TREASURY PLAYS "HIDE THE DEDUCTION," WITH THE LESSOR'S DEMOLITION LOSS

Long term leases of real property with improvements frequently contain a provision granting the lessee a right to demolish and replace the structures. Such a clause is essential to the protection of the lessee; lest he may be confronted with a situation in which he is bound by the lease to pay rent, yet prevented from using the leasehold advantageously because of the presence of dilapidated, outmoded or unsuitable buildings which he is legally powerless to remove.[1] Prior to 1960, inclusion of a permissive demolition clause beneficial to the lessee may have been detrimental to the "best" tax interest of the lessor. "[S]eeing this provision in the lease, eagle-eyed Revenue Agents matter-of-factly disallowed the lessor's loss [deduction] on demolition."[2] In support of this position, the Service maintained that the "loss" had been compensated[3] by the long term lease which the lessor would otherwise not have acquired.

The issuance of a new regulation by the Treasury in 1960 was apparently an attempt to define a "demolition loss" more accurately and to provide firm guidelines for the taxpayer. A "demolition loss", as now defined, is, in essence, a deduction taken from gross income when a building is razed. Comparison of the language in the 1960 regulations, section 1.165-3(a) and (b), with the 1939 regulations reveals that the modern version is decisively more liberal.

1. Raby, *New Regulations Clarify Loss on Demolition of Leased Property*, 13 J. TAX. 227 (1960). Demolition loss only applies to buildings used for a trade, business or a transaction entered into for profit. Treas. Reg. § 1.165-3(a) (1960). The amount of the deduction is to be the adjusted basis of the building plus the cost of the demolition, minus any salvage value received. Treas. Reg. § 1.165-3(b)(2) (1960).

2. Raby, *supra* note 1, at 228. Lessors argued they should be able to deduct the entire remaining adjusted basis of the building in the year of demolition.

3. INT. REV. CODE OF 1954, § 165(a) says that a loss incurred in the taxable year shall be allowed as a deduction unless compensated for by "insurance or otherwise". The Service maintains that the acquisition of the lease is compensation.

The earlier regulations provided that when a taxpayer bought real estate upon which a building was located, and razed that building to erect another in its stead, the owner had suffered no loss by reason of the removal. "[The basis] of the real estate, exclusive of the old improvement being presumably equal to the purchase price of the land and the building plus the cost of removing the useless building."[4] Although similar language is found in the first section of the new regulations,[5] a definite distinction can be drawn. The 1939 regulation, increasing basis, applied to *all* purchase cases where demolition subsequently occurred, whereas the 1960 regulation only denies a deduction when the realty is purchased *with the intent* to remove the structure. Thus, if the intent to demolish is formed subsequent to the time of acquisition, § 1.165-3(b) applies and the owner is entitled to the deduction which he had been previously denied under the prior regulations. Logic would dictate that this "intent test" should apply to all purchasers of real property, not only to those using their own property but to lessors as well; however, this logic is not reflected in the regulations or cases.

Controversy rages over the interpretation of § 1.165-3(b)(2) which provides: "If a lessor or lessee of real property demolishes the buildings pursuant to the *requirements* of the lease or . . . an agreement which resulted in a lease, no deduction shall be allowed to the lessor. . . ." (emphasis added) Two divergent translations of this language have developed in the post-regulation cases. First, the position taken by the taxpayers and adopted by the Ninth Circuit in *Feldman v. Wood*[6] is that the word "requirements" is to be given a strict interpretation and "unless the demolition is 'pursuant to the requirements' of the lease the loss sustained is to be allowed."[7] The Service maintained that "requirements" should

4. Treas. Reg. 118, § 39.23(e)-2 (1939). The first part of this section says that loss deductions due to voluntary removal or demolition of old buildings incident to replacement are allowed. The balance of the quoted paragraph says if property is purchased upon which a building is located, and that structure was subsequently razed in order to erect another, no deduction was allowed.

This section was interpreted by the courts to mean that if a building was demolished because it was unsuitable for further use, the transaction was deemed closed with regard to that asset and the loss was deductible. But, when a building was razed to clear the land in order to erect another, the result was merely to substitute a more valuable asset for one less valuable and the demolition loss was viewed as part of the cost of acquiring the new asset. 5 MERTENS § 28.22 at 84.

