

# 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 three-fold:

- 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 investor's 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



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compare the two properties.

As can be seen in Table I all three of the return increasing variables work to the benefit of the historic property (Building B): a lower net initial investment, a lower annual taxable income (which will result in a higher annual cash flow) and a lower taxable gain at sale (which will increase the net proceeds at sale).

The positive effects of the 1981 Act become even more apparent when the financing arrangements and the investor's tax bracket are also considered. Two additional assumptions will be made for this purpose:

- 1) Financing is available for 75% of project cost at 15% interest for a 25 year term.
- 2) The investor is in a 50% marginal tax bracket.

**TABLE I**

	<u>Building A</u>	<u>Building B</u>	<u>Notes</u>
Purchase Price	\$ 50,000	\$ 50,000	Same for both
Rehabilitation Cost	150,000	150,000	Same for both
Total Cost	\$ 200,000	\$ 200,000	Same for both
Less Tax Credit*	30,000	37,500	Greater for Historic Property
Net Initial Investment	\$ 170,000	\$ 162,500	Less initial cash for Historic Property
Gross Annual Rent	\$ 40,000	\$ 40,000	Same for both
Less Expenses	14,000	14,000	Same for both
Net Operating Income	\$ 26,000	\$ 26,000	Same for both
Less Depreciation	10,667	12,667	Greater for Historic Property
Taxable Income	\$ 15,333	\$ 13,333	Lower taxable income for Historic Property combined with identical cash income will result in greater annual after tax cash flow
Purchase Price	\$ 50,000	\$ 50,000	Same for both
Rehabilitation costs	150,000	150,000	Same for both
Less Depreciation**	64,002	76,002	Greater for Historic Property
Less tax credit	30,000	N/A	Reduction of basis by tax credit not required for Historic Property
Adjusted Basis at sale	\$ 105,998	\$ 123,998	Higher basis for Historic Property
Sale Price	\$ 200,000	\$ 200,000	Same for both
Less Adjusted Basis	105,998	123,998	Higher for Historic Property
Taxable gain at sale	\$ 94,002	\$ 76,002	Lower taxable gain for Historic Property combined with identical proceeds at sale will result in greater net proceeds at sale

\* It is assumed that the investor will use the tax savings from the tax credit to help finance the investment.

\*\* Represents the total depreciation taken over the six year period.



Table II again illustrates the comparison between Building A and Building B. With these calculations completed, it is possible to "spread the numbers" over the period that the property will be owned.

**TABLE II**  
**Comparison of Calculations**

	<b>Building A</b>	<b>Building B</b>
Purchase Price	\$ 50,000	\$ 50,000
+ Rehabilitation Costs	+ 150,000	+ 150,000
= Total Costs	\$ 200,000	\$ 200,000
Rehabilitation Costs	\$ 150,000	\$ 150,000
X Applicable Credit	X 20%	X 25%
= Tax Credit	\$ 30,000	\$ 37,500
Total Costs	\$ 200,000	\$ 200,000
X 75% (Available Financing)	.75	.75
= Mortgage Amount	\$ 150,000	\$ 150,000
Purchase Price	\$ 50,000	\$ 50,000
+ Rehabilitation Costs	+ 150,000	+ 150,000
— Mortgage Available	— 150,000	— 150,000
= Cash Required	\$ 50,000	\$ 50,000
— Cash from Credit *	— 30,000	— 37,500
= Net Cash Required	\$ 20,000	\$ 12,500
Purchase Price	\$ 50,000	\$ 50,000
— Land Portion	— 10,000	— 10,000
+ Rehabilitation Costs	+ 150,000	+ 150,000
— Tax Credit (if applicable)	— 30,000	N/A
= Depreciable Basis	\$ 160,000	\$ 190,000
÷ 15 year life	÷ 15	÷ 15
= Annual Depreciation	\$ 10,667	\$ 12,667
Building Size	5,000/sq. ft.	5,000/sq. ft.
X Rental Rate	X \$8/sq. ft.	X \$8/sq. ft.
= Gross Rent	\$ 40,000/year	\$ 40,000/year
— Expenses (35%)	— 14,000	— 14,000
= Net Operating Income	\$ 26,000/year	\$ 26,000/year
— Principle & Interest Payments	— 23,055	— 23,055
= Cash Flow Before Taxes	\$ 2,945/year	\$ 2,945/year

\* It is assumed the investor will use the tax savings from the tax credit to help finance the investment.

Table III illustrates the cash received from the non-historic property for each of the six years. Table IIIa shows the tax calculations for the investor. Since the property generates an operating loss for tax purposes, there are actually negative taxes owing on the property. This negative tax liability thus effectively increases the after tax cash flow for the property for each year of ownership.



