “terms” with the word “requirements” becomes meaningful, since an optional demolition near the end of the lease would still be pursuant to its “terms.”

The courts in the later cases relied on the differing interpretations of Feldman or Landerman. Following the Feldman rationale, the Fifth Circuit in Hightower v. United States adopted a strict construction of the word “requirement.” Because the regulation is defining an ambiguous Code section, the courts favoring a current deduction have construed the regulation most strongly against the Commissioner invoking it to disallow a current deduction. The Hightower court upheld a current demolition deduction because the wording of the regulation is not contrary to the statute, and the interpretation of the wording should reflect the reasonable person's viewpoint of a requirement.

Following the Landerman rationale, the Eighth Circuit in Foltz v. United States asserted that a strict interpretation of the regulation would circumvent the intent of the drafters of the Code on loss deductions. Since the regulation only clarifies the Code, its interpretation must be consistent with the Code. To allow a current deduction when the lease requires demolition (regardless of the particular wording in the lease) arguably violates Code section 165(a) which allows deductions for only uncompensated losses.

While the courts have differed on the scope of the regulation, the wording of the leases in the instant cases has not conflicted with the precise wording of the regulation. Each case gave the lessee “permission” to demolish or the “right” to demolish rather than “requiring” demolition. The ostensible compliance with the wording of the regulation has caused many courts to scrutinize the intention of

39. Id. at 341.
40. 463 F.2d 182 (5th Cir. 1972).
41. 458 F.2d 600 (8th Cir. 1972).
42. See note 14 supra.
43. The one exception is Levinson, where demolition was not mentioned in the lease.
44. Hightower v. United States, 463 F.2d 182 (5th Cir. 1972); Foltz v. United States, 458 F.2d 600 (8th Cir. 1972).
45. Feldman v. Wood, 335 F.2d 264 (9th Cir. 1964); Landerman v. Commissioner, 454 F.2d 338 (7th Cir. 1971), cert. denied, 406 U.S. 967 (1972); Holder v. United States, 444 F.2d 1297 (5th Cir. 1971).
the parties rather than stopping with a resolution of the wording problem.

**INTENT TO DEMOLISH**

Both sides in the wording conflict agree that the ultimate decision to allow a present deduction should resolve the factual question of intent. However, the courts disagree on the permissible scope of an inquiry into intent. The *Feldman* rationale presumes that a formalized agreement permitting demolition *prima facie* evidences an intent not to demolish. In *Feldman*, the land was not the sole object bargained-for and the building purportedly had value to both parties.

Where there is no commitment to demolish, the lease includes the right to put the buildings to beneficial use and a portion of the rental may well be attributed to them. It may well be said that they have not yet lost their status as income-producing property. The Regulation appears simply to shift emphasis upon the factual issue of intent. Of the many rights secured to the parties and presumably bargained for, stress is laid upon the right to put the property to beneficial use instead of upon the right to demolish it. Instead of inviting an examination into the possibility that something of value really was not important, the Regulation presumes that it was unless the parties have formally demonstrated in the manner specified that it was the land alone which was bargained for.46

The *Feldman* rationale limits judicial inquiry into the intent of the parties regarding demolition because *Feldman* states that the regulation has settled the question of intent by implying its absence in a "permissive" context.

The inflexible reading of the regulation makes the interpretation of *Feldman* less persuasive because substance should prevail over form.47 The *Landerman* rationale examines all the facts and circumstances surrounding the execution of the lease in resolving the intent question. Invoking the doctrine of substance over form, the *Landerman* court disregards the wording of the lease in deciding whether the

---

46. 335 F.2d at 266.
47. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935). In the lower court opinion, 69 F.2d at 810-11, Judge Learned Hand wrote:

We agree with the Board [of Tax Appeals] and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . Therefore, if what was done here, was what was intended by [the statute], it is of no
parties actually intended to raze the building at the execution of the lease. If the wording of the particular lease controlled, a carefully drafted lease would include only words of permission and not of requirement to assure a current deduction to the lessor. This approach disregards the real agreement of the parties and obscures their real intent regarding demolition. A finding of intent, based upon a presumption that the wording represents the parties' actual intent, should be rebuttable upon a showing of conflicting surrounding circumstances and prior negotiations of the parties.

