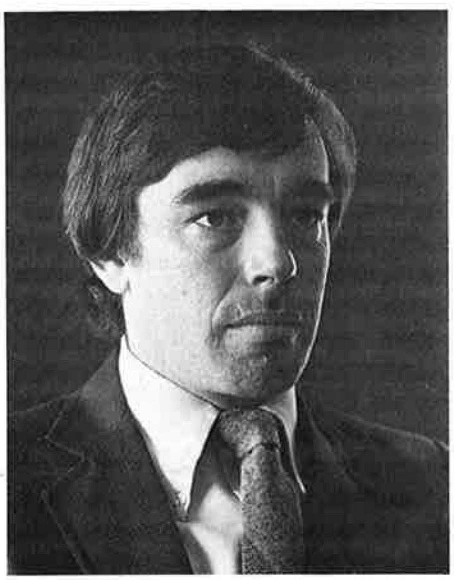
Historic Preservation and the 1981 Economic Recovery Act

by Donovan D. Rypkema



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If historic preservation is to be successfully achieved in this country, it will be achieved primarily through the workings of the private sector. Thus, historic preservation must primarily make economic rather than aesthetic, artistic, or historic sense as important as the latter elements may appear. The 1976 Tax Reform Act and the 1978 Revenue Act helped make economic sense of historic preservation, but the 1981 Economic Recovery Act has transformed historic preservation from a fantasy of historical societies to a working business reality for hard-nosed developers and steely-eyed accountants.

As a working preservationist, I consider it important that buildings on the National Register and in Historic Districts be restored and that this restoration be done within the guidelines laid down by the Secretary of the Interior. Personal experience has taught me that these guidelines not only make for good restoration but they also make for good sense.

As a developer, however, I must be convinced, from a fiscal perspective, that there is an advantage to having my building on the National Register and to rehabilitating it within the Secretary's guidelines. With the passage of the 1981 Economic Recovery Act, this advantage becomes an economic point of fact.

There are, in reality, only three ways to increase the net return on a real estate investment. Those are:

1) Reduce the initial net investment.
2) Increase the annual cash flow during the ownership period.
3) Increase the net proceeds when the property is sold.

Given the structuring of the 1981 Economic Recovery Act, not just one but all three of these variables can be used to benefit the investor in an historic property.

An additional broad-based benefit to preservationists from the 1981 Act is to be found in its increased encouragement for more buildings to be listed on the National Register, more historic districts to be formed, and more restoration to take place within the guidelines formulated by the Secretary of the Interior.

The purpose of this article is threefold:

1) To briefly outline what impact the 1981 Act does in regard to rehabilitation expenditures,
2) to present an example of how the resultant tax changes affect investment in an historic structure and its rehabilitation, and
3) to compare the appropriate restoration of a duly designated historic structure with the rehabilitation of a 50 year old building not on the National Register and not accomplished within the Secretary's guidelines.

The major provisions of the 1981 Economic Recovery Act relating to building rehabilitation are as follows:

First, buildings eligible for special tax benefits for rehabilitation are divided into three classes.

The first class of buildings is one composed of commercial 30 to 39 years old not qualifying as historic structures. The rehabilitation costs for this type of building are eligible for a 15% tax credit. A tax credit is an amount that can be subtracted directly from an investors income tax liability. For this class of property, however, the tax credit reduces the basis in the property. The basis is that number upon which the annual depreciation allowance is calculated.

The second category includes commercial property that is 40 years old or older and not of historic designation. For this type of property a 20% tax credit against rehabilitation expenditures is allowed. Once again the tax credit reduces the investor's basis in that property.

The third class of property designated under the new tax act is historic structures. The definition of an historic structure has been essentially unchanged from earlier acts. A building qualifies as an historic structure if it 1) is individually listed on the National Register of Historic Places or 2) is located in a qualifying historic district.

If the building qualifies as an historic structure and rehabilitation takes place within the Secretary's guidelines, the property is eligible for a tax credit of 25% of the rehabilitation expenditures. In the case of historic properties only, however, the tax credit does not serve to reduce the basis of the property. The net effect of this is to increase the annual depreciation allowance. While the first two classes of properties must be commercial, historic structures may also be residential.

There are three other provisions of the 1981 Act that should be noted:

1) If the properties are held for at least 5 years there is no recapture of the tax credit. This results in all of the gain at sale being treated as a long term capital gain.
2) Rehabilitation must be "substantial". "Substantial" means that either the greater of $5,000 or the basis of the building must be spent on rehabilitation.
3) 15 years can be used as the life over which the property may be depreciated.

This explanation of the Act is, necessarily, over simplified. There are undoubtedly pounds and pounds of regulations and interpretations yet to be written, but this explanation should be sufficient for use in the following demonstration of how the new tax act will work. The following narrative, with the accompanying tax tables, illustrates the comparative tax treatment of two structures. Building A is a 50 year old building but it is not an historic structure. Building B denotes a qualified restoration of an historic structure. The assumption for rental rates, restoration costs, ownership period and selling price are assumed to be the same for both buildings. The additional benefits for restoration of an historic structure become very clear. This example is initially detailed without financing and later will be recalculated with the financing and the tax brackets considered.

The assumptions common to the two buildings are as follows:

1) The building is a 50 year old structure of 5,000 square feet. Building "A" is not an historic structure; Building "B" is a property on the National Register with restoration work accomplished within the guidelines.
2) Each property is available for $50,000. The purchase price consists of $10,000 for land and $40,000 for building.
3) Rehabilitation costs are $150,000.
4) The property can be rented on a gross basis for $8 per square foot per year. Vacancy and operating expenses will consume 35% of that amount.
5) The property will be sold at the end of the 6th year for $200,000.
6) The rental income and the expenses will remain stable over the ownership period.

It bears repeating that the three ways that the return on a real estate investment can be increased are: 1) lower the initial cash investment 2) increase the annual cash flow 3) increase the net proceeds at sale. Table 1 illustrates several of the calculations required to appropriately