Real Estate Values and Historic Designation

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Both the federal government and local jurisdictions across the country exercise regulatory powers over older properties through historic preservation laws. This article focuses on the growth of federal historic preservation legislation, and on the impact that historic preservation ordinances exert on real estate values.

A Brief History of Historic Designation

The preservation movement in the United States began as a private effort in the mid-1800s. During that period, individuals and organizations, members of which typically were women from affluent families, sometimes sought to prevent new construction on sites containing monuments that would otherwise have been demolished. Only rarely did these efforts attract national attention, as when the Mount Vernon Ladies' Association undertook their successful effort to save George Washington's home.

People think of the historic preservation movement as a fairly recent phenomenon because the federal government did not become widely involved in preserving and rehabilitating historic property until the mid-1970s. Yet federal preservation efforts had begun on a smaller scale much earlier, with attempts to preserve land as National Parks under the 1906 Antiquities Act. These efforts expanded in 1924, when the National Park Service was created and given responsibility to oversee federal parks and other properties.[1] They further grew in 1935, when the Historic Sites, Buildings, and Antiquities Act gave Congress its first statutory power over historic improvements not located on federal lands.

The Taxman Giveth

Prior to 1976, however, federal laws had provided no incentives for the preservation or rehabilitation of deteriorated historic buildings. The various programs offering tax benefits for preservation began with the Tax Reform Act of 1976. The Act amended depreciation schedules to allow for the writeoff over five years (rather than the standard 25 – 30 years) of costs relating to rehabilitating historic properties. As an alternative, the building owner was permitted to depreciate the structure plus rehabilitation costs on an accelerated basis (150% or 200% declining balance, rather than straight line or 125% declining balance). The Act also encouraged rehabilitation by ending incentives that had served to encourage the demolition of older (and therefore, in some cases, historic) buildings.

On the heels of the 1976 tax legislation came the Revenue Act of 1978, which created a rehabilitation tax credit equal to 10% of rehabilitation costs for older commercial and industrial buildings. As an alternative to claiming the tax credit, an owner could utilize the 60-month amortization schedules from the 1976 Act on the depreciable basis of a qualifying property.

By 1981, though, only the rehabilitation credit remained as a federal incentive for rehabilitating historic property. The Economic Recovery Tax Act (ERTA) of 1981 established a 3-tiered investment tax credit (ITC) system for old and historic buildings. The credit ranged from 15% for 30-year old buildings to 20% for those more than 49 years old, and a 25% credit was allowed for any structure certified as "historic" by the Secretary of the Interior. ERTA also established stringent requirements for rehabilitation approval.

The Taxman Taketh Away

These ITCs were offset somewhat by the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, which required the reduction of the building's depreciable basis by 100% of any investment credit taken for most older buildings and 50% for historic buildings. New alternative minimum tax requirements also curtailed the tax reduction possibilities available through historic renovation.

Further reductions in incentives were seen with passage of the Tax Reform Act of 1986 (TRA). One provision of this legislation was a reduction in ITCs to 10% and 20% for old and historic structures, respectively. Even greater impact came from a new method of classifying income and an accompanying reduction in investors' ability to offset taxable income with losses realized on real estate investments. TRA created three classes of income: active, portfolio, and passive. Losses realized on rental real estate were classified as passive, and therefore could be used only to offset taxable gains from other passive investments; such losses could no longer offset salary ("active") income or other investment ("portfolio") income.

An exception does allow the rental property owner who actively participates in management to deduct up to $25,000 per year of passive losses in excess of passive income. At the 28% maximum tax rate that applied when TRA was passed, a passive investor therefore could have received a tax benefit of no more than $7,000 per year (maximum rates now are higher). Because of the annual limitations, any excess negative taxable income must be carried forward to offset positive taxable incomes in subsequent years. As a result, some tax benefits, including JTCs, can be realized only at a future date when the property is sold.