5. Treas. Reg. § 1.165-3(a)(1) (1960). "The entire basis of the property so purchased shall . . . be allocated to the land only."

6. Feldman v. Wood, 335 F.2d 264 (9th Cir. 1964).

7. *Id.* at 265.

be given a broader meaning which would include permission to demolish. This argument was summarily dismissed by the *Feldman* court—"[a] right to do an act is far different from a requirement to do it."[8]

Much to the consternation of the taxpayer-lessor, the approach propounded by the Commissioner has indeed been adopted by two circuits. The Seventh Circuit Court of Appeals, in *Landerman v. Commissioner of Internal Revenue*,[9] rejected the taxpayer's position and held that there was no reason to confine "requirements" to the narrow construction found in *Feldman. Landerman* relied upon *Webster's Dictionary* and defined "requirement" as "something required, wanted, needed, called for or demanded; a requisite or essential condition."[10] Demolition by the lessee pursuant to a permissive demolition clause was held not deductable as a loss. The Eighth Circuit, in *Foltz v. United States*,[11] rallied to the support of *Landerman* and the Commissioner, but without unanimous court approval. The dissent of District Judge Webster, in *Foltz*, offered a well reasoned and convincing opinion in which he supported the *Feldman* analysis and declared that *Landerman* "tortured the plain meaning of the regulation" to avoid its consequences, deductability.[12] The dissent also suggested that in light of the history of the regulation a restrictive interpretation was not only appropriate, but compelled.

EVOLUTION OF THE CURRENT REGULATION

Prior to the promulgation of the "new regulation"[13] in 1960, the

8. *Id.*
9. Landerman v. Comm'r of Int. Rev., 454 F.2d 338 (7th Cir. 1971).
10. *Id.* at 340.
11. Foltz v. United States, 458 F.2d 600 (8th Cir. 1972). Reversing the interpretation and decision of the District Court which had followed *Feldman.* Foltz v. United States, 322 F. Supp. 414 (W.D. Ark. 1971).
12. *Id.* at 605 (Dissenting opinion).
13. Treas. Reg. § 1.165-3(b)(2) (1960).

"If a lessor or lessee of of real property demolishes the buildings situated thereon pursuant to the requirements of the 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 proceeds from demolition, shall be considered part of the cost of the lease to be amortized over the term thereof." [Hereinafter referred to as the Regulation; the new Regulation; or § 1.165 3(b)(2).]

test evolved from the case law for the determination of the demolition loss deduction turned on whether or not the demolition was necessary to the "purposes of the lease".[14] The tenor of these old cases was that the adjusted basis of the razed building was part of the cost of the new lease and as such should be capitalized and amortized over the term of the lease.[15] The lessee's obligation under the rental agreement, i.e. payment of rent, was not curtailed by removal of the structure and therefore no loss had been sutained by the lessor.[16]

The "purposes of the lease" test was ill defined and, in general, too broad and nebulous to be of any use to the taxpayer as a guideline in resolving his demolition loss dilemma. Apparently in an attempt to codify the case law and more adequately prescribe the boundries of the deduction, the Service proposed a new regulation in 1959 providing: "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). . . ."[17]

Despite the change in the wording from "purposes of the lease" to "pursuant to the terms of the lease", the problem of uncertainty in application was not alleviated. Consequently, at the taxpayer's hearing regarding the proposed terminology, the public argued that in light of the judicial decisions in years past, the phrase "pursuant to the terms of the lease" was capable of broad construction. The taxpayers urged that this language could be applied to deny a deduction to an owner where demolition was begun with a general intent to lease but prior to entering into negotiations with a specific tenant. The Service was requested to adopt a more narrow definition so that the loss would be denied only in cases where demolition was bargained for during the lease negotiations.[18]

The final regulation dropped the "pursuant to the terms" phrase and substituted the more limiting language, "pursuant to the requirements of the lease".[19] While the proposed language would

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14. Blumenfeld Enterprises, Inc. v. Comm'r of Int. Rev., 23 T.C. 665, 671-672 (1955); aff'd by 252 F.2d 396 (9th Cir. 1956).

