Michigan Law Review

Volume 65 | Issue 2

1966

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INCOME TAX—DEDUCTIONS—Lessor's Amortization of the Amount by which the Purchase Price of Improved Realty Exceeds the Appraised Value of Land—*Bender v. United States**

Taxpayer, upon being informed that his tenant would not renew his lease unless he could be assured of additional parking facilities, purchased three lots adjacent to the leasehold and immediately demolished the houses thereon in order to provide the necessary space. Since the owners of these residential properties knew of taxpayer's special need, taxpayer was forced to pay substantially more than the total appraised value of the land.[1] In computing his income tax, taxpayer sought to amortize over the life of the lease the cost of razing the buildings and the amount of the purchase price in excess of the appraised value of the land as expenditures incident to securing a lease. The Commissioner of Internal Revenue, disallowing this amortization deduction, contended that since taxpayer bought the improved realty with the intention of razing the buildings, the entire purchase price as well as the cost of demolition should be allocated to the land which is a nondepreciable asset. In a suit for refund of taxes, the federal district court reversed the Commissioner's determination and allowed the deduction. The court held that when improved realty is purchased to secure a lease renewal, the amount by which the purchase price exceeds the appraised fair market value of the land alone may be amortized by the lessor over the period of the leasehold as a capital expenditure incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. This is true even though the taxpayer intended at the time of the purchase to demolish the buildings on the land.

An expense incurred in securing a lease is generally recognized as being a legitimate cost of producing income, and, as such, may be deducted under section 212 of the Internal Revenue Code of 1954.[2] If the lease-term runs more than a year, the securing costs

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* 246 F. Supp. 189 (N.D. Ohio 1965) [hereinafter cited as principal case].

1. The total appraised fair market value of the three lots was $37,300: $4,100 for the land and $33,200 for the buildings. The lots were purchased by taxpayer for a total of $75,136.55. Brief for Taxpayer, ¶ 8.

2. INT. REV. CODE OF 1954, § 212, provides in part:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
> (1) for the production or collection of income;
> (2) for the management, conservation, or maintenance of property held for the production of income.

are considered capital expenditures to be amortized over the lease-term in accordance with section 167 which permits deductions for depreciation.[3] The court in the principal case recognized that the cost of land, even if the land were purchased to secure a lease, would not constitute such a capital expenditure because land is always considered a non-depreciable capital asset.[4] However, since the taxpayer was forced to pay a greatly inflated price for the land because of his lessee's particular demands, the court felt that taxpayer had an investment in something more than the non-depreciable land; the amount by which the purchase price exceeded the fair market value of the land was thus attributable to the ability to secure the lease renewal and therefore constituted a deductible capital expenditure.[5] In allocating to the non-depreciable land only that portion of the purchase price equal to the land's appraised value and in designating the remainder of the cost as the basis for the deduction, the court is subject to criticism for (1) disregarding the well-established rule of allocating the total cost of purchased realty to the land alone when the buildings thereon are intended to be destroyed[6] and (2) incorrectly allocating the purchase price between the land and building, if such an allocation were permitted.

The Treasury Regulations relating to section 165 which deals with deductions for certain losses provide that if a lessor is required to demolish buildings in order to secure a lease, the adjusted basis of the buildings plus the cost of demolition may be amortized over the term of the lease.[7] However, Treasury Regulation 1.165-3(a) provides that a loss incurred by the demolition of buildings should not be deducted if the intent to demolish is formed at the time of

3. INT. REV. CODE OF 1954, § 167(a), provides in part:

(a) GENERAL RULE—There shall be allowed as depreciation deduction a reasonable allowance for the exhaustion . . .

(1) of property used in the trade or business, or

(2) of property held for the production of income.

4. Land is not subject to a depreciation allowance because it suffers no appreciable loss of usefulness and because it does not have a determinable life with which to measure a period of depreciation. See 4 MERTENS, FEDERAL INCOME TAXATION §§ 23.09, .12 (1958).