The *Foltz* dissent enunciated the difficulty of an intent test that goes beyond the precise wording of the regulation. The dissenting judge in *Foltz* would not allow earlier negotiations of the parties to affect the interpretation given to the wording of the lease.

To speculate upon what the parties anticipated would occur by reference to earlier negotiations seems to me to be akin to the admission of parol evidence to alter or vary the terms of an unambiguous written instrument. The history of the regulation itself supports this conclusion. If the authors had intended to exclude from the provisions of section 165 all demolitions which were contemplated (and necessarily permitted) under the provisions of a lease, the originally proposed language "pursuant to the terms of a lease" would have been adequate for such purpose.48

The regulations, however, state that substance and not mere form shall govern in the determination of a deductible loss under Code section 165(a).49 To effectuate the doctrine of substance over form, the regulations concerning demolition losses generally presuppose an inquiry into the intent of the taxpayer.

The question as to the taxpayer's intention is not answered by any inference that is drawn from any one fact or circumstance but can be answered only by a consideration of all relevant facts and cir-

---

48. 458 F.2d at 604.
49. Treas. Reg. § 1.165-1(b) (1960):
   (b) Nature of loss allowable. To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.
circumstances and the reasonable inferences to be drawn therefrom.  

Regulation 1.165-3(a) disallows a current deduction if the intent to demolish exists at the time of the acquisition of the property. However, regulation 1.165-3(b)(1) permits a current loss deduction if the taxpayer forms an intent to demolish subsequent to the acquisition of the property. While the regulation concerning demolition losses of a leased building does not specifically discuss intent, the intent of the parties should be as controlling on the deductibility of demolition losses in a leasing context as in a non-leasing context.

Furthermore, the parol evidence rule does not bar an inquiry into the intent of the parties. Because the courts have made the wording of the demolition loss regulation uncertain, leasing agreements relying upon the language of the regulation cannot be unambiguous. Therefore, extrinsic evidence bearing upon intent does not alter, modify or vary the terms of a written demolition agreement. Admitting evidence of intent will not solve the demolition deduction issue until the courts have established consistent standards to determine intent. The courts currently apply a variety of standards in assessing the intent of the parties to a leasing agreement involving demolition.

The courts should use the length of time between the leasing of the property and its subsequent demolition as a standard in assessing the intent of the parties. The Feldman lessee demolished the building approximately two and one-half years after the execution of the lease; however, the court of appeals did not consider this delay a significant

---

50. Treas. Reg. § 1.165-3(c) (1960).
51. Treas. Reg. § 1.165-3(a)(1) (1960): (a) Intent to demolish formed at time of purchase. (1) Except as provided in subparagraph (2) of this paragraph, the following rule shall apply when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the buildings situated thereon: No deduction shall be allowed under section 165(a) on account of the demolition of the old buildings even though any demolition originally planned is subsequently deferred or abandoned. The entire basis of the property so purchased shall be allocated to the land only. Such basis shall be increased by the net cost of such demolition or decreased by the net proceeds from demolition.
52. Treas. Reg. § 1.165-3(b)(1) (1960): (b) Intent to demolish formed subsequent to the time of acquisition. (1) Except as provided in subparagraph (2) of this paragraph, the loss incurred in a trade or business or in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under section 165(a) if the demolition occurs as a result of a plan formed subsequent to the acquisition of the buildings demolished. The amount of the loss shall be the adjusted basis of the buildings demolished increased by the net cost of demolition or decreased by the net proceeds from demolition. The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property demolished.
fact because the wording of the lease was controlling on the question of intent. In *Hightower*, while the lessee demolished the buildings only five and one-half months after acquisition, the Fifth Circuit followed *Feldman*. In *Foltz* the demolition occurred approximately one and one-half years after the lessees took possession of the property; yet the Eighth Circuit did not consider this long delay controlling.