15. Spinks Realty Co. v. Burnet, 62 F.2d 860, 861 (D.C. Cir. 1932).

16. Blumenfeld Enterprises, Inc. v. Comm'r, 23 T.C. 665, 671.

17. Proposed Treas. Reg. § 1.165-3(d), 24 Fed. Reg. 8177, 8180 (1959).

18. Knight, *New Regulations on Demolition Losses Formalizes the Critical Intent Test*, 12 J. TAX. 218, 220 (1960).

19. Treas. Reg. § 1.165-3(b)(2) (1966). *See* note 13 *supra*. It should also be noted that this regulation instituted the intent test in paragraph (b)(2) effectively liberalizing the deduction for owner-demolishers. This seems to add weight to the argument of the taxpayer that the new Regulation was meant to be a modification of the old law rather than a mere restatement.

have applied to all cases in which demolition was authorized or mandated by the lease agreement, the adopted "requirements" terminology appeared to restrict the application of the regulation to those instances in which one of the parties was obligated, by the lease, to demolish. From this change it could be inferred that the I.R.S. had indeed acquiesced in the argument of the taxpayers and thus more narrowly restricted the instances in which the deduction should be denied. One commentator has observed:

> [W]e are at last in a position to reach some certainty on the treatment of these losses. The Treasury is to be congratulated on its modification of the proposed regulations. [The statement is qualified by a well deserved caveat.] If they are now administered in the same reasonable spirit as they were formulated, perhaps one area of controversy has been settled.[20]

The refreshing clarity of the new regulations notwithstanding, the Treasury has steadfastly continued to maintain its stale, obfuscatory position of the pre-1960 regulation era.

THE TREASURY'S STAND

Four years passed between the promulgation of § 1.165-3(b)(2) and *Feldman v. Wood*,[21] the first case interpreting the "requirement" language. The *Feldman* court strictly construed the word "requirement" and allowed the deduction where the lessee, by the terms of the lease, was permitted, but not required, to demolish the structures on the leasehold.[22] The Commissioner flatly rejected *Feldman*,[23] expressing the longstanding position of the Internal Revenue Service that the lessor is not entitled to a demolition loss where the removal was either permitted or required by the terms of the lease. This position is reflected in *Blumenfield Enterprises, Inc. v. Comm'r.*,[24] and the pre-regulation cases advocating the "purposes of the lease" test. The Service contends

20. Raby, *supra* note 1, at 229.
21. The Treasury has taken the position, Brief for Appellant, at 13, *Hightower v. United States*, 463 F.2d 182 (5th Cir. 1972); that the first case was *Nickoll's Estate v. Comm'r*, 282 F.2d 895 (7th Cir. 1960). This is incorrect because *Nickoll's* involved a lease agreement entered into during 1953. Therefore, *Nickoll's* was decided pursuant to the pre-1954 regulations because the new 1960 regulation applies to all cases arising after December 31, 1953. Proposed Treas. Reg. § 1.165-3, 24 Fed. Reg. 8177, 8180 (1959).
22. 335 F.2d 264 (9th Cir. 1964). *See* text at notes 8, 9, and 10.
23. Rev. Rul. 67-410, 1967-2 CUM. BULL. 93, at 94.
24. 23 T.C. 665.

that the regulation echoes the prior judicial decisions and was "not intended to liberalize that position by allowing the loss where the demolition is permitted (as opposed to required) by the terms of the lease."[25]

Viewing the old cases, the proposed and adopted regulations, and *Feldman* in retrospect, it seems that the logical approach is that taken by the Ninth Circuit, in *Feldman*, and recently upheld by the Fifth Circuit's decision in *Hightower v. United States*.[26] For the Service to argue that the new regulations were not designed to work a modification of the older decisions is ludicrous, if one stops to consider the history of the regulation.[27] The old "purposes of the lease" phraseology is perfectly compatible with the originally proposed wording of the regulation—"pursuant to the terms of the lease." Had the intent of the Treasury been to encompass permissive demolition, either the "pursuant to the terms of the lease" clause *or* the "purposes of the lease" clause would have been ideally suited to the task. Instead of retaining this terminology, "requirement" was inserted. After close scrutiny of the Commissioner's position, the essence of the argument appears to be that the change in the language was merely a substitution of one phrase for another, with no re-definition and no ramifications. (If this is true, why the change?)