5. Principal case at 196.

6. See Providence Journal Co. v. Broderick, 104 F.2d 614 (1st Cir. 1939); Liberty Baking Co. v. Heiner, 37 F.2d 703 (3d Cir. 1930); N.W. Ayer & Son, 17 T.C. 631 (1951).

7. Treas. Reg. § 1.165-3(b) (1960). See also Camp Wolters Land Co. v. Commissioner, 160 F.2d 84 (5th Cir. 1947); Spinks Realty Co. v. Burnet, 62 F.2d 860 (D.C. Cir. 1932), *cert. denied*, 290 U.S. 636 (1933); Young v. Commissioner, 59 F.2d 691 (9th Cir.), *cert. denied*, 287 U.S. 652 (1932); Anahma Realty Corp., 16 B.T.A. 749 (1929), *aff'd*, 42 F.2d 128 (2d Cir.), *cert. denied*, 282 U.S. 854 (1930); Charles N. Manning, 7 B.T.A. 286 (1927).

For examples of other types of capital expenditures which a lessor may include in his cost of securing a lease, see Young v. Commissioner, *supra* (certification of title charges); Central Bank Ass'n v. Commissioner, 57 F.2d 5 (5th Cir. 1932) (attorney fees); Laurene W. Berger, 7 T.C. 1339 (1946) (costs of removing buildings from leased land); Richard G. Babbage, 27 B.T.A. 57 (1932) (court costs in connection with litigation over lease); James M. Butler, 19 B.T.A. 718 (1930) (real estate broker commissions).

the purchase of the property. If the purchaser intends to demolish the buildings, the regulation states that the entire cost of the property is to be allocated to the basis of the land itself. In the principal case, the court made a specific finding of fact that the taxpayer wanted to obtain only the land and intended at the time of purchase to demolish the buildings.[8] However, the court refused to consider the above regulation, since the taxpayer was not seeking a loss deduction under section 165, but rather was attempting to amortize under section 167, a section 212 expenditure for the production of income over the term of the renewed lease. *Section* 165 is clearly inapplicable, but it appears that the court acted improperly in mechanically refusing to include within its analysis of the problem presented in the principal case a *regulation* issued under this section. A relationship does exist between sections 165 and 167, since both sections provide a means of recovering basis tax free and both require that the adjusted basis, as determined by section 1011, shall be the guideline for determining the amount of their respective deductions.[9] Thus, although the two sections serve different purposes, a regulation issued under one would be relevant to a problem brought under the other so long as the regulation involves a question of the allocation of basis. The relevance of Treasury Regulation 1.165-3(a) to the principal case is thus in its method of allocating the purchase price when land and buildings are purchased with the intent to raze the buildings, not in its ultimate purpose of allowing or disallowing a loss deduction.[10] Although

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8. Principal case at 193.

9. INT. REV. CODE OF 1954, § 165(b), provides:

> (b) AMOUNT OF DEDUCTION—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

INT. REV. CODE OF 1954, § 167(g), provides:

> (g) BASIS FOR DEPRECIATION—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

10. The relationship between §§ 165 and 167 for determining basis has been acknowledged by the courts. See Lynchburg Nat'l Bank & Trust Co., 20 T.C. 670, *aff'd on other grounds*, 208 F.2d 757 (4th Cir. 1953). In *Lynchburg* a taxpayer intended to demolish a building when he purchased it, but used it in his business prior to the demolition. The Tax Court disallowed depreciation for the interim use since the building had a basis of zero. The brief for the Government in *Lynchburg*, which relied upon § 165 cases, stated:

> While these cases involve losses rather than depreciation and no cases presenting this question with respect to depreciation have been found, nevertheless, the principle involved must necessarily be the same with respect to both questions . . . . [S]ince the property involved was purchased with the intention of demolishing the brick building, the purchase price was properly charged to the land, and the building had a basis of zero, and, in accordance therewith, the taxpayer [must be denied] . . . any deduction for depreciation with respect to the building.

