Marquette Law Review

Volume 30
Issue 1 *May 1946*

Article 3

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INCOME TAX CONSEQUENCES OF BUILDING DEMOLITION AND REPLACEMENT PROGRAMS

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With the cessation of hostilities and the return to civilian peacetime production many business enterprises will undertake long-delayed programs to expand their plant facilities. Many of these programs may contemplate either or both of the following: the demolishing of existing facilities or the demolishing of buildings on newly acquired improved realty to make way for the new construction. The question will arise as to how to treat the loss, if any, arising out of the demolition of the buildings, together with the expenses of such demolition, for Federal Income Tax purposes. More specifically, shall the loss on the buildings, plus expenses of demolition,

(1) Be deducted in full from the gross income in the year sustained, or
(2) Be amortized over the life of the new building, or
(3) Shall it simply be capitalized as cost of land.

The sections of the Internal Revenue Code and regulations thereunder applicable to these questions are as follows:

INTERNAL REVENUE CODE[1]

"Section 23: In computing net income there shall be allowed as deductions:

(e) *LOSSES BY INDIVIDUALS* — In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise —

(1) if incurred in trade or business;

(f) *LOSSES BY CORPORATIONS* — In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

REGULATIONS[2]

Regulation 111, Section 29.23 (f) *LOSSES BY CORPORATIONS:* Losses sustained by corporations during the taxable year and not compensated for by insurance or otherwise are deductible ***. The provisions of Section 29.23 (e) 1 to 29.23 (e) 5 inclusive *** are in general applicable to corporations as well as individuals.

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1 Internal Revenue Code of 1939, as amended.

2 U. S. Treasury Department, Bureau of Internal Revenue, Regulations 111—Income Tax.

> Regulation 111, Section 29.23 (e) 2 *VOLUNTARY REMOVAL OF BUILDINGS:* — Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income.
>
> When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old buildings, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building."

At this point it should be indicated that while the second part of the regulation states "raze with a view" to erecting another building, the courts have construed this to mean "intent". Hereafter, "intent" will be used most frequently.

These regulations have been in force for a number of years, and for a long time were commonly understood to mean, (1) that when a taxpayer removed and replaced an old building already owned and used in his business he could deduct the undepreciated basis[3] of such old building as a loss from his gross income in the year of demolition; and (2) that when a taxpayer purchased land upon which a building was located, and at the time of purchase intended to raze the old building and replace it with a new one, then there would be no deductible loss upon demolition, but rather the cost of the land and old building plus the cost of removal would be capitalized as land cost.[4]

The earlier cases, decided under the code and regulation provisions referred to, apply them as stated above. The courts were principally concerned with a determination of the fact of taxpayer's "intention" at the time of purchase or acquisition. However, a recent case, *Henry Phipps Estate vs. Commissioner*,[5] which relied heavily on the case of *Commissioner vs. Appleby*[6] has created confusion as to the application of the regulation dealing with voluntary removal of buildings, particularly the first sentence. In a situation which appears to come within the meaning of the first sentence, the decision creates a doubt as to whether the loss will be allowed in the year sustained or whether such loss, being the adjusted basis of the demolished building, plus cost of demolition, should be carried forward into the cost of the new building and recaptured by depreciation thereof.

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[3] See Sec. 113 (b), Internal Revenue Code of 1939, as amended.
[4] See Mertens, "Law of Federal Taxation," Vol. V, Sec. 28.23.
[5] 5 USTC 964 (1945).
[6] 123 Fed. 2nd. 700 (C.C.A., 2nd., 1941).

In order to reach a better understanding as to the purport of the Phipps decision, it is considered desirable to analyze some of the earlier cases, and thus ascertain the evolution of the *Appleby* and *Phipps* decisions. Many of these cases are relied upon, either directly or indirectly, in those decisions.

In the cases of *Liberty Baking Company vs. Heiner*[7] and *Providence Journal Co. vs. Broderick,*[8] the court found that the taxpayer intended to expand its plant facilities, and at the time it acquired additional improved realty, it intended to demolish the old buildings and erect new ones in their place. The taxpayer in these cases sought to deduct his loss in the year of demolition. The court held that the *loss was not deductible,* quoting the second sentence of the regulation verbatim as authority.

In the *Providence Journal Co.* opinion it was stated the loss became a part of the taxpayer's *capital investment,* but went no further in defining this statement. According to the concluding paragraph of the decision, the taxpayer claimed the Commissioner had stated in his brief "that the undepreciated balance of the cost of the demolished buildings could be added to the cost of the new building and depreciated over its life."[9] The court refused to pass on this contention, stating the case had been decided on other grounds. No such light was shed in the *Liberty Baking Co.* decision.