*The Buell Building, construction completed in 1888. Renovation under Tax-Act assistance - 1981.*

**TABLE III**

Year	1	2	3	4	5	6
Gross Rents	40,000	40,000	40,000	40,000	40,000	40,000
Expenses	14,000	14,000	14,000	14,000	14,000	14,000
Net Operating Income	26,000	26,000	26,000	26,000	26,000	26,000
Debt Service	23,055	23,055	23,055	23,055	23,055	23,055
Cash Flow (B/T)	2,945	2,945	2,945	2,945	2,945	2,945
- Taxes	(3,564)	(3,516)	(3,461)	(3,396)	(3,321)	(3,235)
Cash Flow (A/T)	6,509	6,461	6,406	6,341	6,266	6,180

**TABLE IIIa**

Net Operating Income	26,000	26,000	26,000	26,000	26,000	26,000
Less:						
Interest	22,460	22,365	22,254	22,125	21,975	21,802
Depreciation	10,667	10,667	10,667	10,667	10,667	10,667
Taxable Income	(7,127)	(7,032)	(6,921)	(6,792)	(6,642)	(6,469)
X Tax Rate	50%	50%	50%	50%	50%	50%
= Taxes	(3,564)	(3,516)	(3,461)	(3,396)	(3,321)	(3,235)

Table IV schedules the like numbers for a rehabilitated historic structure. The primary difference is the greater depreciation to which the historic structure is entitled as calculated above. It should be noted that the historic structure generates approximately \$1,000 per year more after-tax cash flow than Building A. Table IV includes the appropriate tax calculations for the historic structure.

TABLE IV						
Year	1	2	3	4	5	6
Gross Rents	40,000	40,000	40,000	40,000	40,000	40,000
— Expenses	14,000	14,000	14,000	14,000	14,000	14,000
= Net Operating Income	26,000	26,000	26,000	26,000	26,000	26,000
— Debt Service	23,055	23,055	23,055	23,055	23,055	23,055
= Cash Flow (B/T)	2,945	2,945	2,945	2,945	2,945	2,945
— Taxes	(4,563)	(4,516)	(4,460)	(4,396)	(4,321)	(4,234)
= Cash Flow (A/T)	7,508	7,461	7,405	7,341	7,266	7,170

  

TABLE IVa						
Net Operating Income	26,000	26,000	26,000	26,000	26,000	26,000
— Interest	22,460	22,365	22,254	22,125	21,975	21,802
— Depreciation	12,667	12,667	12,667	12,667	12,667	12,667
= Taxable Income	(9,127)	(9,032)	8,921	8,792	(8,642)	(8,469)
X Tax Rate	50%	50%	50%	50%	50%	50%
= Taxes	(4,563)	(4,516)	(4,460)	(4,396)	(4,321)	(4,234)

Table V compares the two types of property when they are sold.

TABLE V		
	Building A	Building B
Gain at Sale	\$ 94,002*	\$ 76,002*
X Tax Rate (50%)	.50	.50
X Capital Gain Rate (40%)	<u>.40</u>	<u>.40</u>
= Capital Gain Tax	\$ 18,800	\$ 15,200
Sale Price	\$200,000	\$200,000
- Mortgage Pay Off	14,650	144,650
-Capital Gain Tax	<u>18,800</u>	<u>15,200</u>
= Net Proceeds at Sale	\$ 36,550	\$ 40,150

\* These numbers are taken from Table I

The advantages in restoring a historic structure within the Secretary's guidelines, rather than simply "remodeling" an old building, now become obvious. As is readily apparent, the historic structure investor had 1) lower initial net cash investment, 2) a higher annual after tax cash flow, and 3) a higher net proceeds at sale.

In real estate investment analysis, there is a procedure to "plug in" these numbers and calculate a compounded annual rate of return. This is called an internal rate of return. When the numbers above are "plugged in", the 50 year old non-historic structure projects a very adequate rate of return on compounded, annual after tax basis.

All three of the items noted above (lower initial cash, higher cash flow, higher proceeds at sale) serve to dramatically increase the effective yield to the investor in the historic property. Based on the kind of analysis as above the investor in that historic property has nearly twice as high an after tax rate of return than has the Building A investor.

These two examples are obviously for demonstration purposes only. The relationship to reality of these numbers vary greatly from one part of the country to another and ob-

viously every time one of the assumptions is changed the "bottom line" subsequently varies.

What is important, however, is that as a result of the 1981 Economic Recovery Act, we as preservationists and as developers stand to benefit substantially. There is a great incentive to rehabilitate older structures including undertaking the work necessary to getting the building listed on the National Register, and to rehabilitating within the Secretary of Interior's guidelines.