Brief for Commissioner, p. 12.

The Commissioner will now allow a limited depreciation for interim use of a building purchased with the intent to demolish. See Treas. Reg. § 1.165-3(a)(2)(i) (1960).

the cases relied upon by the Commissioner involve attempts by taxpayers to take loss deductions under section 165,[11] the reasoning of those decisions is that the actual value to the taxpayer of the desired land is equal to the entire purchase price paid for both land and buildings and, therefore, the basis of the land itself should be equal to this same amount. If the buildings have no value to the purchaser, there can be no loss to him upon their demolition. Hence, any appraised value assigned to the buildings at the time of purchase is deemed immaterial.[12] This reasoning, developed in section 165 for loss situations, should also be applicable in the section 167 depreciation setting of the principal case. If the lessor intended to destroy the buildings upon their purchase, the entire cost should be allocated to the land, and thus no amount is left to be assigned to a depreciable lease-renewal expense.

In other situations in which an aggregate of property is acquired for the purpose of obtaining only a specific asset which happens to be part of the aggregate, the courts have held that the entire purchase price is to be designated as the basis for that specific asset.[13] For example, when an individual purchased a tavern for the sole purpose of acquiring the tavern's liquor license, the court allocated the entire cost to the license's basis since the taxpayer intended to abandon the tavern.[14]

The principal case is unique because in determining the amount of the purchase price to be allocated to the amortizable expense, the court examined the taxpayer's motives; since it found that the sole reason he paid more than the appraised value of the land was so that he could secure the lease renewal, this extra amount was deemed to be an amortizable expense and, as such, it was not to be included in the land's basis.[15] In no other case involving a purchase of improved realty where the purchaser intended to raze the building has a court made such an examination of the purpose for

11. See cases cited *supra* note 6.

12. See, *e.g.*, Providence Journal Co. v. Broderick, 104 F.2d 614, 616 (1st Cir. 1939); Robert B. Griffin, 17 B.T.A. 255, 256 (1929). In addition to the purchase price, the cost of removing the unwanted buildings is also added to the land's basis. See, *e.g.*, Liberty Baking Co. v. Heiner, 37 F.2d 703 (3d Cir. 1930). Nor is it important to this rationale that the demolition is delayed and the building is used in the meantime. See N. W. Ayer & Son, 17 T.C. 631 (1951); Lansburgh & Bros., 23 B.T.A. 66 (1931). The buildings retain a basis of zero even when the original reason for the demolition is abandoned. See Super Markets, Inc. v. United States, 194 F. Supp. 291 (N.D.N.Y. 1961). Also the courts will assign the entire cost as the basis of the land even if the intention to demolish is fairly uncertain and depends upon the fulfillment of several conditions. See Meyer v. United States, 247 F. Supp. 939 (D. Mass. 1965), *aff'd per curiam*, 362 F.2d 264 (1st Cir. 1966); The Montgomery Co., 32 P-H Tax Ct. Mem. 541 (1963); WLS Investment Co., 30 P-H Tax Ct. Mem. 1265 (1961).

13. See 4 Research Institute of America, Tax Coordinator P-1202.6 (1964).

14. Tube Bar, Inc., 15 T.C. 922 (1950).

15. Principal case at 196.

obtaining the property.[16] For example, the court in *Bank of Millvale v. United States*,[17] without considering the taxpayer's business reason for constructing a parking lot, automatically refused to allow the cost of destroying the buildings on the purchased property to be amortized over the life of the parking lot, since they had been purchased with the intent to destroy. The Commissioner has long held that no depreciable business expense results from the demolition of one building to erect another, as long as the razed building was purchased with that intent, for the destroyed structure has no basis on which to allow an expense deduction upon demolition.[18] None of the cases employed by the court to substantiate its theory of designating the excess of price over the fair market value of the land as a lease-renewal expense involved a situation in which a taxpayer bought the improved realty intending at the time of purchase to demolish the structure thereon.[19] Consequently, these cases did not present circumstances which would warrant the application of Treasury Regulation 1.165-3(a).