The *Providence Journal Co.* case was recently cited with approval in a T. C. Memo dated December 29, 1945, *Bro-Jeff Theatres, Inc. v. Commissioner et al.*[10]

The *Bro-Jeff Theatres, Inc.* case is similar to the *Providence Journal Co.* case in that the acquired improved realty was held and operated for several years before demolition. The facts of the two cases were so similar on the question of demolition loss that the court followed the *Providence Journal Co.* case without discussion or elaboration.

In summation it may be said that the three foregoing cases represent the line of decisions adhering strictly to the original concept of the meaning of the second sentence of the regulation.

Where the taxpayer had not intent to demolish old buildings at the time of purchase of improved realty for plant expansion, but rather intended to use the land and buildings as bought, making only repairs and alterations, but shortly thereafter discovered that such repairs and alterations would not be sufficient and decided to demolish

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[7] 37 Fed. 2nd. 703 (C.C.A., 3rd,. 1930).
[8] 104 Fed. 2nd. 614 (C.C.A., 1st., 1939).
[9] In this case demolition was delayed almost 7 years because of an unexpired lease on the building at time of purchase.
[10] CCH Current Decisions 14,931 (M), Docket Nos. 4008, 4009, 4014.

the old structure and replace it with a new one, the loss was held deductible. In *Union Bed & Spring Co. vs. Commissioner,*[11] *Parma Co. vs. Commissioner,*[12] and *Winter Gardens vs. Commissioner,*[13] the taxpayer claimed the loss in full on his return and the Commissioner contended that the loss should be capitalized. The decisions were in favor of the taxpayer on the ground there was no *intent* to demolish and rebuild at the time of acquisition, and the loss was allowed as being within the scope of the first sentence of the regulation.

The next group of cases can be classed as "lease cases". In these cases the taxpayer owned improved realty, and some length of time after acquisition entered into negotiations for a long term lease. Provisions of the lease required the destruction of the old building and erection of a new one by the lessee, the new one ultimately reverting to the taxpayer (lessor). Here the taxpayer attempted to deduct the loss of the undepreciated value of the old building, from his tax return in the year of demolition. The Commissioner contended that the adjusted basis of the old building should be added to the cost of the new building and exhausted in depreciation charges during the life of the new building. The courts sustained the Commissioner on the theory that the lease represented a valuable asset to the taxpayer, and the destruction of the old building was a part of the cost or expense of acquiring this asset; or putting it another way, there was a substitution of assets rather than a loss sustained in the destruction of the building.

The *Young*[14] case approves the reasoning and result of the *Liberty Baking Co.* decision, and extends the rule of the second sentence of the regulation not to *exclude* cases where a taxpayer has not the intent to demolish at the time of purchase. The court distinguished the facts in the *Young* case from those in the *Liberty Baking Co.* case, and after determining that the rule of the second sentence applied to the *Young* case, said "it would seem just and reasonable that the value of the buildings removed be charged as a contribution to the cost of securing his lease" (asset), citing the regulations applicable to depreciation charges. The court followed the rule used in the capitalizing and depreciation of brokerage fees for negotiating a lease, applied in *Central Bank Block Ass'n. vs. Commissioner,*[15] and *Bonwit Teller Co. vs. Commissioner.*[16]

It should be pointed out here that the *Appleby* case relied on the foregoing cases, and in particular the *Young* and *Anahma* cases. In the

[11] 39 Fed. 2nd. 383 (C.C.A. 7th, 1930).
[12] 18 BTA 429 (1929).
[13] 10 BTA 71 (1928).
[14] Young v. Commissioner, 59 Fed. 2nd. 691 (C.C.A. 9th, 1932); see also Anahma v. Commissioner, 42 Fed. 2nd. 128 (C.C.A. 2nd., 1930).
[15] 57 Fed. 2nd. 5 (C.C.A. 5th, 1932).
[16] 53 Fed. 2nd. 381 (C.C.A. 2nd., 1931).

Phipps case, the *Young* and *Anahma* cases are again referred to, and the *Union Bed & Spring Co.* and *Parma* cases are distinguished from the *Phipps* case.

With these cases as background we proceed to a careful analysis of the holdings and purport of the *Appleby* and *Phipps* cases. In *Appleby vs. Commissioner* the taxpayer, an individual, acquired the improved realty by devise in 1913. In 1917 the building was demolished with intent to erect a new one in its place, which was done. No question over treatment of the undepreciated basis of the old building for Federal Income Tax purposes arose until 1934 when the Commissioner levied a deficiency assessment against taxpayer, on his 1934 return. Apparently in an effort to reduce this deficiency as much as possible the taxpayer contended for the first time that the adjusted basis of the demolished building should be added to the cost of the new building for depreciation purposes. The Commissioner contended at the trial that under the first sentence of the regulation the loss was deductible in the year of demolition, and that under the rule of the second sentence of the regulation there was no deductible loss.

