

# **The Federal Historic Preservation Tax Incentive Program**

## **Information for the Tax Advisor**

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## **The Federal Historic Preservation Tax Incentive Program Internal Revenue Code Section 170 (h)**

### **Qualified Conservation Contribution**

- (1) In general. For purposes of subsection (f) (3) (B) (iii), the term "qualified conservation contribution" means a contribution:
  - (A) Of a qualified real property interest,
  - (B) To a qualified organization, and
  - (C) Exclusively for conservation purposes.
- (2) Qualified real property interest. For purposes of this subsection, the term "qualified real property interest" means any of the following interests in real property:
  - (A) The entire interest of the donor other than a qualified mineral interest,
  - (B) A remainder interest, and
  - (C) A restriction (granted in perpetuity) on the use which may be made of the real property.
- (3) Qualified organization. For purposes of paragraph (1), the term "qualified organization" means an organization which:
  - (A) Is described in clause (v) or (vi) of subsection (b) (1) (A), or
  - (B) Is described in section 501 (c) (3) and:
    - (i) Meets the requirements of section 509(a) (2), or
    - (ii) Meets the requirements of section 509(a) (3) and is controlled by an organization described in subparagraph (A) or in clause (i) of this subparagraph.
- (4) Conservation purpose defined.
  - (A) In general. For purposes of this subsection, the term "conservation purpose" means:
    - (i) The preservation of land areas for outdoor recreation by, or the education of, the general public,
    - (ii) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
    - (iii) The preservation of open space (including farmland and forest land) where such preservation is:
      - (1) For the scenic enjoyment of the general public, or
      - (11) Pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
    - (iv) The preservation of a historically important land area or a certified historic structure.
  - (B) Certified historic structure. For purposes of subparagraph (A) (iv), the term "certified historic structure" means any building, structure, or land area which:
    - (i) Is listed in the National Register, or
    - (ii) Is located in a registered historic district (as defined in section 47(c)(3)(13)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district. A building, structure, or land area satisfies the preceding sentence if it satisfies such sentence either at the time of the transfer or on the due date (including extensions) for filing the transferor's return under this chapter for the taxable year in which the transfer is made.
- (5) Exclusively for conservation purposes. For purposes of this subsection:
  - (A) Conservation purpose must be protected. A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is

protected in perpetuity. (B) No surface mining permitted.

(i) In general. Except as provided in clause (ii), in the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.

(ii) Special rule. With respect to any contribution of property in which the ownership of the surface estate and mineral interests has been and remains separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible.

6) Qualified mineral interest. For purposes of this subsection, the term "qualified mineral interest" means:

(A) Subsurface oil, gas, or other minerals, and

(B) The right to access to such minerals.

## **The Federal Historic Preservation Tax Incentive Program Applicable Regulations**

The US Code of Federal Regulations, Section 1.170A-14, contains the IRS standards used to determine if a conservation easement may be claimed as a charitable contribution deduction for federal income tax purposes. The following excerpts from this section are particularly relevant to "Facade Conservation Easements" and have been compiled to assist professional advisors to review and advise a client on the propriety and consequences of making such a donation.

(a) **Qualified conservation contributions.** A deduction under section 170 is generally not allowed for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property other than certain transfers in trust (see Sec. 1.170A-6 relating to charitable contributions in trust and Sec. 1.170A-7 relating to contributions not in trust of partial interests in property). However, a deduction may be allowed under section 170(f) (3) (B) (iii) for the value of a qualified conservation contribution if the requirements of this section are met. A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. To be eligible for a deduction under this section, the conservation purpose must be protected in perpetuity.