The only case which considered timing important was *Landerman* in which the lessee demolished the structure after eight months. According to *Landerman* the timing of the demolition substantially resolves the deduction issue because, to be nondeductible as a current loss, the demolition must be an underlying condition of the lease at the time of execution. If the demolition took place early in the leasehold, the courts should presume that the parties preconceived the demolition. If more than one year elapsed from the execution of the lease to the demolition of the building, intervening circumstances probably made the building no longer useful. In the latter instance, the parties probably did not bargain for the land alone.

The courts should also inquire into the pre-lease negotiations allocating the demolition costs between the parties as another standard determining intent. With rare exceptions, the courts have disregarded this aspect of the issue of intent. The *Hightower* court said that both parties to the lease knew that the lessee required a demolition provision and/or an option to purchase in the lease before executing it. The court did not regard this fact as significant because the Fifth Circuit followed the "plain-meaning" rule of *Feldman*.

Leases commonly include permissive demolition clauses as a practical necessity if the lease term is lengthy and the existing building has a relatively short useful life. Without such a clause the lessee has

---

54. Holding likewise was *Holder v. United States* in which demolition occurred one and one-half years after execution of the lease.

55. 458 F.2d at 604.

56. In *Levinson*, demolition took place immediately. Though demolition was not mentioned in the lease, the lessors were obligated to erect a new building on the premises for the lessee. In order to do so, the lessors had to demolish the existing building. [The fact that demolition is carried out by the lessor is generally held to be irrelevant. See Nicholl's Estate v. Commissioner, 282 F.2d 895 (7th Cir. 1960), and Raby, *New Regulations Clarify Loss on Demolition of Leased Property*, 13 J. OF TAXATION, 227, 228 (1960).] The Tax Court in *Levinson* relied on *Landerman*, holding that demolition was an underlying condition of the lease and thus a "requirement" under the regulation, in spite of the lessors' assertion that the regulation was inapplicable since it was not the land for which bargaining took place. The lessors asserted that demolition occurred in order to have the use of a new, bargained-for building. In any case, the timing of the demolition made it apparent that destruction of the building had been previously contemplated.

Deductibility of Demolition Losses

no right to demolish existing buildings that become useless due to casualty or gradual deterioration. Consequently, pre-lease negotiations allocating the costs of demolition should not alone dispose of the question of intent. The courts should especially consider which party to the lease suggested the insertion of the permissive provision.58

A significant circumstance of any leasing agreement is the relationship of the lease term to the remaining useful life of the leased premises. In Feldman the government urged that since the term of the lease exceeded the remaining useful life of the demolished building, the lessor had no economic interest in that building subject to a loss deduction.59 Relying on Alaska Realty Co. v. Commissioner,60 which states that a taxpayer can depreciate property even if the useful life of the property is less than the lease term, the Ninth Circuit rejected the government’s argument. Because the lessor can continue to depreciate the leased building before demolition, he has retained his capital investment in the property regardless of the length of the lease, and he should not lose the tax benefit of a current demolition deduction.

Revenue Ruling 67-410 contradicts this rationale by presuming an intent to demolish when the useful life of the demolished building is shorter than the term of the lease absent other evidence of the parties’ intent.61 Not only does this Ruling conflict with Alaska Realty, but it also conflicts with the regulation on demolition losses in a leasing context. The regulation only makes a presumption of intent if the lease “requires” demolition because a requirement presumes that the parties bargained for the demolition costs before executing the lease.62

The suitability of the existing improvements for the lessee’s intended use at the execution of the lease clearly aids the evaluation of any purported pre-existing intention to demolish. If the surrounding circumstances indicate that the lessee’s intended use did not relate to an appropriate or feasible use of the existing building, a strong presumption of a preconceived intent to demolish should exist. In that