The elimination of favorable treatment of capital gains further reduced the value of tax benefits previously enjoyed by real estate owners who preserved their properties. Combined with longer depreciation schedules, the benefits of rehabilitation ITCs were greatly reduced for many investors who might have considered buying historic properties. On the positive side, TRA created an ITC for the rehabilitation of low income housing; this credit can be used in combination with the JTC for historic rehabilitation.

What impact do the various tax enactments of the past two decades seem to have had on historic properties? Between 1976 and 1994 nearly $17 billion was invested in nearly 26,000 rehabilitation projects. However, the number of historic properties rehabilitated annually has declined substantially since the early 1980s. In fiscal year 1984, the National Park Service approved 3,214 projects accounting for $2.1 billion in investment. Following the 1986 legislation, however, investment fell precipi tously. In 1994, only 524 projects, worth $483 million, were approved. This serious decline in rehabilitation activity suggests that the availability of ITC benefits might have a major impact on rehabilitation and preservation efforts.[2] The constantly-changing nature of federal laws on historic preservation incentives, combined with their conflicting results, indicates that the federal

government has yet to precisely define its preservation goals, that it does not know how best to achieve its goals, or both.

Value Impacts

A key issue is whether historic preservation laws have an impact on property values. While there have been several attempts to ascertain the impact of federal historic designation on property values and real estate markets,[3] it is difficult to draw solid conclusions. One reason is that the study areas encompass a variety of local real estate markets, so results derived in a particular study might not be applicable to other geographic areas. Furthermore, local historic preservation ordinances (discussed below) can differ considerably from one jurisdiction to another, so the interplay between federal and local laws is not uniform. In addition, the administration of federal laws at times requires judicial interpretation, and because the areas involved in these studies were located in different federal court districts, accepted practices in some areas might be subject to question in others. Still, despite the uncertainty, some conclusions are beginning to emerge.

First, although conventional wisdom would suggest, at worst, no impact and, at best, a positive impact associated with the ITC incentives, the effect of federal historic designation on investment properties appears mixed, with impacts appearing negative in some studies and positive in others. Second, federal historic preservation legislation appears to yield positive results for residential properties, probably because of neighborhood stabilizing effects (owner-occupied residential property is not eligible for federal ITCs). Studies attempting to isolate the impact of historic designation by local authorities appear to have provided more definitive results. Some observations regarding local areas are worth discussing.

Local Historic Designation

When local officials select an area for historic preservation district status, they are likely to utilize a combination of restrictions and incentives in achieving compliance. Restrictive ordinances establish procedures for the designation and treatment of locally certified historic property. It is common for local commissions or other authorities to reserve the right to review and/or approve all permits for the construction, repair, alteration, or demolition of designated properties. Incentives serve to reward owners whose maintenance or rehabilitation efforts comply with historical standards.

Such incentives can be included in local zoning codes via ordinances that allow for lot mergers, the transfer of development rights (TDRs), or bonuses. Mergers permit the joining of adjacent lots under separate ownership for the purpose of clustering development, thus potentially preserving a historic property. TDRs permit the sale of unused development potential, thereby letting a site's owner recoup part of the opportunity cost associated with historic designation by selling his development rights to another property owner who wishes to develop more intensively than would otherwise be permitted. Localities can also combine flexibility ("bonuses") regarding floor areas, based on special design features, with such specific public goals as deeper setbacks and larger open areas.

Historic preservation can also be encouraged at the local level through the use of rehabilitation grants and low interest rate loans, or through property tax abatement. Real estate tax constitutes one of the largest expenses for the typical property. Local areas can create tax relief programs by freezing assessments on historic properties, or by exempting rehabilitated improvements from tax.

Programs vary considerably, often based on state laws. Oregon, for example, allows the owner of a certified historic property to apply for a 15-year freeze on assessment increases. North Carolina allows a locally designated historic property to be taxed based on half its market value; the tax savings is recaptured if the property is "decertified." Tennessee allows a total exemption from property taxes for 15 years if the historic structure is totally rehabilitated under established guidelines. In return for this exemption, the owner must agree not to demolish or significantly alter the structure during the exemption period. While Pennsylvania law generally prohibits tax relief, a 1971 act permits localities to offer exemptions from tax during various periods, and further allows exemptions for a percentage of rehabilitation expenditures on properties in deteriorated neighborhoods, with special exemptions for non-residential improvements in blighted areas. The city of Philadelphia, with some of the oldest structures in the nation, also makes moderate use of these exemptions, although they are not restricted to historic rehabilitations.

