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Under a 99-Year Lease, a Lessor, Who Permitted, but Did Not Require, His Lessee to Demolish His Buildings and Construct New Improvements, Was Entitled to a Deductible Demolition Loss under Section 165 of the Internal Revenue Code of 1954.

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is necessary to the particular result.[33] This proposal inures to the benefit of the insured.

Each case seems to be a question of comparative analysis in which two separate factors are present: (1) whether the means or causes were accidental, and (2) whether the preexisting disease was a condition contributing to the ultimate result. Additionally, "[t]he two basic problems underlying all of the cases are the definition of accident and the question of where to draw the line with respect to causation."[34]

The myriad of degrees between death or disability caused wholly by the accident, and death or disability caused solely by the preexisting disease is limitless. "The need for some clear and easy-to-follow rule which avoids both converting accident policies into life insurance and reducing the coverage to an absurdity is fairly apparent."[35]

The present difficulty of predicting insured's rights in an action in which both accident and preexisting disease combine to produce injury or death establishes a definite need for judicial guidance. It is not so important which rule the courts adopt. Of primary importance is the need of the claimant to have some basic guidelines to follow in determining his right to recovery, rather than the present system which provides only doubt and uncertainty.

Patricia Koch Irvine

INTERNAL REVENUE—DEMOLITION LOSSES—UNDER A 99-YEAR LEASE, A LESSOR, WHO PERMITTED, BUT DID NOT REQUIRE, HIS LESSEE TO DEMOLISH HIS BUILDINGS AND CONSTRUCT NEW IMPROVEMENTS, WAS ENTITLED TO A DEDUCTIBLE DEMOLITION LOSS UNDER SECTION 165 OF THE INTERNAL REVENUE CODE OF 1954. *Hightower v. United States,* 463 F.2d 182 (5th Cir. 1972).

Plaintiffs, Dr. and Mrs. Hightower, brought action in the Tax Court for refund of income tax deficiencies. Dr. Hightower in 1943, 1952, and 1961 purchased three adjoining parcels of real estate. Three buildings, approximately 100 years old, were located on the land and were used either for rental income or in relation with Dr. Hightower's medical practice. In 1963 plaintiffs and Fidelity Building, Inc., agent for Fidelity Savings & Loan Association, entered into a lease for 99 years. The lease gave the lessee the right to demolish the plaintiff's buildings. It

[33] Comment, *Pre-existing Disease and Accident Insurance: Pathology and Metaphysics in the Common Speech of Men,* 21 U. CHI. L. REV. 266, 274 (1954).

[34] *Id.* at 275. "Accident is an illusive needle in a semantic haystack, satisfactorily defined only by example." *Id.* at 272.

[35] *Id.* at 277.

was known that Fidelity Savings & Loan Association wanted the premises as a site for bank purposes. Both parties knew that Fidelity would not have entered into the lease contract if there were no demolition rights. Subsequent to the lease the buildings were demolished and a new building erected. In their 1964 income tax return the plaintiffs claimed a loss deduction due to the demolition. The Tax Court held for the plaintiffs and the Commissioner of Internal Revenue appealed. Held—*Affirmed.* Under a 99-year lease, a lessor, who permitted, but did not require, his lessee to demolish his buildings and construct new improvements, was entitled to a deductible demolition loss under section 165 of the Internal Revenue Code of 1954.

Section 165 of the Internal Revenue Code allows a taxpayer to deduct from his income tax during the taxable year a loss which is not compensated by insurance or otherwise.[1] The statute is silent, however, as to losses arising from demolition of buildings. The Treasury Regulations do allow deductions arising from demolished buildings,[2] but the loss must be an actual loss.[3] It must be substantive and not merely formative.[4] The burden of proof is on the taxpayer to prove the statutory basis for his loss.[5]

Hightower v. United States[6] was primarily concerned with a taxpayer's privilege to deduct a loss for his demolished buildings pursuant to Treasury Regulation 1.165-3(b)(2).[7] According to the Internal Revenue, prior to the adoption of the present regulation in dispute, it was the position of the Service that established case law did not allow a lessor-taxpayer to deduct demolition losses pursuant to a lease agree-

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1 INT. REV. CODE OF 1954, § 165.

(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.