Refusing to accept *Feldman*, the Commissioner adheres instead to the all inclusive *Landerman* definition.[28] The Treasury concludes that since the meaning 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."[29] Therefore, it is the Ninth Circuit, not the Service, who has erroneously applied the regulation so as to work a modification of the statute, thereby offending the basic concept of a loss deduction.[30] This determination is arrived at by retreating to the earlier philosophy which considers demolotion or the right to demolish as the *quid pro quo* for the lease agreement[31] and, consequently, the lease is a new asset to be substituted for the razed building. Pursuing this line of "reasoning", it is contended that the lessor is further compensated for the razed structure

25. Rev. Rul. 67-410, 1967-2 CUM. BULL. at 94.
26. Hightower v. United States, 463 F.2d 182 (5th Cir. 1972). A strict interpretation of "requirements".
27. *See* text, *supra* at notes 17, 18, 19.
28. 454 F.2d at 340. *See* text, *supra* at note 10.
29. *Id.*
30. Brief for Appellant at 15, Hightower v. United States, 463 F.2d 182 (5th Cir. 1972).
31. Spinks Realty Co. v. Burnet, 62 F.2d at 861.

(thus no loss deduction) when the leasehold reverts to him encumbered with a building erected by the tenant at no cost to the landlord.[32]

Continuing this compensation campaign, the Treasury attacks *Feldman* upon its facts, because the lease term outlasted the useful life of the buildings involved and following destruction the rent payable to Feldman remained unchanged.[33] This, therefore, demonstrated that the lessor had "substituted assets" and, consequently, had sustained no loss. Since the benefit of a loss deduction is available only when the taxpayer can establish his loss,[34] Feldman was not entitled to the demolition deduction. The Eighth Circuit has ruled, in *Foltz*, that to hold otherwise and allow the deduction "whenever a lessee demolishes pursuant to an optional clause, would be to subvert the underlying statutory mandate. . . ."[35] Flimsy rationale supports this "no loss" fixation: the taxpayer has suffered no loss since he has retained the right to depreciate the adjusted basis of the buildings over the *term* of the lease, whether or not the structures have been leveled. Furthermore, the right to a demolition loss was bargained away in the lease agreement by the conferral of permission upon the tenant to raze the structure. As a consequence of this bargaining, the lessor was "otherwise compensated" within the meaning of section 165(a) of the Internal Revenue Code.

Cursory consideration of the reasoning above might permit acceptance, but contemplation of commercial realities as opposed to mere abstract hypothesis reveals the error in the Treasury doctrine. Instead of *bargaining* for the permissive demolition clause, thereby "exchanging assets", the lessor may automatically include such a provision in the lease. He may even be forced to include it due to external pressures dictated by prevailing commercial practice.

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32. *Id.* at 862. Consider the logic of this argument. A large percentage of the long term leases involving this problem are ninety-nine years in length. How much compensation does the lessor receive if the "new" building, reverting to his heirs or assigns, was erected at the outset of the lease, thus making it a century old when it reverts? The lessee is not likely to erect another building on the leasehold immediately preceding the termination merely to compensate the landlord.

33. Feldman v. Wood, 335 F.2d 264.

34. Blumenfeld Enterprises, Inc. v. Comm'r, 23 T.C. 665.

35. 458 F.2d at 602.

Without a permissive demolition clause the tenant would be trapped:[36] the leasehold may become useless due to a change in the demands of the lessee's business or the age of the structures, and yet he would be bound to pay rent without the alternative of modifying the premises for productive use. At this point, the tenant would be in an awkward bargaining position and, even if the lessor does eventually permit demolition, the lessee may have to agree to increase his rental payments in exchange for this privilege. Clearly it is not in the best interests of the tenant to enter into a long-term lease devoid of a demolition clause; consequently, the prospective lessor must either insert the permissive provision and suffer the inevitable tax consequences, or seek the fortuitous alternative of an unsophisticated lessee.

Distinctions which are unwarranted are implicit in the Service's overall approach to demolition losses. For example, according to the regulations,[37] an owner who razes his structures prior to offering the property on the rental market is entitled to a demolition loss deduction, provided he did not acquire the property with the intent to demolish. By removing the building, the owner will not only derive the tax benefit of the demolition loss, but may also demand a higher rental for the property. The land may be worth considerably more to potential tenants as unencumbered realty, the reason: an outmoded building limits the uses to which the premises might otherwise be put; and permitting demolition at the tenant's expense will certainly diminish capital that might instead be spent for rent. Thus, a lessor who rents with a permissive demolition clause is not only deprived of the loss available to owners, but, continuing the premise, is also unable to demand as much rent because the lessee will have to level the building at his own expense. This discrimination is supposedly remedied by allowing the lessor to amortize the adjusted basis of the asset over the term of the lease,[38] a less beneficial alternative. Thus, instead of deducting all of the remaining adjusted basis in the year of demolition and thereby maximizing the tax benefit, the taxpayer is required to amortize over the *entire* term of the lease. Frequently the lease period will exceed the remaining useful "depreciation life" of the asset and, as a consequence, the disparity in tax treatment between the owner and the lessor is further widened.