Two Philadelphia Cases

Philadelphia is unique in that its original historic preservation regulations, passed in 1955, did not allow for the creation of historic distrifts. (Such districts were not authorized until a revision of the historic ordinances was undertaken in 1985.) As a result, more than 50,000 individual buildings are designated "historic" by the city. After the 1985 revisions, the city's historic ordinances were struck down in a surprising move by the Pennsylvania Supreme Court when the city attempted to regulate the interior of a local movie theater. (After considerable public debate and outcry in the ensuing years, the Court reversed its original decision in 1993.)

A recent study[4] of local historic designation's adverse impact on Philadelphia apartment buildings offers evidence that historic designation can be associated with lower values. This study found price discounts of about 24% relative to values of non-designated apartment properties for the sample analyzed. The results support the view that a severe regulatory framework can produce adverse impacts on investment property values.

Another recent study,[5] based on data relating to facade easements[6] for Philadelphia condominium buildings, found this type of easement to be associated with a value discount of approximately 30%. However, the city's facade easement program is one of the most stringent in the country in terms of restoration requirements, maintenance obligations imposed on owners, and monitoring for compliance. Yet as we have noted regarding local historic designations in general, it is expected that less (more) stringent programs would be associated with smaller (greater) value discounts relative to unaffected parcels.

Conclusions

Though results from studies that attempt to quantify the impacts of federal historic designation are somewhat mixed, the impact of local designation appears more certain. Specifically, the

impact of local ordinances, which depends on specific combinations of incentives and restrictions, can be negative when restrictive ordinances place substantial limitations on owners' rights. Local incentives in the form of property tax abatements, grants, loans, and other bonuses may be critical in making local historic preservation palatable to property owners.

Policy makers and preservationists must exercise care in their efforts to preserve historic property. The costs incurred, especially those associated with stringent restrictions on alteration and development, can cause net losses in the amount of local property tax collected. Preferable are incentives that encourage the rehabilitation and use of historically significant properties. The budgetary impacts on local authorities can be quite pronounced, as the static conditions inherent in historic preservation regulation can limit the values of individual properties and also reduce the potential for local economic growth and development that otherwise would occur.

Notes

1. The Antiquities Act (P.L. *59-209,* 34 5tat 225) created several national park sites and provided for protection of historic structures on federal land. Ten years later, the National Park Service was given authority to administer all historic structures in National Parks. Today, the Park Service remains the federal government's primary administrator for federally certified historic properties.

2. See, for instance, U.S. Department of the Interior, *Tax Incentives for Rehabilitating Historic Buildings: Fiscal Year 1994 Analysis,* February 1994; and R. Guenther, "Historic Rehabilitations Drop Despite Continued Tax Credit," *The Wall Street Journal,* June 3, 1987: 1. Alternative minimum tax requirements may also have contributed to a reduction in the use of the tax credit

3. Studies include those by Lockard and Hines (1983),

Benson and Klein (1988), Asabere *et al.* (1989), Ford (1989), Nelson and Talley (1991), and Asabere and Huffman (1991).

4. See Asabere, Huffman, and Mehdian (1994).

5. See Asabere and Huffman (1994).

6. Historic facade easements are grants or donations by owners of historic property that preserve the outside fabric of historic buildings. In return for this encumbrance of his rights, the owner receives a federal income tax deduction theoretically equal to the value of rights lost. Subsequent buyers are faced with the restrictions imposed by the facade easement, but do not receive tax advantages. It is expected that buildings subject to prior grants of such easements will sell at discounts relative to the values of unencumbered properties. However, as noted above with regard to local historic designations in general, the exact impact would be a function of the stringency of the program.

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