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DEMOLISHING FARM IMPROVEMENTS

— by Neil E. Harl*

Farm consolidation and shifts in livestock production patterns have generated intense interest in the demolition of buildings on farms and ranches.[1] The income tax treatment of — (1) any remaining basis in the property and (2) the costs of demolition,influence the timing of the decision to demolish and whether unused buildings and other improvements should be left standing.

Demolition before 1984

Prior to enactment of the Deficit Reduction Act of 1984,[2] if a building or other improvement was acquired with an intent to demolish, it was not possible to deduct a depreciation allowance for any income tax basis in the property.[3] If the intent to demolish was formed after acquisition and allocation of a basis amount to assets, a deduction could be claimed for the remaining basis at the time of demolition.[4] The litigated cases tended to focus on when the intent to demolish a structure was formulated.[5]

Demolition after 1983

After December 31, 1983,[6] no deduction has been allowed for losses "on account of" demolition with respect to a structure or for any expenses incurred in the demolition.[7] Those amounts are to be capitalized and added to the income tax basis of the land on which the structure was located.[8]

Repeal of the land clearing expense deduction in 1986 effective at the end of 1985[9] removed also the possibility of a deduction for removal of trees, stumps and brush and for other expenses associated with the clearing of land to make it suitable for use in farming.[10]

In 1990, IRS pointed out that the 1984 enactment prohibiting a deduction on demolition did not apply to "amounts expended for the demolition of a structure damaged or destroyed by casualty, and to any loss sustained on account of such a demolition."[11] The IRS noted that if a casualty damages or destroys a structure, and the structure is then demolished, the income tax basis of the structure must be reduced by the deductible casualty loss[12] before the "loss sustained on account of" the demolition is determined.[13] Thus, if a building were to be destroyed by an earthquake, the basis in the building would be deductible as a casualty loss but the cost of cleaning up the rubble would have to be added to the basis of the land.[14]

DeCou v. Commissioner

A 1994 Tax Court case, DeCou v. Commissioner,[15] allowed an "abnormal retirement loss" where a building had suffered a reduction in value before demolition took place. In that case, a government inspector had noted deterioration of the building in question, defects in the floor, water leaks in the roof and shorts in the electrical system.[16] Later, the building was demolished.

The owner of the building claimed the remaining basis in the building ($85,987) as "an ordinary abandonment or retirement loss deduction" but added the cost of demolition ($17,655) to the basis in the land.[17] IRS disagreed, arguing that the taxpayer was not entitled to a loss deduction because it was not the result of a casualty or extraordinary obsolescence. The Service position was that the remaining basis in the building should be considered as a nondeductible cost of demolishing the building.[18]

The Tax Court agreed with the taxpayer and allowed a deduction for an "abnormal retirement loss."[19] The court noted that IRS had implied, in Notice 90-21,[20] that a loss sustained before a building's demolition would not be treated as sustained "on account of" the demolition. Therefore, such losses would not be disallowed by I.R.C. § 280B. As the court explained, "the withdrawal of the...building constituted an abnormal retirement that was caused by the unexpected and extraordinary obsolescence of the building."[21] The court found that the building's fair market value and salvage value were both zero on the date of demolition; therefore, the entire remaining basis was an allowable deduction.

In conclusion

Although the amounts actually expended for demolition are usually non deductible and must be added to the basis of the land, two possibilities exist for claiming a partial or total deduction for any remaining basis in the property demolished. First, a casualty loss may be claimable if, in fact, a casualty has damaged or destroyed the property.[22] Second, an abnormal retirement loss deduction may be available if the improvement had suffered a reduction in value prior to the demolition.[23]