36. The remedy of commercial frustration would not be available to the lessee. His failure to insist upon a demolition provision would merely have constituted a bad bargain on his part. Perry v. Champlain Oil Co., 101 N.H. 97, 99, 134 A.2d 65, 67 (1957).
37. Treas. Reg. § 1.165-3(b)(1).
38. Treas. Reg. § 1.165-3(b)(2).

An additional contention of the Service, advanced to support the propriety of *Landerman's* broad construction of the word "requirements", finds its foundation in what is argued to be the intent behind the regulation. Based on the early cases and the evolution of the prior regulations, ". . . 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."[39] Therefore, to determine whether the demolition qualifies for loss treatment, attention must be focused on the intent of the parties during the lease negotiations. If, during negotiations, the parties intended to raze the building, subsequent demolition falls within the "requirements" of the lease and no deduction is allowed.[40] Applying this test, the Commissioner maintains the actual language of the lease is not important. The underlying circumstances leading to the formation of the lease agreement determine the deductibility of the "loss". If demolition is an integral element of the bargaining no deduction is allowed. Incontrovertibly this approach closely parallels the spirit of the regulations "requirement" clause, because to the extent the lessor is assured by the preliminary lease negotiations that the tenant will raze the structure, the same end is achieved as if the lease "required" the destruction.[41] The rationale of this approach comes full circle and returns to the Treasury's main theme, if demolition is contemplated the lessor will surely protect his economic interest

39. Landerman v. Comm'r of Int. Rev., 454 F.2d at 341.
40. *Id.*
41. Brief for Appellant at 18, Hightower v. United States, 463 F.2d 182. The early cases denied the deduction when demolition was *intended* at the inception of the lease, was a part of the bargaining process or was accomplished pursuant to the "requirements" of the agreement. *Blumenfeld Enterprises, Inc. v. Comm'r*, 23 T.C. 665 (1955), *aff'd per curiam*, 232 F.2d 396 (9th Cir. 1956); *Spinks Realty Co. v. Burnet*, 62 F.2d 860 (D.C. Cir. 1933). "The regulation interprets Section 165 to mean that a lessor's loss of his remaining basis will be deemed compensated for by insurance or otherwise where the lease, or collateral agreement of the parties, requires demolition since . . . where this is the situation the parties invariably intend demolition in entering the lease, and provide for the lessee's obligations to compensate the lessor for his loss in terms of the rentals and/or the lessee's replacing the demolished improvements. . . ." Brief for Appellees at 17, Foltz v. United States, 458 F.2d 600 (8th Cir. 1972). In this context the presumption of compensation in a "requirement" lease may well have to be conceded to have merit. But this logic does not carryover to "permissive" demolition clauses.

in such a manner as to be adequately and fully compensated.[42] The circuity of this argument may well be acceptable when solely applied to lessors. However, the argument becomes questionable because it is not equally applied to owners. For if a landlord is presumed to be sufficiently astute to insure that removal of his structures will be adequately compensated by future rental payments, why is the owner who razes his own building entitled to a demolition loss, when he can subsequently lease the premises and demand a higher rental by allowing the tenant to erect a building to his own specifications?

Furthermore, why does the Treasury presume the lessor has been adequately compensated by the lease agreement? As previously discussed,[43] it is *at least* as logically consistent with reality to assume that the lessor has given his tenant the option to demolish because he could not otherwise rent the property. Secondly, he may have been depending upon the loss deduction, rather than the rental income, to make him whole. To require amortization of this loss over the term of the lease denies him a loss he could otherwise have taken had he demolished first and then leased; tax planning demands an election by the owner.

