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Treasury Regulations Section 1.165-3(b)(2): Lessor Deduction for Demolition Loss

COMMENTS

TREASURY REGULATIONS SECTION 1.165-3(b)(2): LESSOR DEDUCTION FOR DEMOLITION LOSS

It is a well known maxim of the tax counsellor that, just as a postponement of the recognition of income is a tax benefit gained, so also is the present recognition of a loss a tax benefit gained. In a recent line of cases involving the demolition of buildings on leased realty, four United States appellate courts have evidenced a split of authority in deciding whether United States Treasury Regulations section 1.165-3(b)(2)[1] allows the lessor to deduct as a loss his adjusted basis in a building demolished by the lessee under a provision in the lease which merely permits demolition. Under the regulations, the alternative to deduction in the year of demolition is amortization of the lessor's basis over the term of the lease. Clearly, the immediate deduction would be more beneficial to the taxpayer; the amount of benefit, of course, can be measured by the amount of his basis remaining in the building and by the number of years over which it would be amortized under the second alternative.

Demolition Losses Generally

In order to gain a proper perspective for the narrow question considered by this Comment, an understanding of the treatment of demolition losses generally is useful. The controlling statute is section 165(a) of the 1954 Code,[2] which provides: "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Thus, in order to qualify for a deduction, the taxpayer must first show that he has sustained a loss; additionally, he must prove that his loss is uncompensated.

The regulations applying section 165(a) to demolition losses may be said to cover four general fact situations.[3] Where the taxpayer purchased improved property with the intention to demolish the improve-

1. Treas. Reg. § 1.165-3(b)(2), T. D. 6445, 1960-1 Cum. Bull. 99 [hereinafter referred to as Treas. Reg. § 1.165-3(b)(2)].

2. Int. Rev. Code of 1954, § 165(a).

3. It should be noted that these are *general* categories of fact situations, and no attempt is made here to examine the many factual variations which may produce different results.

ments, he has sustained no loss.[4] The reason stated is that, the land being the only part of the package of land and buildings that is valuable to the purchaser, all basis is allocated to the land; consequently, since the buildings have no basis, the taxpayer could not have sustained any loss.[5] The other three fact situations occur where the intent to demolish was formed subsequent to the purchase.[6] Where the buildings are demolished with no intent to replace them, the loss is deductible.[7] Where the buildings are demolished to make way for replacement buildings, the loss is deductible.[8] Finally, where the buildings are demolished pursuant to the requirements of a lease, no deduction will be allowed.[9] This last situation has proved particularly troublesome, and this Comment will focus on variant judicial interpretations of the application of section 165 to the lease situation.

Conflicting Judicial Interpretations

The conflict in the courts has arisen over a slight change in language from the proposed regulations to those finally promulgated in 1960. Although the Code provisions allowing loss deductions have remained substantially unchanged since 1918,[10] there was no discussion in the regulations of demolition losses in a lease context[11] until the first regulations interpreting the 1954 Code were proposed in 1959.[12] The pro-

4. Treas. Reg. § 1.165-3(a). However, where the purchaser intends to use the buildings for a short period of time prior to demolition, he may allocate a proportional part of their cost to them for depreciation purposes.

5. *Id.*

6. Treas. Reg. § 1.165-3(b).

7. Treas. Reg. § 1.165-3(b)(1).

8. *Id.* There is a conflict of opinion in the courts, however, over whether this is the proper treatment of such demolitions. *See* note 69 *infra* & accompanying text.

9. Treas. Reg. § 1.165-3(b)(2).

10. Revenue Act of 1918, Act of Feb. 24, 1919, ch. 18, § 214(a), 40 Stat. 1073 stated: "(a) In computing net income there shall be allowed as deductions... (4) losses sustained during the taxable year and not compensated for by insurance or otherwise..." In all succeeding Revenue Acts, the provision allowing loss deductions was retained in virtually identical language, including Int. Rev. Code of 1939, § 23(a) and Int. Rev. Code of 1954, § 165(a).

11. The regulations, beginning with Treas. Reg. 45, art. 142 (1918), under the Revenue Act of 1918, also remained substantially the same, concerning themselves primarily with whether demolition was intended by the purchaser at the time he acquired the property.