2 Treas. Reg. § 1.165-3 (1960).

3 Holder v. United States, 444 F.2d 1297 (5th Cir. 1971). *See* Stivers v. Commissioner, 360 F.2d 35 (6th Cir. 1966) where the court sets out the four primary requirements that must be met for the basis of a loss deduction.

4 Treas. Reg. § 1.165-1(b) (1960).

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, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses. . . . Only a bona *fide* loss is allowable. Substance and not form shall govern in determining a deductible loss.

5 Burnet v. Houston, 283 U.S. 223, 227, 51 S. Ct. 413, 415, 75 L. Ed. 991, 994 (1931). *See generally* 5 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 28.05 (1969).

6 463 F.2d 182 (5th Cir. 1972).

7 Treas. Reg. § 1.165-3(b)(2) (1960):

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 or 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.

ment.[8] It did not matter whether the lessee was permitted[9] or obligated[10] to demolish the lessor's buildings.

The crucial question, as far as the Internal Revenue is concerned, is whether the present regulation changes the prior policy so as to liberalize it and allow a demolition loss, where, under a lease, the lessee has the permission, but not the obligation, to destroy the lessor's buildings.[11]

Prior to the adoption of the present regulation, the courts recognized that if a taxpayer voluntarily destroyed his buildings he could get a loss deduction.[12] The courts, however, would look at the economic circumstances of the transaction and if it were found that the demolition was in anticipation of a subsequently executed lease contract, no deduction was allowed since the lessor sustained no actual loss.[13] The rationale of the prior cases was that the taxpayer allowed his buildings to be cleared for the purpose and as part of the cost of obtaining or securing a lease. The new asset compensated the lessor for the value of the old asset, the demolished buildings. There was, in essence, a *quid pro quo* or substitution of assets.[14] The cost of acquiring an asset was not deductible as a loss in the year in which it was paid or incurred.[15] Since the undepreciated value of the building destroyed contributed to the cost of the new lease, the remaining undepreciated basis of the cleared building had to be amortized over the terms of the lease.[16]

In 1959 the foundation for the present controversy was laid. In that year the Internal Revenue proposed for the first time a new regulation concerning demolition losses within the context of a lease. The Proposed regulation would have disallowed a deduction if the demolition was "pursuant to the terms of a lease."[17] The regulation finally

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8 Rev. Rul. 67-410, 1967-2 CUM. BULL. 93.

9 Blumenfeld Enterprises, Inc. v. Commissioner, 23 T.C. 665 (1955), *aff'd*, 232 F.2d 396 (9th Cir. 1956); Anahma Realty Corp. v. Commissioner, 42 F.2d 128 (2d Cir.), *cert. denied*, 282 U.S. 854 (1930).

10 Manning v. Commissioner, 7 B.T.A. 286 (1927); *accord*, Spinks Realty Co. v. Burnet, 62 F.2d 860 (D.C. Cir. 1932), *cert. denied*, 290 U.S. 636 (1933); Smith Real Estate v. Page, 67 F.2d 462 (1st Cir. 1933); Continental Ill. Nat'l Bank & Trust Co. v. United States, 18 F. Supp. 229 (Ct. Cl. 1937).

11 Rev. Rul. 67-410, 1967-2 CUM. BULL. 93.

12 Dayton Co. v. Commissioner, 90 F.2d 767 (8th Cir. 1937). *See generally* 5 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 28.22 (1969).

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

14 Manning v. Commissioner, 7 B.T.A. 286, 290 (1927).

15 Anahma Realty Corp. v. Commissioner, 42 F.2d 128, 130 (2d Cir.), *cert. denied*, 282 U.S. 854 (1930).

16 Blumenfeld Enterprises, Inc. v. Commissioner, 23 T.C. 665 (1955), *aff'd*, 232 F.2d 396 (9th Cir. 1956).

17 Proposed Treas. Reg. § 1.165-3(d), 24 Fed. Reg. 8177, 8180 (1959). The original proposed regulation read:

> Buildings demolished to obtain lease. If, pursuant to the terms of a lease, the lessor of real property demolished buildings situated thereon, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings . . . .

adopted[18] changed the wording from "pursuant to the terms of a lease" to "pursuant to the requirements of a lease or the requirements of an agreement which resulted in a lease." Since the adoption of the current regulation the issue of allowing or denying a demolition loss growing out of a lease agreement has arisen in four circuits. The courts for these circuits have equally divided over the interpretation to be given the current regulation.

