

Valuation of Facade Easements - Methodology, Trends & Case Study

By: Marc Nadeau, SRA

The Premise of Historic Facade Easements

Facade easements are essentially grants or donations of historic property to a qualified organization for the purpose of preserving the historic fabric and/or character of a building's facade. The easement serves to preserve the character of that building into perpetuity with the burden of preserving such building being borne by the grantor of the easement.

The obvious benefit is in preserving the historic nature of a property with the real boon being to the grantor, who typically is entitled to a tax benefit which is recognized as a "charitable tax deduction" by the IRS.

The vehicle of a facade easement seemingly has been used sparingly in New England despite a large population of historic structures. This trend may be reversing as more taxpayers, developers and preservationists become aware of the tax advantages and the benefits that can often make the restoration and maintenance of a historic structure more feasible.

Of course, when an avenue for tax benefits exists often come abuses of the same. There have been many of a story of taxpayers claiming deductions for as much as 50% of the value of say a brownstone in New York where values often reach into the stratosphere. The Internal Revenue Service has often challenged these deductions and as a result made strides in revising the language governing charitable deductions of easements.

New Developments in the Valuation of Historic Facade Easements

The tax benefits of preservation easements date back to 1969 with major revisions to the Internal Revenue Service Code via the Tax Reform Act of 1986. Over the past twenty years the language regarding preservation easements and allowable provisions for tax deductions has remained virtually unchanged. On August 17, 2006, as part of the omnibus pension bill, H.R. 4 was signed into law by the President as Public Law 109-280.¹

The bill included sweeping new language that enhanced the language of the tax code, made reporting requirements more stringent but at the same time expanded the availability of tax deductions.

¹ Easement Reforms Act as summarized by the National Trust, 2006, www.nationaltrust.org/legal/easements/developments

The following is a summary of the new rules as they relate to buildings in registered historic districts:

- ★ Disallowing deductions for preservation easements that fail to protect the entire exterior of a property;
- ★ Prohibiting deductions for easements that allow changes that are incompatible with a building's historic character;
- ★ Requiring the donor and donee to certify under perjury that the easement-holding organization is qualified to accept easements, and had the resources and commitment to manage and enforce the easement;
- ★ Requiring the owner to provide the IRS with more detailed substantiation to prove the value of the donation;
- ★ Imposing a new filing fee of \$500 for easement deductions more than \$10,000.
- ★ Lowering thresholds for overvaluation penalties for donors, and imposing new overvaluation penalties for appraisers
- ★ Imposing new qualification standards for appraisals and appraisers. ²

Major benefits of the bill include:

- ★ The law expands the availability of the charitable tax deduction for easements donated in 2006 and 2007.
- ★ The law increases the annual amount deductible for most taxpayers from 30% to 50% of a taxpayers contribution base (adjusted gross income less net operating loss carrybacks) ³

Establishing a Value for an Easement - Historical Benchmarks

In theory, the encumbrance of a facade easement results in a diminution in market value to the encumbered property. The percentage of diminution is driven by two primary factors. Firstly, the extent of the restrictions and responsibilities contained in the easement agreement and secondly, the level of detail and type of material that the building consists of. The greater the restrictions and/or greater the detail that the building has, the greater the percentage of diminution.

This appraiser has reviewed numerous facade easements with the majority of the instruments in plain and simple language providing restrictions that prohibit changes to the building's facade. The typical easement also requires the grantor to pay for periodic inspections and to maintain the building to a specific standard, keeping a certain maintenance level and using like materials for replacement and repairs.

A typical facade easement creates a number of impositions that can be summarized as follows:

2. Ibid
3. Ibid

- * Limitation of development opportunities. The typical facade easement would prohibit the construction of any additions or to make any changes to the exterior of the building.
- * Higher ongoing operating costs. Facade easements impose a higher level of maintenance which translates into greater expenses. Such costs include higher on-going maintenance by product of maintaining what is typically a material intensive design and construction. Materials such as limestone, terra cotta and detailed wood facades are much more costly to build and maintain in comparison to the predominate building materials and standards used today.
- * Periodic inspection costs are typically borne by the grantor.
- * If the building were damaged or destroyed, the facade must be restored to the original condition. As a result, the grantor would be required to carry greater insurance to fulfill not just replacement, but a reproduction of the current detail which is far more costly in today's market.