THE TAXPAYER'S POSITION

In *Feldman* the court attached a plain meaning to the regulation and decided that the clause, "pursuant to the requirements of the lease", did not encompass "permission".[44] The Ninth Circuit reasoned that the pre-regulation and proposed regulation tests (denying a demolition deduction when accomplished via the terms or purposes of the agreement) were superseded by the "requirements" phrase included in the final version of § 1.165-3(b) (2). "Not only does this provide the desirable attribute of certainty, but in our judgment the line drawn cannot be said to be unreasonable."[45]

Upholding *Feldman, Hightower v. United States* allowed the loss where demolition by the lessee was pursuant to an option, election, or permissive clause in the lease.[46] Only required removal

42. Brief for Appellees, *Id.* at 17.
43. *See* text *supra* at note 36.
44. 335 F.2d at 265.
45. *Id.* at 266. The reference to "unreasonableness" is made by the court in deference to the well settled law that Treasury Regulations must be upheld unless *unreasonable* and plainly inconsistent with the revenue statute. *Comm'r v. So. Tex. Lumber Co.*, 333 U.S. 496, 501 (1948).
46. This language is found in the District Court opinion in the *Hightower* case. *Hightower v. United States*, 346 F. Supp. 707, 712 (M.D. Fla. 1971).

was proscribed. A strong dissent in *Foltz v. United States*,[47] supported the taxpayer's position and emphasized that excluding "permission" was consistent with the fact that the "pursuant to the terms" language of the proposed regulations was opted in favor of the "requirement" terminology and, therefore, a narrow construction of the new language was mandated.[48]

A favored objection raised by the Service is that *Feldman* is inconsistant with the statute since the lessor is being compensated by the lease. By way of opposition, the Ninth Circuit responded:

> The question is not whether demolition is economically advantageous or disadvantageous to the owner. (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.)[49]

This reasoning and narrow construction allows, as nearly as possible, similar treatment for owners and lessors.

The Treasury's reliance upon *Landerman* is warranted when limited to the facts, but its universal dependence upon *Landerman's* definitional approach to "requirements" is misplaced. In *Landerman*,[50] demolition was at all times contemplated by the parties. The lessee intended to erect a parking garage and nego-

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47. 458 F.2d at 604. "For me the word 'requirements' means nothing less than that which mandates a specific act or forbearance . . . I do not find in the dictionary definition cited in *Landerman* or in the majority opinion any words which connote 'taken into consideration' or 'contemplated' or 'anticipated'."

48. It is interesting to note that the Treasury has argued for a narrow construction of the word "requires", when such construction would benefit the Service. In *Kurt Frings Agency v. Comm'r*, 42 T.C. 472 (1964); the Service argued over the meaning of Treas. Reg. § 1.543(b)-1(b)(8)(ii). This regulation deals with determination of personal holding companies and says in part: ". . . an allocation of income must be made if the contract . . . *requires* the performance of services. . . ." (emphasis added). The court, at page 479, sustained the Service's argument: "[R]equires . . . must be given its ordinary and common meaning . . . to interpret 'requires' to mean 'may require' would be contrary to the regulation. In accordance with the policy of strict interpretation of statutes of this nature . . . we give a strict interpretation to the regulation." It would appear that the Treasury had misplaced the dictionary upon which it relied so heavily in *Feldman, Landerman, Foltz* and *Hightower*. (Or has the Service merely been caught with its hand in the proberbial cookie jar?)

49. Feldman v. Wood, 335 F.2d at 266.

50. 454 F.2d 338.

tiations focused upon the possibility of razing the existing structure and which of the parties should bear this burden. The premises were leased with a permissive demolition clause and the loss was denied. Although the decision unduly strains the definition of "requirements",[51] the holding does find proper foundation in the "compensation argument".[52] Demolition was expected and both the duty of removal as well as the permissive demolition clause were bargained for during the negotiations. Additionally, the leveling of the building was an underlying condition without which the lessee would not have rented. Thus, it must be conceded to the Treasury that the lessor, presumably, had been compensated through the active bargaining process.

A similar situation and conclusion must be found in *Holder v. United States*,[53] in which the court found no bona fide loss. The lease required that upon termination of the ninety-nine year leasehold, the tenant was obligated to return the premises with a warehouse of specified dimensions and value. Again, the decision was founded upon the bargaining process and the resultant compensation rather than regulatory construction.