(b) **Qualified organization.** (1) **Eligible donee.** To be considered an eligible donee under this section, an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions. A conservation group organized 6( operated primarily or substantially for one of the conservation purposes specified in section 170(h) (4) (A) will be considered to have the commitment required by the preceding sentence. For purposes of this section, the term qualified organization means: (Ji) A charitable organization described in, section 501 (c) (3) that meets the public support test of section 509(a) (2);

(c) (2) **Transfers by donee.** A deduction shall be allowed for a contribution under this section only if in the instrument of conveyance the donor prohibits the donee from subsequently transferring the easement (or, in the case of a remainder interest or the reservation of a qualified mineral interest, the property), whether or not for consideration, unless the donee organization, as a condition of the subsequent transfer, requires that the conservation purposes which the contribution was originally intended to advance continue to be carried out. Moreover, subsequent transfers must be restricted to organizations qualifying, at the time of the subsequent transfer, as an eligible donee under paragraph (c) (1) of this section.

(d) (5) **Historic preservation.** (i) In general. The donation of a qualified real property interest to preserve a historically important land area or a certified historic structure will meet the conservation purposes test of this section. When restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed under this section only if the terms of the restrictions require that such development conform to appropriate local, state, or Federal standards for construction or rehabilitation within the district. See also, Section 1.170A-14(h) (3) (ii).

(d) (5) (iii) **Certified historic structure.** The term certified historic structure, for purposes of this section, means any building, structure or land area that is:

(A) Listed in the National Register, or

(B) Located in a registered historic district (as defined in section 48(g) (3) (13)) and is certified by the Secretary of the Interior (pursuant to 36 CFR 67.4) to the Secretary of the Treasury as being of historic significance to the district.

A structure for purposes of this section means any structure, whether or not it is depreciable. Accordingly easements on private residences may qualify under this section. In addition, a structure would be considered to be a certified historic structure if it were certified either at the time the transfer was made or at the due date (including extensions) for filing the donor's return for the taxable year in which the contribution was made.

(g) **Enforceable in perpetuity.** (1) In general. In the case of any donation under this section, any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions (for example, by recordation in the land records of the jurisdiction in which the property is located) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation.

(g) (2) **Protection of a conservation purpose In case of donation of property subject to a mortgage.** In the case of conservation contributions made after February 13, 1986, no deduction will be permitted under this section for an interest in property, which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity. For conservation contributions made prior to February 14, 1986, the requirement of section 170 (h) (5) (A) is satisfied in the case of mortgaged property (with respect to which the mortgagee has not subordinated its rights) only if the donor can demonstrate that the conservation purpose is protected in perpetuity without subordination of the mortgagee's rights.

(g) (5) (D) (ii) **Donee's right to inspection and legal remedies.** In the case of any donation referred to in paragraph (g) (5) (i) of this section, the donor must agree to notify the donee, in writing, before exercising any reserved right, e.g. the right to extract certain minerals which may have an adverse impact on the conservation interests associated with the qualified real property interest. The terms of the donation must provide a right of the donee to enter the property at reasonable times for the purpose of inspecting the property to determine if there is compliance with the terms of the donation. Additionally, the terms of the donation must provide a right of the donee to enforce the conservation restrictions by appropriate legal proceedings, including but not limited to, the right to require the restoration of the property to its condition at the time of the donation.

(g) (6) **Extinguishment.** (i) **In general.** If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g) (6) (ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

(ii) **Proceeds.** In case of a donation made after February 13, 1986, for a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. See Sec. 1.170A-1 4(h) (3) (iii) relating to the allocation of basis. For purposes of this paragraph (g) (6) (ii), the proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction under paragraph (g) (6) (i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

(i) **Substantiation requirement.** If a taxpayer makes a qualified conservation contribution and claims a deduction, the taxpayer must maintain written records of the fair market value of the underlying property before and after the donation and the conservation purpose furthered by the donation and such information shall be stated in the taxpayer's income tax return if required by the return or its instructions. See also Sec. 1.170A-1 3(c) (relating to substantiation requirements for deductions in excess of \$5,000 for charitable contributions made after 1984), and section 6659 (relating to additions to tax in the case of valuation overstatements).

## **The Federal Historic Preservation Tax Incentive Program Case Law Summary**

The Tax Treatment Extension Act of 1980 (Public Law 96-541) established that taxpayers may deduct the value of conservation easements as a charitable contribution. Subsequent Treasury Regulations issued in 1986, Section 1.170A-14, provided the specific conditions that must be satisfied for the deduction to be allowed.