The more recent case of *Meyer v. United States* held the principal case to be an "unsound precedent."[20] As in the principal case, the taxpayer-lessor purchased improved realty and destroyed the buildings thereon in order to secure a lease. In *Meyer*, the court used the rationale of Treasury Regulation 1.165-3(a) to show that the entire cost had to be designated as the basis for the land, thus leaving nothing to be attributed to the deductible cost of securing a lease.[21]

16. The sole exception to the rule of not examining either the purchaser's motive for buying or the value of the asset purchased in determining the proper basis of the acquired property appears to occur in the setting of medical expenses under INT. REV. CODE OF 1954, § 213. Usually, when one makes a capital expenditure for permanent improvement to his property, the entire cost will simply be added to the basis of his property. However, if the cost also qualifies as a § 213 medical expenditure, the Commissioner will allow as a deduction that portion of the expense which exceeds the increase in the value of the related property. Thus, if a person with a heart disease is forced to install an elevator in his home at a cost of $1,000 and this results in a $700 increase in the value of his residence, the difference ($300) is deductible as a medical expense while the basis of the taxpayer's home will be increased by $700. See Treas. Reg. § 1.213-1(e)(iii) (1964).

17. 62-1 CCH Tax Cases 83,309 (W.D. Pa. 1961).

18. Rev. Rul. 110, 1955-1 CUM. BULL. 280.

19. The court's decision was based upon World Publishing Co. v. Commissioner, 299 F.2d 614 (8th Cir. 1962) (purchaser of property subject to lease may amortize portion of price allocable to tenant-erected building which will be valueless before end of lease-term); Millinery Center Bldg. Corp. v. Commissioner, 221 F.2d 322 (2d Cir. 1955), *aff'd on other grounds*, 350 U.S. 456 (1956) (where taxpayer, who had erected on leased premises a building which was to be surrendered to the lessor at the termination of lease, purchased the premises, taxpayer was entitled to allocate part of the purchase price to the building and to depreciate it as such, even though taxpayer had fully written off the cost of the building during the first term of lease); and Camp Wolters Land Co. v. Commissioner, 160 F.2d 84 (5th Cir. 1947) (basis of building demolished to secure lease constitutes expense amortizable over period of lease).

20. 247 F. Supp. 939 (D. Mass. 1965), *aff'd per curiam*, 362 F.2d 264 (1st Cir. 1966).

21. In *Meyer* the court pointed out that Treas. Reg. § 1.165-3(a) (1960) is the lineal descendant of a 1918 Regulation—Article 142 of Regulation 45—and that the series of

The *Meyer* court's conclusion as to the soundness of the decision in the principal case is apparently well founded. If the reasoning of the principal case were considered valid, it appears that a lessor might be able to amortize that portion of the purchase price which exceeds the appraised value of the land as a section 212 expenditure even when unimproved realty is purchased to secure a lease. For example, if a business is planning to expand its facilities by purchasing neighboring land and the business is forced to pay an inflated price because of the seller's knowledge of the proposed expansion, the principal case suggests that the company could deduct the premium paid as a section 162 business expense. Such a result, however, would be wholly inconsistent with the principle that land is a non-depreciable asset, the basis of which is to be measured by its actual cost and not by its value.