The first case to apply the new regulation was *Nickoll's Estate v. Commissioner.*[19] The lessee, although no mention as to demolition was in the lease, was obligated in effect to demolish since he had to make additions and improvements to the lessor's premises after gaining possession. Since the case arose prior to the adoption of the present regulation the taxpayer did not rely on it. Instead reliance was placed upon a line of cases based on *Union Bed & Spring Co. v. Commissioner*[20] which stood for the proposition that if demolition occurred as a result of a plan formed after the purchase of a building by a taxpayer, a demolition loss was allowable. The court distinguished the *Union Bed* case on the ground that it involved a purchase of land, not leases. Since the *Nickoll's* case involved demolition under a lease, the court stated:

> 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.[21]

The court merely applied the reasoning of the prior case law and stated further that this reasoning was consistent with the then recently formulated regulation now disputed.[22]

Four years after *Nickoll's Estate,* one of the two cases which has generated the most discussion involving the present issue was decided. In *Feldman v. Wood*[23] the Court of Appeals for the Ninth Circuit was concerned with a 99-year lease whereby the lessee was given the right to demolish for the purpose of providing for an additional parking area and making other improvements. Two years after the lease was entered into the buildings were removed. In *Feldman* the Internal Revenue presented three arguments. The first was the familiar rationale of prior

18 T.D. 6445, 1969-1 CUM. BULL. 93.

19 Nickoll's Estate v. Commissioner, 32 T.C. 1346 (1959), *aff'd,* 282 F.2d 895 (7th Cir. 1960).

20 39 F.2d 383 (7th Cir. 1930). *See also* Providence Journal Co. v. Broderick, 104 F.2d 614 (1st Cir. 1939); Liberty Baking Co. v. Heiner, 37 F.2d 703 (3d Cir. 1930); Lynchburg Nat'l Bank & Trust Co. v. Commissioner, 20 T.C. 670, *aff'd,* 208 F.2d 757 (4th Cir. 1953).

21 Nickoll's Estate v. Commissioner, 282 F.2d 895, 897 (7th Cir. 1960).

22 *Id.* at 897.

23 335 F.2d 264 (9th Cir. 1964).

case law—the right to demolish was bargained for; it was part consideration for the lease; and there was a substitution of assets. Therefore no loss under section 165 had been sustained. The court responded by stating that the Internal Revenue's argument was not what the regulation said. Unless the demolition was "pursuant to the requirements" of a lease, the alleged loss was allowable.[24]

Secondly, the Internal Revenue argued that the word "requirements" in a lease should include permissive demolition clauses. The court disagreed. "A right to do an act is far different from a requirement to do it."[25]

Lastly, it was felt by the Service that to allow a deduction where the lessee is permitted but not required to demolish would in effect allow a deduction where no economic loss was really sustained. In these instances the lessor really has no interest in the demolished building, therefore no loss should be allowed. The argument was not persuasive. The taxpayer still had an interest in the removed building because he remained the owner and retained the capital investment in it.[26] The court also took judicial notice of the earlier "purposes of the lease" test applied in determining losses. But here the court believed that this test was superseded by the "requirements of a lease" language found in the regulation. Moreover, the court gave its interpretation of the regulation by stating:

> The question, then, 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 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 question, rather, would seem to be whether the property demolished was then to be regarded as being used by the taxpayer in a trade or business for production of income.[27]

Consequently the regulation would provide the necessary certainty and answer the question whether the taxpayer regarded the removed structures as still valuable or not. So, unless there was a mandatory obligation in the lease that the lessee remove the lessor's buildings, the regulation would presume that the parties bargained for both the land and the beneficial use of the buildings, and not the land alone. Thus, a loss deduction would be available.[28]

The Court of Appeals for the Seventh Circuit's decision in *Lander-*

[24] *Id.* at 265.
[25] *Id.* at 265.
[26] *Id.* at 265.
[27] *Id.* at 266.
[28] *Id.* at 266.