Neither *Feldman*[54] nor *Hightower v. United States*[55] involved active bargaining for the demolition provision nor the additional compensation found in *Holder*. Permissive demolition clauses were included in both leases and the courts concerned applied the regulation strictly, found no requirement language, and consequently allowed the deduction.

Perhaps the best reason for accepting the historical evolution and plain meaning construction of the new regulation, is to be found in a 1932 grabbag case, *Smith Real Estate v. Page*.[56] The court was impressed with the plaintiff's logic that whenever possible a lessor

51. *See* text, *supra* note 10.
52. *See* text, supra at notes 31 and 36.
53. Holder v. United States, 444 F.2d 1297 (5th Cir. 1971).
54. 335 F.2d 264. Taxpayer entered into a ninety-nine year lease of his realty encumbered with a warehouse and filling station. The remaining useful life of the buildings was twenty-five years. Noting the discrepancy between lease term and building life, one realizes that a demolition clause was necessarily included.
55. 463 F.2d 182. Premises leased included three row houses over 100 years old. Although lessee was a bank and would not have entered into a long term lease without permission to demolish, is it possible to conceive of a lessee, other than an antique museum or a termite colony, who would be willing to rent 100 year old wooden buildings for 99 years without a demolition clause?
56. Smith Real Estate v. Page, 60 F.2d 592 (D. R.I. 1932). This case had something for everyone. The court adopted and agreed with the taxpayer's logic, but rendered the verdict for the Treasury.

of real estate should receive the same tax treatment as an owner; therefore, it should be of no consequence whether the owner or lessee removes the structure, when demolition would allow a more profitable use of the premises. Unfortunately, the logical concurrence was not carried through to the decision, for the court held that this area is so affected by artificial considerations and tax regulations that there is no great regard for legal logic.[57] To extend this groundless distinction any further than necessary (as urged by the I.R.S.), confounds the taxpayers and courts alike and defeats the "guideline" function of the regulations.

It is precisely this affliction from which the Eighth Circuit suffered when it rendered the *Foltz* decision. The smoke screen thrown out by the Treasury, with the aid of *Webster's Dictionary*, obscured the vision of the court and induced reliance upon the "permissive" interpretation in *Landerman*, without comparing the facts of the two cases.[58] *Foltz* was without the bargained for compensation[59] found in *Landerman*. Although the Eighth Circuit, in *Foltz*, was not bound to adopt the *Feldman* interpretation, logic dictated that it should. *Feldman* presented a lease factually identical to that before the court in *Foltz*. However, instead of following the sister circuit's interepretation, *Foltz* adhered to *Landerman*, a Tax Court case involving compensation coupled with overly broad construction.

Dissenting Judge Webster's attack on the opinion of the majority in *Foltz* pointed out that the "requirement" terminology was cer-

57. *Id.* at 594.

58. Foltz v. United States, 458 F.2d 600. The taxpayers leased their building to a bank, including a permissive demolition clause. The lessee had intended to use the existing structure but after execution of the agreement a contractor employed by the bank determined this would not be feasible. As a result the building was razed. The District Court properly followed *Feldman*.

59. The court points out that Dr. and Mrs. Foltz negotiated with one party and negotiations terminated when the owners refused to include a demolition clause. The court then concludes that when they rented to the bank at a rental higher than agreed upon with the previous potential tenant, that the lessor had been compensated by the increase. Nowhere is it reflected in the court's thinking that the most probable reason for the more favorable rental agreement was that the bank was adjacent to the lot in question. Since the tenant intended to use the lot to make a drive-in teller facility available to customers, the bank necessarily had to meet the lessor's price or abandon the plan.

tainly more narrow than the previous "pursuant to the terms of the lease" clause.[60] Moreover, despite the fact that the Commissioner argued otherwise, no attempt to clarify the language of the regulation had been made by the Service in the eight years that had elapsed since *Feldman*.[61] As the court noted in *Smith Real Estate v. Page*,[62] artificiality may indeed play a part in the Treasury Regulations, but it should not be given such weight that it preponderates over factual identity and logic.

PROPOSED AMENDMENT

Responding to Judge Webster's persuasive dissent, the Commissioner has issued a proposed amendment[63] to the regulation in question in an attempt to "clarify" the tax treatment of buildings razed by lessees. The amended clause would read, "as required or permitted by a lease". Current regulations still contain the pre-amendment "requirement" language, so evidently the amendment is awaiting a taxpayer hearing or has been tabled.