Both before and after the issuance of the IRS regulations, cases were heard in Tax Court concerning conservation easement deductions involving exterior only restrictions in areas where there were already local ordinances regulating such changes.

The following citations cover the five significant cases that are relevant to the kind of easement supported by this program, the last of which was concluded in 1990:

- Hilborn v. Commissioner, 85 T.C. 677 (U. S. Tax Ct. 1985)
- Nicoladis v. Commissioner, T.C. Memo 1988-163 (U.S. Tax Ct. 1988)
- Griffin v. Commissioner, T.C. Memo 1989-130 (U.S. Tax Ct. 1989)
- Losch v. Commissioner, T.C. Memo 1988-230 (U.S. Tax Ct. 1988)
- Dorsey v. Commissioner, T.C. Memo 1990-242 (U.S. Tax Ct. 1990)

The common threads running through these cases are:

- The court ruled that there is at least a minimal loss of value of 10% when an in-perpetuity easement is placed on a qualifying property even when a local ordinance applies similar restrictions on the property;
- The way the actual loss of value is to be determined is by the "before" and "after" method, taking into account the best and highest use of the property;
- The appraised fair market value of the entire property including the land is the "before" basis for the valuation;
- The "after" valuation must take into account that the granting of a conservation easement gift is a relinquishment of part of the "bundle of rights" held by the property owner. The appraiser must determine the impact of the additional restrictions and burdens imposed on the property by the conservation easement agreement and determine what "loss of value," if any, these additional restrictions and burdens create. The greater number of rights given up, or additional burdens placed on the property through the terms and conditions of the conservation easement, the greater the "loss of value."
- The difference between the "before" and "after" valuations constitutes the value of the easement for the purpose of the tax deduction;
- In each case, the IRS sought a valuation of 10% and was overruled by the court which determined the value to be higher than 10% but not as high as the taxpayer sought; and
- The court strongly urged the IRS to avoid bringing to it future disputes about the technical issues of deciding the precise percentage value of the easement donation.

## **The Federal Historic Preservation Tax Incentive Program Legislative History**

The Historic Preservation Tax Incentive Program evolved from the National Historic Preservation Act (Public Law 89-665), which greatly expanded the Federal government's role in historic preservation. Prior to this legislation, historic preservation had been primarily

directed toward preserving individual landmark buildings or properties of national historical significance, such as Thomas Jefferson's home at Monticello or the Civil War battlefield at Gettysburg. This new legislation, passed by the U.S. Congress in 1966, recognized the importance of preserving properties and places that have cultural value, not just historical significance. This included historic neighborhoods, whole streets of old historic houses and historic markets.

The National Historic Preservation Act established legal guidelines for identifying and protecting important cultural resources. Under the law, the Secretary of the Interior, through the National Park Service, was authorized to create a list of those historic places and properties worthy of preservation. This list, "The National Register of Historic Places," identifies "sites, buildings, objects, districts and structures significant in American History, architecture, archaeology and culture." The National Register includes not only properties of national significance, but also significant properties on the state and local levels.

This legislation gave the Secretary of the Interior responsibility for planning and oversight of federal historic districts. A historic district was defined as, "a geographically definable area - urban or rural, large or small -possessing a significant concentration, linkage or continuity of sites, buildings or structures, and/or objects united by past events or aesthetically by plan or physical development."

The 1966 Act was a major advance in the Federal government's role in historic preservation. However, after ten years of experience with the legislation, the Congress was concerned that this legislation was not being effective in protecting the nation's cultural resources. The Congress had relied primarily on local and state governments! i citizens groups and local zoning ordinances to protect the nation's cultural heritage. The creation of the National Register of Historic Districts through the Department of the Interior did not give the federal government control over these districts. The control remained exclusively with the state and municipal governments. Thus, it allowed by the state and/or the municipal government, any building in any historic district could be legally destroyed.