58. For example, in Foltz, the permissive demolition clause was inserted into the lease at the suggestion of the lessee’s counsel as a protective provision in light of the long lease term. 322 F. Supp. 414, 416 (W.D. Ark. 1971), rev’d, 458 F.2d 600 (8th Cir. 1972).
59. 335 F.2d at 265-66.
60. 141 F.2d 675 (6th Cir. 1944). See also Treas. Reg. § 1.167(a)(4) (1960); St. Paul Union Depot Co. v. Commissioner, 123 F.2d 235, 238 (8th Cir. 1941), dictum; 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.89 (1973 rev.).
61. See note 30 supra.
62. The district court in Holder approved this reasoning and declared the ruling to be erroneous where in conflict with the regulations. 70-2 U.S.T.C. 84,672, 84,673-74 (N.D. Ga. 1970).
instance the courts could justly say the lease “required” demolition within the meaning of the regulation.

The Fifth Circuit has not consistently applied this standard of intent. In *Holder v. United States* the parties stipulated that, at the execution of the lease, the lessee had definite plans to use part of the land for a parking facility and to sublease the remainder of the premises (including the building) to the prior lessees for an indefinite period. The lessee in *Hightower* wanted the leased premises for a savings and loan facility. At the execution of the lease three 100-year-old row houses were built on the land. While the Fifth Circuit in *Hightower* allowed a current deduction to the lessor, it disallowed a current deduction in *Holder*, notwithstanding an apparent preconceived intent to demolish in *Hightower* and the absence of such an intent in *Holder*. The court reconciled its two apparently inconsistent opinions on other grounds.

While the Fifth Circuit has taken an ambiguous position on the suitability test, the Seventh Circuit has apparently adopted this test as a measure of the parties’ intent. In *Landerman* the lessee desired to erect a multi-story parking garage on premises which already contained a furnished building. The prior intent to demolish clearly stands out in this case and justifies the Seventh Circuit’s denial of a demolition deduction.

The Eighth Circuit has extended the suitability test to include situations involving alterations but not demolition of the leased premises. In *Foltz* the lessee wanted to construct a tunnel between his building and the leased premises to assure adjacent ground space for future expansion. As a condition of the lease, the lessee required the lessor not to remove fixtures already in the leased premises. Until a general contractor concluded that constructing a tunnel between the two buildings was not feasible, the lessee had opposed any demolition. Notwithstanding the lack of any evidence of a preconceived intention to demolish, the Eighth Circuit denied a demolition deduction by invok-

---

63. 444 F.2d 1297 (5th Cir. 1971).
64. In *Hightower*, the court stated:
   This decision is not inconsistent with our holding in *Holder v. United States*, 444 F.2d 1297 (5th Cir. 1971). There we held that the taxpayer was not entitled to a loss because the lease required the tenant to replace the demolished building with other buildings meeting certain specifications and value. Thus “they were compensated for their loss by the lessee’s contractual duty to construct other improvements to be delivered to taxpayers at the termination of the lease (p. 1300).” There is no such contractual duty under the *Hightower* lease. 463 F.2d 182, 183 (5th Cir. 1972).
65. 322 F. Supp. at 417.
The Eighth Circuit has probably carried the suitability test to an unreasonable point.

The inquiry into intent should not degenerate into a battle of semantics, and the courts should not carry the intent test to extremes. A set of guidelines such as those set forth in regulation 1.165-3(c) for non-lease demolitions is essential to a consistent judicial analysis of the parties' intent.\textsuperscript{66} Other criteria of intent uniquely applicable to lease situations should supplement the evidence of intent already enumerated in this regulation. The standards already considered in this note should aid the Service in establishing new measures of intent in a leasing context.