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FOOTNOTES

1 See generally 4 Harl, *Agricultural Law* § 29.06 (1995).
2 Pub. L. 98-369, Sec. 1063(a), 98 Stat. 494, 1047 (1984).
3 4 Harl, *supra* n. 1.
4 *Id*.
5 See Canelo v. Comm'r, 53 T.C. 217 (1969), *acq*., 1971-1 C.B. 2, *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971); Irish v. Comm'r, T.C. Memo. 1969-45; Butz v. Comm'r, T.C. Memo. 1976-118.
6 Deficit Reduction Act of 1984, Pub. L. 98-369, Sec. 1063(c), 98 Stat. 1047 (1984).
7 I.R.C. § 280B(a).
8 I.R.C. § 280B(a)(2).
9 I.R.C. § 182, repealed by Pub. L. 99-514, Sec. 402(a), 100 Stat. 2221 (1986).
10 See 4 Harl, *supra* n. 1, § 28.04[3].
11 Notice 90-21, 1990-1 C.B. 332, 333.
12 I.R.C. § 165.
13 Notice 90-21, 1990-1 C.B. 332, 333.
14 *Id*. at 333-334.
15 103 T.C. 80 (1994).
16 *Id*. at 82.
17 103 T.C. 80, 85.
18 103 T.C. 80, 87.
19 103 T.C. 80, 89.
20 1990-1 C.B. 332.
21 103 T.C. 80, 88.
22 I.R.C. § 165.
23 DeCou v. Comm'r, 103 T.C. 80 (1994).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

DISCHARGE. The debtor's corporation had purchased real property from the creditor and had given a note personally guaranteed by the debtor for a portion of the purchase price. The note required written consent from the creditor before the property could be sold. The debtor's corporation sold the property to a partnership when the debtor sought modification of the note terms. The creditor sought a ruling that the note was nondischargeable under Section 523(a)(2)(A) because the debtor had committed fraud in failing to reveal the conveyance or seek prior consent for the transfer. The court ruled that the standard of justifiable reliance by the creditor applied to Section 523(a)(2)(A), instead of reasonable reliance as required by Section 523(A)(2)(B). **Field v. Mans, __ S. Ct. __ (1995), *rev'g*, 36 F.3d 1089 (1st Cir. 1994)**.

LIMITED LIABILITY COMPANIES. The debtor was a member of several limited liability companies (LLC), all of which had incorporated the Nebraska limited liability company law into their Articles of Organization such that the bankruptcy of a member dissolved the company unless two-thirds of the other members vote to continue the LLC. After the debtor's Chapter 11 filing, the members of the LLCs voted to continue the LLCs but without the debtor. The court held that the state law dissolution provision was unenforceable against a member in bankruptcy and that the actions of the other members in continuing to operate the LLCs without the debtor violated the automatic stay. The court held that the LLC Articles of Organization and Operating Agreements were executory contracts which the debtor could assume or reject in bankruptcy. The court also refused to order sanctions for the violations of the automatic stay because the other members were acting in good faith under the state law. **Matter of Daughtery Const., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995)**.

PRIORITY. The debtor was a walnut handler subject to assessments by the California Walnut Commission for promotional and marketing programs. The Commission filed a claim for unpaid assessments and sought priority status for the claim as a tax claim. The assessments were used to promote and advertise the sale of walnuts, to conduct marketing research and to publish information for walnut producers and handlers. The court held that the claim was not entitled to priority status as a tax because the assessments primarily benefited private walnut producers and not the general public. ***In re* S.N.A. Nut Co., 188 B.R. 392 (Bankr. N.D. Ill. 1995)**.

CHAPTER 13-*ALM* § 13.03.*

PLAN. Prior to filing for bankruptcy, the debtors had granted to a creditor a security interest in the debtors' rural residence and farm equipment. The security interests were subordinated by agreement of the creditor to a security interest held by another creditor. On the petition date, the value of the farm equipment was less than the secured claim of the first security interest holder and the value of the real property was insufficient to fully secure the claim of the creditor with the second security interest. That creditor argued that, under Section 1322(b)(2), its secured claim could not be modified by the plan because it was secured only by the debtors' residence at the time of the petition. The court held that, in determining whether Section 1322(b)(2) applied, the rights of the creditor under state law determined whether the creditor's claim was secured solely by the debtors' residence. The court held that, because the security interest covered the residence and farm equipment, the creditor's claim was not secured solely by the residence and could be modified by the Chapter 13 plan. ***In re* Barrett, 188 B.R. 285 (Bankr. D. Or. 1995)**.

TRUSTEE'S FEES. The debtors were farmers with nonfarm income. The debtors' Chapter 13 plan provided for direct payments to the IRS and payment of all unmodified claims. The plan also provided payment on an impaired claim filed by the FmHA. The debtors' plan projected income of $34,854 and annual expenses of $16,613.67. The direct payments left only $569.00 for payments to unsecured creditors and trustee's fees. Therefore, if the trustee's fee had to be paid on any of the direct payments, the plan could not be confirmed because there was insufficient income. The court held that, as in Chapter 12