12. Proposed Treas. Reg. § 1.165-3(d), 24 Fed. Reg. 8177, 8180 (1959). Section 1.165-3(d) provided:

> (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

posed rule provided that, where the intent to demolish was formed subsequent to the acquisition of the property, the owner could deduct as a loss his undepreciated basis in any buildings demolished, *except* where the demolition was "pursuant to the terms of a lease." [13] When section 1.165-3(b)(2) was finally adopted in 1960,[14] that vital phrase was changed to "pursuant to the requirements of a lease." Where demolition is pursuant to the *requirements* of a lease, the lost basis is considered to be a cost of acquisition of the lease, to be amortized over the term of the lease.[15]

The first court to consider the impact of this change in wording[16] was the Court of Appeals for the Ninth Circuit in *Feldman v. Wood*.[17] In that case, two years after the lessee took possession of the property, the building was demolished by the lessee under a provision which gave him the "right" to demolish improvements at his own expense. The court allowed the lessor to deduct his basis in the building, holding that the use of the phrase "pursuant to the requirements of a lease" in the regulations necessarily implied that where demolition was merely *permitted* by a lease, deduction of the full adjusted basis must be allowed in the year of demolition.[18] The split of authority emerged when *Landerman v. Commissioner*,[19] the only case to originate in the Tax Court,[20]

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. (emphasis supplied)

13. *Id.*

14. Treas. Reg. § 1.165-3(b)(2) states:

(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. (emphasis supplied)

15. *Id.*

16. Actually, the first case decided under § 1.165-3(b)(2) was Nicholl's Estate v. Commissioner, 282 F.2d 895 (7th Cir. 1960), but that opinion did not address directly the problem here discussed. There, the lease obligated the lessee to demolish the building, so there was no need to construe the term "requirements."

17. 335 F.2d 264 (9th Cir. 1964).

18. The Internal Revenue Service declined to follow *Feldman* in Rev. Rul. 67-410, 1967-2 CUM. BULL. 93.

19. 454 F.2d 338 (7th Cir. 1971).

20. 54 T.C. 1042 (1970). All four of the other principal cases discussed herein, originated in district courts.

was decided by the Court of Appeals for the Seventh Circuit. The Tax Court had found that demolition of the building was negotiated extensively and was contemplated by the parties as an underlying condition of the lease.[21] The court of appeals held that the term "requirements" in the regulation should not be read restrictively, for two basic reasons. First, the word itself can connote something that is wanted, needed, called for, or a necessary condition,[22] and, so defined, may include something that is merely permitted by the lease, as long as it is important to the bargain between lessor and lessee. Second, the court said, the regulation must be read in light of earlier case law, and since the basic rule derived by the early decisions was that demolitions intended at the execution of the lease were not deductible,[23] the distinction between demolitions permitted and those required was an artificial one. Thus, it was held in *Landerman* that the regulations were not intended to distinguish between optional and mandatory demolition provisions, or to make any basic alteration in the existing rule,[24] and the taxpayer's deduction was disallowed.

The next case to be decided under section 1.165-3(b)(2) was *Holder v. United States*,[25] in the Court of Appeals for the Fifth Circuit. In *Holder*, the lease gave the lessee the right to demolish but required him to replace demolished buildings with new buildings meeting certain specifications. It was stipulated by the parties that at the time of execution, the lessee had no immediate plans for demolition and that the replacement requirement was included solely to protect the lessor against the possibility that the lessee might demolish the buildings and then terminate the lease. The court did not reach the construction problem which was the basis of *Feldman* and *Landerman*.[26] Rather, it reasoned that the regulation is inoperative until the taxpayer shows himself to be within section 165(a) by proving an uncompensated loss. In the *Holder* situation, the court held that the taxpayer was compensated by the lessee's obligation to replace the demolished building, and

21. 54 T.C. 1042, 1047.

22. 454 F.2d 338, 340. The court cites WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY, UNABRIDGED for the definitions.

23. See notes 37-47 *infra* & accompanying text.

24. This is the position the Commissioner takes in Rev. Rul. 67-410, 1967-2 CUM. BULL. 93.

25. 444 F.2d 1297 (5th Cir. 1971).