If the negotiations of the parties to the lease show that they intended demolition from the outset,\textsuperscript{67} no demolition loss deduction should be allowable, notwithstanding the actual wording of the lease. If the parties merely discussed the possibility of demolition, or if the parties inserted a permissive demolition clause into the lease to protect the lessee who had no intent to demolish immediately, the courts should

\begin{itemize}
  \item An intention at the time of acquisition to demolish may be suggested by:
    \begin{itemize}
      \item A short delay between the date of acquisition and the date of demolition;
      \item Evidence of prohibitive remodeling costs determined at the time of acquisition;
      \item Existence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes;
      \item Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or
      \item Inability at the time of acquisition to realize a reasonable income from the buildings.
    \end{itemize}
  \item The fact that the demolition occurred pursuant to a plan formed subsequent to the acquisition of the property may be suggested by:
    \begin{itemize}
      \item Substantial improvement of the buildings immediately after their acquisition;
      \item Prolonged use of the buildings for business purposes after their acquisition;
      \item Suitability of the buildings for investment purposes at the time of acquisition;
      \item Substantial change in economic or business conditions after the date of acquisition;
      \item Loss of useful value occurring after the date of acquisition;
      \item Discovery of latent structural defects in the buildings after their acquisition;
      \item Decline in the taxpayer's business after the date of acquisition;
      \item Condemnation of the property by municipal authorities after the date of acquisition; or
      \item Inability after acquisition to obtain building material necessary for the improvement of the property.
    \end{itemize}
\end{itemize}

\textsuperscript{66} Treas. Reg. § 1.165-3(c)(2) (1960):

(2) An intention at the time of acquisition to demolish may be suggested by:

(i) A short delay between the date of acquisition and the date of demolition;
(ii) Evidence of prohibitive remodeling costs determined at the time of acquisition;
(iii) Existence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes;
(iv) Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or
(v) Inability at the time of acquisition to realize a reasonable income from the buildings.

\textsuperscript{67} Treas. Reg. § 1.165-3(c)(3) (1960):

(3) The fact that the demolition occurred pursuant to a plan formed subsequent to the acquisition of the property may be suggested by:

(i) Substantial improvement of the buildings immediately after their acquisition;
(ii) Prolonged use of the buildings for business purposes after their acquisition;
(iii) Suitability of the buildings for investment purposes at the time of acquisition;
(iv) Substantial change in economic or business conditions after the date of acquisition;
(v) Loss of useful value occurring after the date of acquisition;
(vi) Substantial damage to the buildings occurring after their acquisition;
(vii) Discovery of latent structural defects in the buildings after their acquisition;
(viii) Decline in the taxpayer's business after the date of acquisition;
(ix) Condemnation of the property by municipal authorities after the date of acquisition; or
(x) Inability after acquisition to obtain building material necessary for the improvement of the property.

\textsuperscript{66} The intent to demolish must be dominant at the time of acquisition of the property if a depreciation deduction is to be allowed; Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1266 (5th Cir. 1973), cert. denied, 94 S. Ct. 867 (1974); Wagner v. United States, 72-1 U.S.T.C. 84,070 (N.D. Cal. 1972).
not deny current demolition deductions on the basis of the old "substitution of assets" theory.

QUID PRO QUO

The IRS has reduced the issue of compensation for the loss of demolished premises to a question of intent. If the intent to demolish existed before the party took possession, no current demolition loss is allowable. No further inquiry into compensation for the loss is necessary. Whether the terms of a lease should expand the inquiry into compensation for the demolition has resulted in a variety of judicial postures.

Earlier courts generally applied the "substitution of assets" theory in deciding whether the demolition of leased premises had resulted in an uncompensated loss within the meaning of section 165(a). The older cases stated that if there was a "substitution of assets," i.e., the lease for the building, there was no immediate deduction because there was no economic loss. Later courts like Feldman have not inquired into the net economic advantage to the lessor from the demolition. Feldman stated that a lessor would not allow demolition unless he expected some benefit.

We can hardly conceive that an owner would agree to demolition unless he felt it to be to his financial advantage. The Code and Regulations must, then, contemplate that there will be occasions where a financially advantageous demolition may constitute a loss for tax purposes.

The Feldman court concluded that, absent a "requirement" to demolish, the lease did not provide the lessor with a compensated loss for the demolition.