Assuming *arguendo* the validity of the court's contention that the purchase price is to be divided between the land and the additional expense of securing a lease, it would appear that the court was incorrect in allocating to the land only that portion of the cost equal to the land's appraised value.[22] As long as the purchase is an arm's length transaction, the basis of property is generally considered to be the cost of such property whether such cost is more or less than the fair market or appraised value.[23] In determining the basis of the taxpayer's capital asset, the court should, therefore, consider exactly what he paid for it, which is not to be confused with what the property was actually worth.[24] Where, as here, an aggregate of property is purchased for a single price, it is necessary to apportion that price among the assets.[25] Although there is no provision in the Code, nor in any previous code, establishing a method for such an apportionment, the courts have consistently followed the method presented in Treasury Regulation 1.167(a)-5, whereby allocation is made in proportion to the relative values at the time of acquisi-

regulations, substantially unchanged over nearly half a century, may be said to be approved by Congressional silence. Meyer v. United States, 247 F. Supp. 939, 942 (D. Mass. 1965), *aff'd per curiam*, 362 F.2d 264 (1st Cir. 1966). Congress had the opportunity to end its silence when bills on the allocation-of-basis problem were proposed in the 83d and 84th Congresses. H.R. 7598, 83d Cong., 2d Sess. (1954); H.R. 665, 84th Cong., 1st Sess. (1955). These measures called for a new section to the Code which would provide that the basis of buildings intended to be demolished at the time of purchase be the same that it would be had they been acquired without such an intent. For a discussion on the need for passage of such a basis provision, see Bullock, *Are We Parked in a Tax Zone?*, 33 TAXES 115 (1955). Neither the House Committee on Ways and Means nor the Senate Committee on Finance has taken any action on these proposals.

22. Principal case at 197.

23. INT. REV. CODE OF 1954, § 1012, provides in part: "The basis of property shall be the cost of such property . . . ." See also Virgil P. Ettinger, 36 B.T.A. 264 (1937), *aff'd per curiam*, 97 F.2d 1000 (1938); Hugh M. Matheson, 31 B.T.A. 493 (1934), *aff'd*, 82 F.2d 380 (1936).

24. See 4 RESEARCH INSTITUTE OF AMERICA, TAX COORDINATOR P-1104 (1964).

25. See 3A MERTENS, FEDERAL INCOME TAXATION § 21.32 (1958).

tion.[26] In the principal case, the relative values of the assets could be determined by comparing the appraised value of the land with the appraised value of the improved realty. That proportion of the purchase price would then constitute the basis for the land. Moreover, in its use of the appraised value, the court overlooked the fact that the appraisal assumed a residential use of the property and a buyer under no compulsion, two elements which were not actually present in the facts of the case.[27] Also, the court determined the value of the three lots by simply totaling the values of each lot appraised individually, although it is very likely that the three lots as a unit might have been appraised at a higher value.[28]

The judgment of the court in the principal case may have understandably been affected by the excessive disparity between the purchase price and the appraised value of the land. Another court, faced with a taxpayer similarly situated, might allow the taxpayer to amortize at least the amount by which the purchase price exceeds the cost of both the land and the buildings rather than the amount paid in excess of the cost attributed to the land alone. Although more realistic, this approach may also be unacceptable, for it would still violate the rule that the motives of the taxpayer are not to be examined when designating bases to property. Furthermore, the adoption of such a method of allocation of bases would lead to tremendous administrative problems regarding the valuation of the acquired property, since everyone purchasing property in the course of a trade or business at an inflated price would be certain to seek deduction or amortization treatment to the extent of the premium paid.

26. Treas. Reg. § 1.167(a)-5 (1956) provides that, if there is a purchase of a combination of depreciable and non-depreciable property for a lump sum, as, for example, building and land, the basis for depreciation cannot exceed an amount, which bears the same proportion to the lump sum as the value of the depreciable property bears to the value of the entire property at that time. If this proportion method were used in the principal case, the amount of the amortizable asset would have been approximately $67,500 rather than $71,000. See Piedmont Nat'l Bank v. United States, 162 F. Supp. 919 (W.D.S.C. 1958); Mark L. Gerstle, 33 B.T.A. 830 (1935).

27. Brief for Taxpayer, ¶ 8.

28. *Cf.* See v. Heppenheimer, 69 N.J. Eq. 36, 49-50 (1905).