26. Actually, *Holder* was decided shortly before the Court of Appeals decision in *Landerman* was handed down, but after the Tax Court decision, which rested on the same basis. Thus, while *Landerman* technically had not been decided, the *Holder* court still refused to reach the same arguments.

thus could not claim the benefit of section 1.165-3(b)(2). The approach taken by the court in *Holder* poses an interesting question[27] which will be discussed below.[28]

In *Foltz v. United States*,[29] the taxpayer, Mrs. Foltz, had unsuccessfully negotiated for a lease, during which negotiations she sought an annual rental of $6,000. She had refused to permit demolition by the lessee. Subsequently, she entered into negotiations with another party who was represented by the same man who represented the first prospective lessee. This time, Mrs. Foltz agreed to an optional demolition provision, and the lease finally executed called for an annual rental of $9,000. It was clear that the lessee, a bank, wanted the property to facilitate expansion of its physical plant. It was not clear from the district court's findings of fact, however, whether the bank expected to have to demolish the existing building. The Court of Appeals for the Eighth Circuit summarily treated the issue of the interpretation of section 1.165-3(b)(2), relying exclusively on the reasoning in *Landerman*, and noting that the distinction between optional and mandatory demolition provisions enunciated by *Feldman* ignored the necessity of determining whether the loss was in fact compensated. However, the court held that "the critical question" in the case was not the interpretation of the regulation but the existence of an uncompensated loss in the first instance.[30] The court found that specific terms in the lease—the large rental, the lessee's obligation to pay the costs of demolition, and the fact that the lessor eventually would obtain title to the new improvements—compensated the taxpayer for her loss.

In *Hightower v. United States*,[31] three buildings were demolished by the lessee pursuant to a permissive provision in the lease. The district court[32] found that the lessor had not required the lessee to demolish the building as a condition precedent to obtaining the lease, but that the lessee would not have agreed to the lease had the lessor not included the optional demolition provision. It should be noted that *Hightower* was decided by the same court that decided *Holder*. In this instance, however, the court justified its conclusion that the case was within the

27. In holding that the regulations cannot be considered until it is determined whether the taxpayer sustained a taxable loss, the court appears to be ignoring the purpose of the regulations—to interpret the Code and explain what "loss... not compensated for by insurance or otherwise" is intended to mean.

28. *See* text accompanying notes 62-67 *infra*.

29. 458 F.2d 600 (8th Cir. 1972).

30. *Id.* at 603.

31. 463 F.2d 182 (5th Cir. 1972).

32. 346 F. Supp. 707, 709 (M.D. Fla. 1971).

regulation by finding that the lessee was not obligated to replace the demolished building and that, consequently, the lessor was not directly compensated for his loss.[33] The court went on to hold that section 1.165-3(b)(2) must be read restrictively, solely on the basis of *Feldman*.[34] Thus, on the narrow question of whether the lessor may deduct as a loss his basis in buildings demolished under permissive lease provisions, the Ninth and Fifth Circuits, in *Feldman* and *Hightower*, conflict with holdings of the Seventh and Eighth Circuits in *Landerman* and *Foltz*.

Interpretation of Section 1.165-3(b)(2)

In order to reach any conclusions about what the change in wording in section 1.165-3(b)(2) was intended to accomplish, it is necessary to examine the scope of the Code section, the rule in the regulations regarding demolition absent a lease, and the state of the law with reference to demolition in a lease context prior to the adoption of section 1.165-3(b)(2).

As noted below, there are two prerequisites to deductibilty under section 165(a): First, there must be a loss, and second, the loss must be uncompensated. Under the regulations, the test for the first requirement—the existence of a loss—is the purchaser's intent. Under section 1.165-3(a), if the purchaser intended demolition at the time he acquired the property, he sustained no loss, and there is no need to consider the question of compensation. Under section 1.165-3(b), if the intent to demolish was formed subsequent to acquisition of the property, the taxpayer has met the first requirement because, at the time he purchased the property, the buildings presumably had some value from his viewpoint, and part of his investment was allocated to them. When the buildings subsequently became worthless to him and he demolished them, he lost that part of his investment which he had not yet recovered through depreciation. His loss was compounded by the fact that he had to pay money to remove the buildings. However, he was compensated for his loss to the extent that he was able to recover his investment by salvaging the materials reclaimed through demolition. The regulations recognize this state of affairs by providing: "[T]he amount of the loss shall be the adjusted basis of the buildings demolished increased by the net costs of demolition or decreased by the net proceeds from demolition."[35] Thus, the regulations offset any compensation (salvage) against

33. 463 F.2d 182, 183.