Other courts have approached the compensation inquiry with a two-fold test: (1) Does the lease permit or require a demolition; and (2) Has the taxpayer actually suffered an uncompensated loss. The answer to the latter question depends upon all the facts and circumstances, and the priority given any fact or circumstance varies with the different courts. In Holder the court of appeals looked for an uncompensated loss before asking whether the lease required or permitted the demolition. In Foltz and in Landerman the court of appeals looked for permission to demolish before deciding whether the lessor had an uncompensated loss.

68. See text accompanying notes 14 through 24 supra.
69. 335 F.2d at 266.
Deductibility of Demolition Losses

Notwithstanding the different order of inquiry in this two-part test, the Fifth, Seventh and Eighth Circuits have agreed that a conflict between the Code and a strict construction of the regulation results from the absence of any judicial inquiry into compensation for the demolition loss.70 The regulation on demolition losses of leased premises does not specifically state that a requirement to demolish results in compensation to the lessor. On the other hand, if the demolition is permissive, the regulation by implication allows a current deduction without an actual showing of no compensation from the lessee to the lessor. To prevent an otherwise unallowable deduction for a compensated loss based on a literal reading of the regulation, the several circuits of the court of appeals have established inconsistent standards to measure compensation to the lessor for a demolition of his premises after the execution of a lease.

Several courts have discussed rental rates as a measure of compensation to the lessor for his demolition losses. The Foltz court noted that the lease rentals exceeded amounts discussed in prior negotiations with a different prospective lessee to whom the lessor had refused demolition. The rental rate under the executed lease did not change irrespective of demolition. These facts led the court to presume that the rental rate compensated the lessor for the demolition. In disallowing a current demolition deduction, the Foltz court considered the fact of a constant rental rate as practically dispositive of the compensation question.

On the contrary, in Holder the fact that the rental rate remained constant over the term of the lease did not influence the court in its ultimate decision to disallow a current demolition deduction. The Feldman court discussed the change in rental rates occurring two years after the execution of the lease and irrespective of demolition. It did not consider the economic ramifications of a demolition occurring almost simultaneously with the raise in rent in reaching its decision to allow a current deduction. The Feldman court has clearly abandoned any judicial inquiry into compensation for the demolition.

In Levinson v. Commissioner71 the lease provided for rent that did not exceed the rent obtainable on vacant land. To comply with a lease requirement to build a new structure, the lessors demolished the

70. The courts justified this further inquiry on the basis of the maxim that since deductions are a matter of grace and not of right, taxpayers are not entitled to deductions unless they are able to bring themselves within the applicable statutory provision. Burnet v. Houston, 283 U.S. 223 (1931); Landerman v. Commissioner, 454 F.2d 338, 341 (7th Cir. 1971); Foltz v. United States, 458 F.2d 600, 602 (8th Cir. 1972).
71. 59 T.C. 676 (1973).
existing structure. In denying a current demolition loss deduction, the Tax Court found that the rent under the lease did not establish the asserted lack of compensation to the lessor for the demolition but only reached the adequacy of the compensation.\textsuperscript{72}

The courts have also considered the payment of the demolition costs by the lessee, the presence of a reverter clause for the lessor and the subsequent sale of the leased property to the lessee as other standards of compensation. In most cases, the lessee bore the cost of demolition. The \textit{Landerman} court treated this payment as compensation to the lessor for the demolition because otherwise, as in \textit{Levinson}, the lessor bore the demolition costs.\textsuperscript{73} Agreeing with \textit{Landerman}, the \textit{Foltz} court stated that the payment of demolition costs was "another indication that [the] lessor has received something in exchange for . . . accession to demolition . . . ."\textsuperscript{74} The \textit{Foltz} court also found that a reverter clause in the lease was evidence of compensation for the demolition. This argument seems frivolous because in the absence of a contrary clause in the lease the building becomes the property of the lessor at the expiration of the lease or at the lessee's earlier forfeiture or default.