The problem typically faced by the appraiser in estimating an appropriate diminution rate is the lack of empirical information also known as market-derived information. Many an appraiser, including myself have often relied upon published tax cases where courts have essentially determined diminution rates. Two of the more significant cases that have been used in establishing the value of facade easements have been:

Hillborn vs. Commissioner, a 1986 decision where 10% of the value of the property (as renovated) was allowed. ⁴ This case involved an apartment building in the historic French Quarter of New Orleans

Griffin vs. Commissioner, a 1989 decision where a 20% deduction was allowed. ⁵

Subsequent decisions have allowed deductions ranging from 12% to 15%

4. *Hillborn vs. Commissioner of Internal Revenue*, 85 T.C. 40 (1985)

5. *Griffin vs. Commissioner of Internal Revenue*, 56 T. C. 1560 (1989)

Case Study

The following is a case study of a property that was sold with a facade easement in place. The property consists of an income-producing apartment building wherein this appraiser had the luxury having the actual income and expense data as of the date of sale. The only subjective element of the analysis was that of the overall capitalization rate which was supported by several market-derived capitalization rates from similar apartment properties in the subject market.

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| Address | 101 Whiting Street, Winsted, CT (Winchester) |
| Property Significance | Mill building built in the late 1800s with significant architectural detail. The building detail includes a 3-story Italianate style stone facade on a portion of the building. The property has significant river frontage and is listed on the "National Register of Historic Places" (Property ID # 85000308) |
| Construction | 3 Story Brick and Stone structure built in 1887 and renovated in 1985. The building contains 39 apartment units which were in good condition at the time of sale. The building further has a partial basement, a 4-stop elevator and on-site paved parking. The gross building area is 38,896 square feet. |
| Facade Easement Limitations | The facade easement protects all architectural elements of the building including, but not limited to: exterior walls, cornices, lintels, sills, oriels, windows, balconies, grills, grates, lamp brackets, scrapers and hand rails. There is to be no future development or change in the facade of the building whatsoever. Replacement of elements is limited to the use of the same or like material, quality and colour and shall be appropriate to the original style of the building. All four facades of the building are encumbered |
| Marketability aside from Facade Easement | The subject property is extremely marketable with a riverfront location and near 100% occupancy for several years. |
| Date of Sale | September 2005 |
| Net Operating Income | \$201,709 |
| Capitalization of NOI | \$201,709 divided by 7.0% = \$2,881,557 or \$2,900,000 (rounded) |
| September 2005 Sale Price | \$2,600,000 |
| Diminution attributed to Facade Easement | \$300,000 |
| % of Value Diminution | 10.34% |

Summary

The case study of a National Register listed building that sold recently produced a market-derived diminution rate of 10.34%. This rate is in concert with the Hillborn Case where a 10% diminution was found by the court.

Based upon the aforementioned analysis, appraisers and grantors alike can safely cite a regional benchmark of diminution while at the same time providing a report that will better meet the stepped-up scrutiny of the Internal Revenue Service. The other intent of this article is to enhance the knowledge and awareness of appraisers and building owners alike that will perhaps lead to greater preservation of the historic fabric that so much defines the New England landscape.

Bio

Marc P. Nadeau, SRA is an appraiser and developer that has spent the better part of his 25-year career appraising, restoring and redeveloping historically significant properties. He is a veteran of working with historic district and preservation groups. In recent years he has appraised properties designed by Philip Johnson, Frank Lloyd Wright, Marcel Breuer and I. M. Pei. On the development side, Mr. Nadeau's current project is "The Residences at Wooster Square" the renovation of a 100-year-old bank building in downtown New Haven. Marc Nadeau can be reached at www.marcnadeau.com.