34. 463 F.2d 182.

35. Treas. Reg. § 1.165-3(b)(2). *See also* Union Bed & Spring Co. v. Commissioner,

unrecovered capital investment in computing the amount of deductible loss.

The regulations prior to the enactment of the 1954 Code, although interpreting virtually the same language as that incorporated in the present section 165(a),[36] did not attempt to deal with demolition losses in a lease context, as already noted. This left the courts free to develop their own rule regarding the lease situation. The courts were generally agreed[37] that where demolition was "necessary to the purposes of a lease" [38]—that is, where it was contemplated by the parties as a necessary condition precedent to the lease agreement[39]—then the lessor was compensated for his loss by the acquisition of a valuable lease.[40]

A "substitution of assets" was said to have taken place[41] (the lease for the building), and the basis of the demolished building was allocated to the lease as a cost of acquisition, and amortized over the term of the lease.[42] If the buildings actually had become worthless to the lessor before the lease was executed, the lease could not be said to be compensation for the loss.[43] On the other hand, if the buildings were still usable by the lessor, and his decision to give the lessee the option to demolish was motivated by the fact that the lease was more profitable than putting the buildings to some other use, then the lessor was said to have bargained away his investment intentionally for something of greater value. The lease, then, was "substituted" for the buildings, and any remaining basis in them had to be recovered over the term of the lease, as did any other cost of acquisition. For example, in *Manning v. Commissioner*,[44] the taxpayer entered into a lease under which the lessee was to construct a theater on the whole of the land. Although

39 F.2d 533 (7th Cir. 1930); Piedmont Nat'l. Bank v. United States, 162 F. Supp. 919 (W.D.S.C. 1958); Louis Pizitz Dry Goods Co. v. Commissioner, 22 B.T.A. 161 (1931).

36. *See* note 10 *supra*.

37. A few early Board of Tax Appeals cases did not follow the generally accepted rule of "substitution of assets." *See, e.g.*, McNeill v. Commissioner, 16 B.T.A. 479 (1929), which held that when a lessor leases property the lessee gains a capital asset—the leasehold estate—but the lessor has merely made a sale, and therefore may immediately deduct any costs of acquiring the lease.

38. Blumenfield Enterprises v. Commissioner, 23 T.C. 665 (1955).

39. Nicholl's Estate v. Commissioner, 282 F.2d 895 (7th Cir. 1960).

40. Smith Real Estate Co. v. Page, 67 F.2d 462 (1st Cir. 1933).

41. Myer Dana v. Commissioner, 30 B.T.A. 83 (1934); Harper v. Commissioner, 27 B.T.A. 293 (1932).

42. Young v. Commissioner, 59 F.2d 691 (9th Cir. 1932), *cert. denied*, 287 U.S. 652 (1932).

43. Smith Real Estate Co. v. Page, 67 F.2d 462 (1st Cir. 1933).

44. 7 B.T.A. 286 (1927).

there was no mention of demolition in the lease, the court found that, since the theater could not be built until the existing structure was removed, demolition was necessary to the purpose of the lease. The loss being compensated by the *quid pro quo* of the lease, no deduction was allowed. In so holding, the court said:

> There was in this instance what amounted to a substitution of assets; instead of an asset in the form of buildings, the petitioners now have another asset, *viz.*, a lease, the giving up or voluntary destruction of the buildings being a necessary incident to the acquisition of the lease.[45]

From the reasoning in these cases,[46] with their emphasis on contemplation of demolition and demolition "necessary to the purposes of the lease," it might be supposed that the converse of the rule they state is also true—that is, where the right to demolish is included in the lease merely as protection for the lessee in the event the improvements become useless in the future, the lessor did not intend to bargain away the right to have his assets remain on the land and therefore was not compensated for his loss. However, there appear to be no cases that purport to resolve the issue. The case that comes closest to that situation is *Blumenfield Enterprises v. Commissioner*,[47] where the taxpayer agreed to lease a theater to the lessee, who was to remodel it into a parking garage. Demolition of the theater clearly was not contemplated because the anticipated alterations were slight. After execution of the lease, such remodeling became unfeasible, and the lessor allowed the lessee to demolish the theater and use the land for street level parking. The court recognized that demolition initially was not contemplated, but held that since the fundamental purpose of the lease would have been defeated if existing structures had not been demolished, the lessor could not deduct his adjusted basis.[48] The clear implication of this decision is that, regardless of the parties' original contemplation and the nature of their bargain, the courts were willing to hold that whenever it becomes advantageous to the lessee to demolish and he exercises his option under

45. *Id.* at 290.