The propriety of the amendment is, at the very least, questionable. Since Section 165(a)[64] allows deduction of losses not "compensated", the Service should concentrate on policing demolition which is compensated by the lease agreement, rather than proclaiming that any demolition accomplished pursuant to specified language will not qualify for the deduction. The regulations are to be used to enforce the spirit of the Code section—loss deductability in the absence of compensation. To deny the deduction merely because certain words are used is the epitome of form over substance. Upon what foundation can the Service rationalize the distinct difference in treatment between owners who demolish and are permitted the deduction, and the owner-lessor who allows his tenant to demolish? The Treasury would have us believe that there is a difference between the two transactions, or more specifically, that the lessor is being compensated by the lease for the loss. The distinction is lacking. Each demolishes the building with a view towards some future benefit. An owner who razes the structure will undoubtedly hire an independent contractor to accomplish the

60. Foltz v. United States, 458 F.2d 600, 604.
61. The uninformative Revenue Ruling notwithstanding. Rev. Rul. 67-410, 1967-2 CUM. BULL. 93.
62. 60 F.2d 592, 594.
63. Proposed Treas. Reg. § 1.165-3(b)(2), 37 Fed. Reg. 7891 (1972). "If a lessor or lessee of real property demolishes the buildings situated thereon, as required *or permitted* by a lease or by an agreement. . . ." (emphasis added).
64. INT. REV. CODE OF 1954, § 165(a).

objective. Why not allow the lessor a similar deduction, if he is not clearly compensated by other than the rental provision, by treating the lessee as an independent contractor? (This treatment would have been appropriate in *Feldman, Hightower* and *Foltz.*) The Treasury, carrying artificiality to the extreme, has instituted a "requirement" that an owner may only take this special demolition loss when he elects to demolish prior to negotiating a lease.

IS THERE AN ALTERNATIVE?

In playing this game of "hide the deduction", both the Service and the taxpayers have overlooked one provision which may offer relief in certain instances. This aid may come from Treasury Regulation § 1.167(a)-8(a)(4),[65] which deals with the retirement of assets.

Scrutiny of the section reveals that it must certainly be a first cousin to the demolition loss. Pursuant to section 1.167(a)-8(a)(4) a taxpayer might successfully argue that it is patently clear that what the lessee wants to lease is the land alone. The building may be more of a liability than an asset due to zoning changes, the size or general condition of the structure, thereby making the land potentially more valuable without the old building.[66] Therefore the lessor rents the property with an option to raze the structure, retiring it from use because it has become useless as an income producing asset. The asset would then be irrevocably retired by abandonement when the destruction occurs, entitling the lessor to deduct the adjusted basis of the asset, (at least in theory), in a manner identical to the tainted demolition loss.[67]

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65. Treas. Reg. § 1.167(a)-8(a)(4) (1954). "Where an asset is retired by actual physical abandonment (as for example in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. . . . [T]he intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange or other disposition." Treas. Reg. § 1.167(a)-8(a): "For the purposes of this section the term 'retirement' means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income."

66. A similar argument was used in *Smith Real Estate v. Page*, 60 F.2d at 593. Lessor was trying to get a demolition loss. The court, using the "cost of the asset" approach prevalent in the depression cases, denied the deduction. The "retirement of assets" argument was not advanced.

67. One caveat is in order. The writer has found no cases discussing demolition in which this argument had been advanced.

Conclusion

Review of this problem by the Supreme Court seems unlikely.[68] In the twelve years since the troubled regulation was promulgated, only a handful of cases have litigated the matter. Defining of the regulation will probably be deemed not worthy of consideration by the Court.

Despite the lack of foundation for the Treasury's distinctly different treatment of owners and lessors, it is doubtful that the distinction will be dropped, or that the regulations regarding lessor's demolition deductions will be properly amended to reflect the compensatory language suggested in this discussion.[69] The lessor would perhaps be well advised to avoid litigating a demolition loss by trying to use one of the alternative methods discussed in the preceding pages.

Michael R. Moore

68. The Court denied certiorari in *Landerman*, indicating that fewer than four justices felt the matter was worth considering.

69. This is said in view of the vehemence with which the Service has argued "definitions" with the taxpayers, as well as in consideration of the Proposed Amendment offered by the Commissioner last spring.