In 1976 the Congress, in response to the perceived inadequacies in the country's historic preservation laws, passed the Tax Reform Act of 1976 (Public Law 94-455). This legislation attempted to strengthen the country's historic preservation efforts by providing federal tax incentives for the preservation and rehabilitation of properties certified as historically significant by the Secretary of the Interior. This was the first time federal tax incentives were merged with historic preservation goals. The tax laws, until then, had given tax benefits only for new construction, which encouraged the destruction and replacement of older buildings. This law, for the first time, made the restoration and rehabilitation of historic buildings economically advantageous to developers and, for the first time, made the preservation of historic buildings economically competitive with new construction.

In the Tax Reform Act of 1976, Congress recognized the enormous political and economic pressures on municipal and state governments to allow new development in historically sensitive areas. To deal with these political and economic realities and to ensure against the possible loss of significant properties within federal historic districts, Congress established unique tax incentives for owners of historic buildings. These tax incentives, authorized by the Tax Reform Act, are the legislative basis for the Historic Preservation Tax Incentive Program.

The Congress created the Historic Preservation Tax Incentive Program to encourage individual property owners living in federal historic districts to participate directly in the historic preservation process. It hoped that, if enough owners of historic properties participated in the Historic Preservation Tax Incentive Program, this program might act as a form of insurance, protecting these historic cultural resources when economic and political pressures on local governments became too great. The Congress wished to protect historic properties but avoid burdening the country with the expense of purchasing and maintaining these properties. It also did not want to remove the protected properties from the tax rolls.

To accomplish these goals, Congress offered owners of historic properties located in federal historic districts a sizable reduction in their federal income tax (in some cases, a reduction in their state and local taxes as well) if the property owner would agree to preserve the historic nature of the property's exterior. The Congress believed that federal historic districts' architectural integrity might remain intact if a large number of property owners participated in the program.

The legal mechanism utilized by the legislation that allows full private ownership while limiting exterior modification of the historic property is called a "historic preservation easement" or "facade conservation easement." It is a property owner voluntarily agrees to place a "historic preservation easement" on their property in order to qualify for financial compensation through a reduction in their tax liability, they are committing to retain historically significant architectural features of the property's exterior appearance.

The Tax Treatment Extension Act of 1980 revised the 1976 statute (Public Law 96-541). The legislation strengthened and clarified the commitment of Congress to promote conservation of historically significant property through tax incentives to individual property owners through the Historic Preservation Tax Incentive Program.

After the 1976 legislation was enacted, there were many conservation easements donated to qualified organizations and claims for charitable contribution deductions made in tax filings. However, as this was a new program, there was considerable confusion and controversy over how to value the easement as a tax deduction. Some IRS regional offices disallowed the deduction, claiming the properties were already protected by local ordinances and there was no real loss of value. By the beginning of the 1980's, because of IRS behavior, property owners became wary of claiming a tax deduction for the donation of historic preservation facade easements.

In 1986, the Department of the Treasury issued final regulations governing the circumstances under which easement donations would be allowable as charitable deductions (Treasury Regulations Section 1.170A-14). Also, during this time, a number of tax court rulings were rendered that clearly state that there is a loss of value in cases when an easement only restricts exterior changes and is granted on a property already restricted by local historic preservation ordinances. In these tax court cases, the IRS took the position that the loss should be valued at 10%. The tax court granted a higher percentage in each case, although not always as high as the taxpayer wanted. Following the case of *Dorsey v. Commissioner* in 1990, there have been no tax court cases involving the valuation of facade conservation easements of historic buildings.

The IRS has subsequently published guidelines stating "that proper valuation of a facade conservation easement should range from approximately 10% to 15% of the value of the property." (Facade Easement Contributions prepared by Mark Primoli, I.R.S.)

Unfortunately, due to the past controversy around the donation of facade conservation easements in the 1980's, only a few historic preservation organizations are knowledgeable enough to assist property owners in participating in the Historic Preservation Tax Incentive Program.

Increased effort is now underway by these organizations to assist owners of historic properties to help protect the nation's architectural resources by participating in this important federal program. The education of the public is one aspect of this effort.