46. *See* cases cited notes 38-44 *supra*. *See also* Camp Wolters Land Co. v. Commissioner, 160 F.2d 84 (5th Cir. 1947); Spinks Realty Co. v. Burnett, 62 F.2d 462 (D.C. Cir. 1932), *cert. denied*, 290 U.S. 636 (1933); Anahma Realty Corp. v. Commissioner, 42 F.2d 128 (2d Cir. 1930); Berger v. Commissioner, 7 T.C. 1339 (1946).

47. 23 T.C. 665 (1955).

48. *Id.*

the lease, the lessor must recover his investment through amortization over the term of the lease.

Consequently, it was no surprise when, in 1959, the newly proposed regulations[49] made the owner's basis non-deductible whenever demolition was "pursuant to the *terms* of a lease." [50] The effect of such language is to render irrelevant the lessor's intent to exchange the right to demolish for the acquisition of a valuable lease, so long as demolition is mentioned in the lease. This may seem to represent a modification of the rule established in the courts, but it must be remembered that although the courts spoke in terms of the intentional substitution of assets, they managed to find such substitution even in cases like *Blumenfield Enterprises*, where the lessor clearly had not contemplated demolition.

The inequitable situations which may arise under such a rule have been noted by one commentator,[51] who suggested that a lessor may lease a building with a 25-year useful life for a 99-year term, fully anticipating that the lessee will continue to use it until he has fully depreciated its basis. In such a lengthy lease, the right to demolish must be granted as a matter of course; otherwise, the lessee may find himself encumbered with a useless building after 25 years. Yet, if for some reason the building becomes useless before anticipated, and the lessee demolishes it, the lessor may not deduct his basis as he could in similar circumstances absent a lease. Instead, he must amortize his loss over a period of 99 years—simply because the demolition was pursuant to the "terms" of a lease.

The fact that such situations cannot be treated equitably under such a rule may provide a clue to the purpose of changing "terms of a lease" to "requirements of a lease" in the regulations. In 1960, following the adoption of that change, it was observed[52] that denying a loss deduction only where demolition was "required" could contribute to eliminating the undesirable result of amortization over a lengthy period where the demolition was not contemplated seriously by the lessor. The court in *Landerman*[53] held that the desire to eliminate such inequities was the

49. Proposed Treas. Reg. § 1.165-3(d). *See* note 12 *supra*.

50. *Id.* (Emphasis supplied).

51. Raby, *New Regulations Clarify Loss on Demolition of Leased Property*, 13 J. OF TAXATION 227 (1960).

52. *Id.*

53. 454 F.2d at 341. The Tax Court reached the same conclusion at 54 T.C. 1042, 1046-47, where it stated:

> As we see it, the attempt by respondent to deal with demolition in a lease context and the evolution of his regulations were designed to make the immediate contemplation and the bargaining stance of the parties, at the

probable reason for the change in regulations, and, in light of the considerations just discussed, this appears to be a reasonable conclusion.

It appears, then, that the divergent judicial interpretations of section 1.165-3(b)(2) may be explained in the following manner: *Landerman* and *Foltz* would read the phrase "pursuant to the requirements of a lease" to call for an inquiry into whether the underlying purposes of the lease, as contemplated by the parties at the time of execution, "require" the demolition, rather than whether the lessor "requires" the lessee to demolish. This interpretation would maintain the rule developed in the courts without the attendant inequitable results.[54] The interpretation adopted by *Feldman* and *Hightower*, on the other hand, would refrain from any inquiry into the parties' intent, and determine deductibility solely on the basis of whether demolition by the lessee is optional or mandatory.[55] Indeed, the court in *Feldman* held that the rule developed in the courts was entirely superseded by the regulations.[56] The problem with this approach is that deductibility is made to turn upon a matter of semantics—the lessor is empowered to bring himself within section 165(a) simply by phrasing the demolition provision as optional rather than mandatory. For example, in *Hightower*, although the district court specifically had found[57] that the lessor was aware that the lessee would not agree to the lease without receiving the right to demolish, and that demolition was completed less than two

> time the lease arrangements were made, the focal point of determination. By so doing, problems of optional demolition at a much later period of the lease would be avoided.