The court and Board of Tax Appeals held that since the building was not used in taxpayer's trade or business and produced no profits in 1917 (the year of its demolition), then the taxpayer could not have deducted the loss as provided for in the first sentence of the regulation.

Referring to the second sentence of the regulations relied on by the Commissioner the court further held, following the lease cases, that cases where the taxpayer does not have "intent to demolish at time of acquisition" are not excluded from the rule of the second sentence. The court decided that the rule of the second sentence was applicable to the facts in the *Appleby* case and further held that,

> "If a building is demolished because unsuitable for further use, the transaction with respect to the building is closed and the taxpayer may take his loss; but if the purpose of demolition is to make way for the erection of a new structure, the result is merely to substitute a more valuable asset for the less valuable and the loss from demolition may reasonably be considered as part of the cost of the new asset and to be depreciated during its life, as is a broker's commission for negotiating a lease."

In conclusion the court stated that the *Providence Journal Co.*, *Liberty Baking Company,* and *Union Bed & Spring Company* decisions are not out of harmony with the *Appleby* decision.[17]

We now come to the *Phipps* case, which relies on *Appleby vs. Commissioner* and many of the cases cited therein. Here the taxpayer

[17] At least in the Liberty Baking Company case one cannot ascertain whether the loss was to be amortized, and to this extent it would appear to be out of harmony.

was a corporation owning numerous income producing properties in New York City. It acquired various parcels of improved property from time to time. In some instances it proceeded to demolish the old buildings immediately upon acquisition and erected new ones in their place. Other buildings were operated from two to seven years after acquisition before destruction and replacement new, the last being in 1927. The court said of this factual situation: "here we assume, without deciding, that there was no intent to demolish at time of purchase".

This case arose over a deficiency assessment levied by the Commissioner or taxpayer's 1939 return. All matters were finally adjusted except taxpayer's claim, which arose after the deficiency assessment, that it should be entitled to include for depreciation purposes the adjusted basis of the demolished buildings in the cost of the new structures. The taxpayer relied on the *Appleby* case for this contention. The Commissioner contended the loss should have been deducted in the year of demolition because there was no intent to demolish and rebuild at time of acquisition.

The Commissioner also contended that the *Appleby* case was distinguishable because there the taxpayer acquired the property by devise and hence could not have had such intent at the time of acquisition. As in the *Appleby* decision, the court disagreed with this contention of the Commissioner, holding that such distinction was of no force.

The court discussed various prior decisions, and approved and followed the *Appleby, Young,* and *Anahma* cases. It distinguished the *Union Bed & Spring* and *Parma* cases on the ground that in those cases the improved property was acquired with intent to use for certain business purposes, and after acquisition was found unsuitable or unusable for such purposes. The court agreed that in such cases an actual business loss occurred.

In the forepart of its opinion, the court made this significant statement, without citation of authority:

> "It is true that cases hold that where there is, at time of acquisition of property, intent to demolish and rebuild no deductible loss occurs *and the basis of the former property may be used in the computation of depreciation.*"

In this case it was stated again that the rule of the second sentence does not *exclude* a situation such as was presented in the *Phipps* case, and that this rule is applicable even though there was no intent to demolish at time of acquisition. Emphasis was placed on the intention of taxpayer at time of demolition rather than time of acquisition.

The conclusion of the *Phipps* case permits depreciation of the old buildings as a part of the cost of the new buildings pursuant to Section 114(a) of the Internal Revenue Code.

Conclusions

The result of the *Appleby* and *Phipps* decisions clearly permits a taxpayer to carry over the undepreciated cost of a demolished building which he has long held, into the cost of the new building. This result appears to be in direct conflict with the plain meaning of the first sentence of the regulation; however, these cases were decided by the courts holding that such situations were not excluded from the rule of the second sentence of the regulation. It is true the cases did not arise over a claim by taxpayer for his loss in full in the year sustained, although this was the contention of the Commissioner in both cases. In this view, it might be said that the first sentence of the regulation was not over-ruled, but it is certainly modified by these decisions.

The fact that taxpayer was allowed to carry over the undepreciated cost of the old building as a part of the depreciable cost of the new building raises the question as to whether these decisions do not open the door for the contention, that in cases falling squarely within the meaning of the second sentence the taxpayer will be permitted to amortize the adjusted cost of the demolished building along with the new building.

It will be interesting to await the Commissioner's reaction to these decisions in the light of his existing regulations.