man v. Commissioner,[29] which the Internal Revenue supports, is in conflict with *Feldman*. The partnership-lessor in *Landerman* entered into a 55-year lease which contained a right-to-demolish provision. The lessee later exercised his option, cleared the premises, and erected a parking garage and branch bank. Contending they were entitled to a loss, the taxpayers relied heavily on *Feldman*. The Court of Appeals for the Seventh Circuit did not. This court held that the word "requirement" meant more than a formal obligation. The meaning of "requirement" was broad enough to include something wanted or needed, an essential condition. The Court of Appeals for the Ninth Circuit's construction in *Feldman* was too narrow.[30] The court in *Landerman*, as did the *Feldman* court, acknowledged the previous case law in this area, but further observed:

> The principal focus of those decisions involved an inquiry into the financial implications of each factual situation. Against the background of these cases and the evolution 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.[31]

Therefore, the test, if it is a test, for deductibility of demolitions in the Seventh Circuit depends upon the parties' intent to raze the buildings at the time the lease was made. If the intent was to remove the buildings, the demolition would be a requirement of the lease and thus not an allowable deduction. It also makes no difference whether the lessee was or was not obligated to take down the lessor's buildings. The distinction was artificial because under either test the taxpayer has sustained no loss. He gave up his right to retain the buildings for acquiring the lease rights.[32] It appears, then, that in the Seventh Circuit it is extremely difficult, if not impossible, for a taxpayer ever to get a demolition loss. This of course would seem to be in line with the earlier case law.

Recently the Court of Appeals for the Eighth Circuit joined the controversy. This court supports *Landerman*. In *Foltz v. United States*[33] the taxpayers had originally entered into negotiations with a municipal parking authority. The authority wanted to lease the taxpayer's land for the purpose of erecting a multi-story garage. The negotiations terminated, partly due to the fact that the taxpayer refused to include a demolition clause in the lease. Subsequently the taxpayer entered into

29 454 F.2d 338 (7th Cir. 1971), *cert. denied*, — U.S. — (June 6, 1972).
30 *Id.* at 340.
31 *Id.* at 340-41.
32 *Id.* at 341.
33 458 F.2d 600 (8th Cir. 1972).

a lease agreement with a bank whose negotiating representative was the same individual who represented the parking authority. The lease provided for substantially higher rental payments than those payments contemplated in the earlier negotiations. The lease contained a permissive demolition clause with the added condition that any improvements constructed after demolition had to have the lessor's written consent. Unsurprisingly, the petitioners placed exclusive reliance on *Feldman.* But here the court argued that to follow *Feldman* would be to undermine the "underlying statutory mandate that only uncompensated losses be deductible, for a permissive demolition well might redound to the financial benefit of a lessor."[34]

Justice Webster dissented in *Foltz,* however, and thought that *Feldman* should have been followed. He argued that the *quid pro quo* was not the demolished building for the lease but the demolished building for the lessor's obligation to build another structure.[35]

The instant case, *Hightower v. United States,*[36] was a case of first impression in the Fifth Circuit. The court disagreed with *Landerman* and felt the *Feldman* decision and the dissent in *Foltz* more consistent with the regulation and not inconsistent with the Code.[37]

In *Hightower,* the lessor knew that the lessee would not have entered into the lease if there were no demolition rights. The right was essential to the lessee because it was a virtual certainty that the lessee's principal, Fidelity Savings & Loan Association, would construct a related banking facility subsequent to demolition. But the court in *Hightower* held that the lessee was permitted, not obligated, to demolish, therefore the lessor could take his loss. The position of the *Hightower* court can be more clearly seen by juxtaposing *Holder v. United States*[38] with *Feldman.*

In *Holder,* the taxpayer entered into a lease contract which gave the lessee the right but not the obligation to demolish. The district court, relying on *Feldman,* allowed the taxpayer to deduct his loss. The Court of Appeals for the Fifth Circuit reversed the district court on the ground that the taxpayer had failed to sustain a loss under section 165. The court held that the taxpayer did not lose anything, basing its decision in part on *Blumenfeld Enterprises, Inc. v. Commissioner,*[39] a pre-regulation case. The essential difference between the *Hightower* and *Holder* cases is that in *Hightower* the lessee, after exercising his right to demolish, was then under no formal obligation to rebuild. However, in *Holder,* once the lessee exercised his right to demolish, he was then

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34 *Id.* at 602.
35 *Id.* at 605.
36 463 F.2d 182 (5th Cir. 1972).
37 *Id.* at 183.
38 444 F.2d 1297 (5th Cir. 1971).
39 23 T.C. 665 (1955), *aff'd,* 232 F.2d 396 (9th Cir. 1956).

obligated to construct buildings meeting certain specifications and certain cost expenditures.