The court concluded:

> In short, we hold that respondent's regulations were intended to encompass an examination of whether demolition was sufficiently within the contemplation of the parties at the time the lease arrangements were made that it can be said that the demolition was an underlying condition of those arrangements.

54. Such an interpretation approximates but is not identical to the Internal Revenue Service's own interpretation of the regulation in Rev. Rul. 67-410, 1967-2 CUM. BULL. 93. There, the Service made it clear that as long as the demolition arises in a lease context, it is not deductible, whether it is permitted or required, and regardless of the lessor's intent at the time of execution. In fact, the Service probably cannot argue "substitution of assets" because in 1.165-3(b)(1) it states explicitly that when, absent a lease, a taxpayer demolishes one building to make way for another, the basis of the old building is never added to that of the new. As will be seen later, the two positions are contradictory. *See* text following note 74 *infra*.

55. Feldman v. Wood, 335 F.2d 264, 265 (9th Cir. 1964); Hightower v. United States, 346 F. Supp. 707, 712 (M.D. Fla. 1971). The district court cite is given for *Hightower* because the court of appeals merely incorporates the district court's reasoning.

56. 335 F.2d at 266.

57. 346 F. Supp. at 709.

months after the lessee took possession, the court still held that since the lessee had the right, but not the obligation to demolish, the lessor's loss was deductible. Clearly, if the true test of deductibility (the existence of an uncompensated loss) is the lessor's intent to bargain away his rights in the building in exchange for the acquisition of a lease, then the distinction between whether demolition is "permitted" or "required," the way *Feldman* and *Hightower* read those terms, is an arbitrary one which exalts form over substance and which ignores the requirement of section 165(a) that losses be in fact uncompensated.[58]

It is thus apparent that, on the narrow question raised—whether the term "requirements" should be read restrictively—the courts in *Landerman* and *Foltz* have the better-reasoned position. Assuming that the "substitution of assets" approach is proper, there is no rational basis for distinguishing between optional and mandatory demolition provisions. In either case the lease has been substituted for the building—or has not been substituted for the building—according to the lessor's intent. And as the court in *Landerman* indicated,[59] the term "requirements" can connote "an essential condition," which definition fits precisely within the rule developed in earlier cases.

In any event, the Internal Revenue Service apparently has decided to eliminate the controversy. New regulations have been proposed which would disallow a deduction whenever demolition is "required or permitted by a lease or by an agreement which resulted in a lease." [60] To be sure, this language would eliminate the possibility of further decisions following *Feldman* or *Hightower*, but the effect would be identical to that of the regulation originally proposed in 1959.[61] That is, any time demolition is mentioned in the "terms of a lease" the deduction would be disallowed, regardless of the lessor's intent, and that result surely would be just as arbitrary as attempting to distinguish between optional and mandatory provisions.

THE *Holder* RATIONALE

Bearing in mind the scope and purpose of section 1.165-3(b)(2), some conclusions may be drawn regarding the basis for the decision in

58. The findings of fact in *Hightower*, for example, would indicate that the parties anticipated immediate demolition, which would bring the case within the substitution of assets rule. See note 57 *supra* & accompanying text.

59. 454 F.2d at 340.

60. Proposed Treas. Reg. § 1.165-3(b)(2), 37 Fed. Reg. 7891 (April 21, 1972).

61. Proposed Treas. Reg. § 1.165-3(d). See note 12, *supra*.

Holder v. United States.[62] There, the court held that before the regulation could even be considered the taxpayer had to bring himself within section 165(a) by proving that he had sustained an uncompensated loss. The court in *Foltz* based its decision substantially on the same ground. Both courts found that the lessors were compensated for their losses by specific provisions in the respective leases. This approach seems inappropriate for two reasons. First, it overlooks the purpose of the regulations, which is to interpret the Code provisions. Specifically, section 1.165-3(b)(2) is intended to define the circumstances under which a demolition loss is "compensated" within the meaning of section 165. This is especially clear in light of the foregoing analysis of the history of this regulation. Both *Holder* and *Foltz* appear to reach their conclusions concerning the requirements of section 165 without considering the regulation which is the authority established by Congress for giving effect to the Code provisions. It is one thing for a court to examine a regulation and find that it falls short of accomplishing its purpose adequately, and quite another to short-circuit the process by formulating its own tests without regard to the regulation. Both courts appear to be answering the question before it is properly stated.