A subsequent sale of the property pursuant to a prearranged agreement makes a stronger argument for compensation to the lessor. In \textit{Hightower} the government argued that the parties to the lease looked primarily toward the sale of the property. The government also argued that the lessors would only sustain a deductible loss at the time of a subsequent sale if the sales price did not exceed the lessors' adjusted basis in the property.\textsuperscript{75} Construing the arrangement between the parties as a lease and not as a sale, the Fifth Circuit rejected this argument summarily.\textsuperscript{76}

The strongest argument for a finding of compensation is a requirement to rebuild in the lease. Two cases discussed such a lease clause.\textsuperscript{77} In \textit{Holder} if the lessee demolished pursuant to permission

\begin{verbatim}
72. Id.
73. 454 F.2d at 341-42; see also note 56 supra.
74. 458 F.2d at 603.
75. 346 F. Supp. 707, 712 (M.D. Fla. 1971). This argument was used with more success in Blumenfield Enterprises, Inc. v. Commissioner, 23 T.C. 665, 671 (1955), aff'd, 232 F.2d 396 (9th Cir. 1956).
76. Id. at 712.
77. The \textit{Feldman} and \textit{Levinson} situations are not directly appropriate to the question of compensation for a replacement structure, though in both cases there was a requirement to build a new structure. In \textit{Feldman} the lessee was required to build a new structure by the end of the lease term even if there were no demolition. The \textit{Levinson} situation did not directly address the issue of compensation to the lessor for the loss of his building through demolition since in that case the lessor was required to build on the premises as a condition of the lease.

\end{verbatim}
granted in the lease, he had to erect new improvements to a specified footage and value worth one and one-half times the value of the existing improvements. The lease also specified that the new building had to be serviceable as a warehouse or as an office building. The Holder court considered these facts decisive in its finding of compensation for the demolition. The dissent in Foltz considered the requirement of a replacement structure as the only measure of compensation to the lessor for the demolition and stated that courts should not attempt to substitute an evaluation of incidental benefits which may or may not inure to the lessor, together with a court determination that such benefits offset the destruction of a depreciable asset.

The destruction of the building must be separately analyzed and not lumped with benefits which were not mandated by the lease as a result of such demolition. 78

While the only benefit balanced against the loss of depreciation deductions due to demolition should be the type and value of the replacement structure, a building useful only to the lessee should not be compensation. However, if the lessor required the lessee to build a replacement structure to certain specifications (such as type, cost and/or footage as in Holder), demolition would be bargained-for, and the lessor would not have suffered a currently deductible loss.

Since the old "substitution of assets" theory treated the lease rather than a new building as the asset bargained-for, a replacement structure was not necessary to a finding of compensation for the demolished structure. 79 The courts should now apply a modified "substitution of assets" theory that requires a new structure for the demolished structure as in Holder before finding consideration for the demolition. The economic adequacy and not only the legal sufficiency of the consideration to the lessor for the demolition should control the ultimate finding of compensation to the lessor.

CONCLUSION

While this writer agrees with the Service's position that the existing regulation is inadequate, this writer does not think that the proposed regulation solves the deduction problem. The proposed regulation on demolition deductions in a leasing context brings the taxpayer back to the old "substitution of assets" theory and effectively ends all current tax deductions. Since the Service has not expressed any intention

78. 458 F.2d at 606.
to revise the entire demolition loss regulations, a loss currently deductible in a *non-lease* context contrasts sharply with a loss *not* currently deductible in a *leasing* context. By adopting an intent test and a modified "substitution of assets" theory, the Service will avoid harsh inequities due to the existing mechanical test of regulation 1.165-3(b)(2) and will make the demolition loss regulations thoroughly consistent. Through the substitution of an intent test for the existing regulation on demolition losses in a leasing context, the Service can improve upon the criteria already developed by the courts and can add criteria specifically related to intent in the framework of lease agreements. The enactment of specific Service guidelines will encourage consistency among the circuits and should provide an orderly development in cases of first impression.

**LINDA KREE WITT**
Comments