The *Feldman* and *Holder* cases are difficult to distinguish. In both cases the lessee had the right to demolish and in both cases the lessee had the duty to rebuild upon execution of this right.[40]

Feldman allowed a demolition loss but *Holder* did not. The implication, then, is that in the Fifth Circuit the emphasis is not exclusively on the right or obligation to demolish but on the right or obligation to rebuild in determining a demolition loss. This implication is contrary to the holding in *Feldman*. The *Feldman* court did not require the taxpayer to prove his loss. The regulation would presume and dictate that he did sustain a loss, unless there was a mandatory obligation on the lessee to demolish. The *Feldman* court did not and would not make an examination into the transaction beyond the permission-obligation dichotomy test. This test *was* sufficient and implied that form over substance was the controlling factor.[41] The Court of Appeals for the Fifth Circuit in *Holder* made an inquiry and found no bona fide loss had occurred.[42] It appears therefore that in the Fifth Circuit a demolition loss pursuant to a lease agreement is a two-step process:

a. Is the lessee required to demolish?
b. Is there an obligation that the lessee rebuild?

A "yes" answer to either *a* or *b* would result in the court construing the lease agreement as being made "pursuant to the requirements of a lease." On the contrary, if both answers are "no" then the lessor can claim his loss.

The present controversy among the several circuits would not have arisen but for the ambiguous regulation. As stated earlier, the proposed regulation read "pursuant to the terms of a lease." A possible answer to why the wording of the adopted regulation was changed from "terms" to "requirements" may be found in the 1959 hearings conducted to solicit comments on the proposed regulation. At the hearings an argument was made that the scope of the proposed regulation, although the language was precise, was too broad. It could have applied, for instance, to a situation where an owner believed it profitable, for business reasons, to demolish improvements on his land for the purpose of leasing the property generally before he entered into any serious negotiations with a specific lessee.[43] This argument may have been advanced in view

40 Brief for Appellee at 21, Hightower v. United States, 463 F.2d 182 (5th Cir. 1972).
41 Feldman v. Wood, 335 F.2d 264, 266 (9th Cir. 1964).
42 Holder v. United States, 444 F.2d 1257, 1300 (5th Cir. 1971): "Did taxpayers actually sustain a bona fide loss? We think not and that to think otherwise would be to exalt form over substance."
43 12 J. TAXATION 218, 220 (1960).

of the holding in *Berger v. Commissioner*.[44] In *Berger* the Tax Court recognized the long standing rule that a lease was a substituting asset for the demolished premises. This the court held did not mean that the new asset had to be in existence at the time of demolition. If there were a sufficient interrelationship between the razing of the building and a subsequent lease agreement, no loss was allowable. Here the taxpayer had a continuing purpose to lease her land for a parking lot. Therefore it was immaterial that the taxpayer entered into a lease 7 months after she demolished her building.[45]

Consequently, the argument was made that the new rule be limited to cases where demolition was bargained for in the lease negotiations. The wording change was designed to narrow the scope of inquiry from pre-lease demolitions where the taxpayer is negotiating generally[46] to cases where a taxpayer is negotiating with a specific lessee and demolition is bargained for.[47]

Due to the division among the several circuits, the Treasury Department has recently proposed a new regulation which will remove the permission-obligation distinction in lease contracts.[48] If and when finally adopted, the Internal Revenue *may* have succeeded in locking, not merely closing, the door on demolition losses within the context of a lease.

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44 7 T.C. 1339 (1946).

45 *Id.*

46 If a lessor negotiates generally, he can get the benefit of competition among several prospective lessees, and hopefully a more favorable lease.

47 12 J. TAXATION 218, 220 (1960).

48 Proposed Treas. Reg. § 1.165-3(b)(2), 37 Fed. Reg. 7890, 7891 (1972). In order to clarify the income tax treatment of the demolition of buildings situated on leased property, paragraph (b)(2) of section 1.165-3 of the Income Tax Regulations (26 CFR Part I) is amended to read as follows:

§1.165-3 Demolition of Buildings

(b) *Intent to demolish formed subsequent to the time of acquisition.*

(2) If a lessor or lessee of real property demolishes his buildings situated thereon, as required or permitted by a lease or by 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 or decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the remaining term thereof.