Second, the compensation that the *Holder* and *Foltz* decisions find is not generally held to be relevant. Both courts found that the lessor was compensated by the right to possession of replacement buildings upon termination of the lease.[63] It has been held, however, that the presence or absence of a requirement to replace demolished structures is irrelevant in determining compensation.[64] Further, it is difficult to find any rationale for amortizing the old basis over the term of the lease, rather than over the life of the replacement, if indeed the replacement is the compensation. *Foltz* also held that the lessor received compensation when the lessee relieved him of the eventual burden of the cost of demolition.[65] However, the distinction between demolition costs borne by the lessor and those borne by the lessee is regarded as irrelevant by section 1.165-3(b)(2); moreover, the arbitrary distinction was rejected specifically in *Nicholl's Estate v. Commissioner.*[66]

Actually, this approach may be merely another way of stating the

62. 444 F.2d 1297 (5th Cir. 1971).

63. 444 F.2d at 1300; Foltz v. United States, 458 F.2d 600 (8th Cir. 1972).

64. Berger v. Commissioner, 7 T.C. 1339 (1946), held that whether the lessee was obligated to replace the demolished building was irrelevant. It was the lease itself which was the compensation, not the specific lease provisions.

65. 458 F.2d at 603.

66. 282 F.2d 895 (7th Cir. 1960).

argument used consistently by the government *viz.*, the taxpayer must show that he has sustained some *economic* loss. However, this argument should not be deemed controlling, because, as expressed in *Feldman*,[67] it is difficult to conceive of a situation where a property owner would demolish if it were not for the prospect of making a more profitable use of his land. Yet, section 1.165-3(b)(1) allows a deduction for demolitions absent a lease without questioning whether the particular transaction is economically advantageous. Thus, economic losses are not the only losses deductible under section 165(a). The fundamental question is probably one of "taxable event"—*when is the most convenient time for recovering one's investment in a demolished building?*

Validity of Section 1.165-3(b)(2)

Having concluded from pre-regulation cases that section 1.165-3(b)(2) embodies a modified version of the "substitution of assets" theory,[68] it remains to be determined whether, as a matter of policy, the regulation as interpreted achieves a desirable result. This involves an inquiry into whether the regulation properly expresses the test required by the statute. As already discussed, the basic requirement of section 165(a) is that, to be deductible, a loss must be uncompensated.[69] The question thus becomes: *Is the substitution of assets theory an appropriate method of determining when a demolition loss is compensated?* In making this determination, it is helpful to consider the treatment of demolition losses absent a lease.

Section 1.165-3(b)(1) provides that "[t]he basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property demolished." Thus, where a property owner demolishes an old building in order to make room on his land for a new building, he may immediately deduct his basis in the old building as a loss. Clearly, in this situation, if the "substitution of assets" approach were taken, it could be argued that the taxpayer was forced to give up his old building in order to acquire the new one. In that event, he would be forced to treat his lost basis in the old building as a cost of acquiring the new one, and add the basis of the old building to that of the new structure. Thus, it appears that under section 1.165-3(b)(1) the "substitution of assets" theory is not applied to demolitions absent

67. 335 F.2d 264, 266.

68. *See* notes 36-45 *supra* & accompanying text.

69. It can reasonably be assumed that § 165(a) itself calls for a desirable result in that only uncompensated losses should be deductible.

a lease. It is manifest that if section 1.165-3(b)(2) is based on the "substitution of assets" theory (and by all indications it is), then sections 1.165-3(b)(1) and (2) are inherently contradictory. In one situation, if the owner must give up an old building to gain a new one which is more profitable, he may take an immediate deduction; in the lease situation, however, if the owner must give up an old building to gain a lease agreement which is more profitable, he must spread his loss over the term of the lease.

Of course, the mere fact that the Internal Revenue Service improperly allows one deduction is no justification for allowing it elsewhere on the same improper grounds. However, it is far from clear that the deduction for demolition absent a lease is improper. There is a distinct division of authority concerning whether a substitution of assets takes place when an old building is demolished to make way for a new one.[70] It has been said that the general rule is that there is a substitution of assets because the transaction as to the old building has not yet closed,[71] since the old building still has value. However, it is difficult to understand how the transaction is any more open in that situation than it is, for instance, when an old building is sold in order to obtain capital to invest in a new building on other property. Yet, in the latter case, the owner would be allowed to recoup his basis from the sale price.[72] To complicate the situation still further, conflicting courts do not deal specifically with each other's views or provide any basis for distinguishing one line of cases from another. The conflict in the courts, however, does not provide any justification for the contradictory treatment of two analogous fact situations within the regulations.

Another aspect of the substitution of assets approach also appears to be unclear. The lessor is said to have exchanged demolition and

70. *Compare* Appleby's Estate v. Commissioner, 123 F.2d 700 (2nd Cir. 1941); R.K.O. Theaters v. United States, 163 F. Supp. 598 (Ct. Cls. 1958) (where a building is demolished to make way for a more valuable one, its basis must be capitalized and amortized as a cost of acquisition), *with* Union Bed & Spring Co. v. Commissioner, 39 F.2d 533 (7th Cir. 1930); Herbert Burwig (T.C. Mem., Doc. No. 37227, 1953); Louis Pizitz Dry Goods Co. v. Commissioner, 22 B.T.A. 161 (1931).

It should be noted that, while the Service will not challenge a demolition deduction on the basis of the intent to replace the old building, a taxpayer who litigates the issue of whether the intent to demolish was formed at the time of purchase (1.165-3(a), may win that issue only to find that the court has disallowed the deduction on the "substitution of assets" theory. Consequently it is best to attempt to obtain a stipulation from the government that if the taxpayer wins the intent issue the loss is deductible, as was done in Cosmopolitan Corp., 59-122 P. H. Memo. T.C. (1959).

71. Appleby's Estate v. Commissioner, 123 F.2d 700 (2d Cir. 1941).

72. This conclusion assumes that INT. REV. CODE OF 1954 § 1031 does not apply.

depreciation rights for a valuable lease and the right to amortize his old basis as a cost of acquisition. It would seem logical, if there is a substitution, to hold that it takes place when the lease is executed rather than when the building is demolished.[73] Yet, under the regulations the lessor is allowed to depreciate his basis at the faster rate (where useful life is shorter than the term of the lease) until the building is actually demolished. As a practical matter then, it may be said that the demolition is contingent upon the lessee's plans, but to be theoretically consistent, amortization should begin upon execution of the lease if "substitution of assets" is to be used as the rationale for later disallowing a deduction for the demolition loss.

Conclusion

As a result of the present confusion in the state of the case law and the multiplicity of arguments for and against deductibility, it is likely that the *Feldman, Hightower-Landerman, Foltz* split will grow to include other courts. In the meantime, prospective lessors who find themselves in the position of having to surrender demolition rights to lessees should frame demolition provisions in optional terms in anticipation of acceptance of the *Feldman* rule, as well as ensuring that they will be compensated in the event their deductions are disallowed. It has been suggested that the lessor could require the lessee to reimburse him for the projected difference in tax dollars between an immediate loss deduction and the amortization write-off, in the event the loss is disallowed.[74]

In the long run, it is hoped that a consistent treatment of demolition losses eventually will be developed. The present inconsistencies between section 1.165-3(b)(1) and section 1.165-3(b)(2) provides the explanation of why the Service has been content merely to recite section 1.165-3(b)(2) in the four principal cases, rather than affirmatively arguing "substitution of assets". It is well accepted that the Internal Revenue Service is not permitted to argue against its own regulations. In any event, inconsistencies permeating the entire area of demolition losses are sufficient to justify an inquiry into the basic rationale for determining when a loss is compensated under section 165(a). And since new regulations are now being contemplated, this would appear to be an appropriate time for a revision of the whole of section 1.165-3 into a uniform treatment of demolition losses in every context.

73. This possibility was suggested as an undesirable extention of the "substitution of assets" theory in Raby, *New Regulations Clarify Loss on Demolition of Leased Property*, 13 J. of Taxation 227 (1960).

74. 36 J. of Taxation 235, 236 (1972).