An Overview

HISTORIC PRESERVATION EASEMENTS

To Preserve, or not to preserve, that is the question.

Big - Commercial

Little - Residential

Important Easement Distinction

- Conservation
  - A restriction that limits the future use of a property to preservation, conservation, or wildlife habitat .
- Historic Preservation
  - A restriction that prohibits certain physical changes in an historic property; usually based on the property's condition at the time the easement was acquired or immediately after proposed restoration of the property

Historic Preservation Easement Characteristics

- Easement in Gross – element of control to non adjacent third party
  - May be called easement in servitude
- Easement Appurtenant – element of control to adjacent third party

- Historic and conservation easements are typically easements in gross

Initial Criteria

- Must meet ***ONE*** of the following:
  - Property individually listed in the National Register of Historic Places
  - Property that contributes to the historic or architectural character of historic districts listed in the National Register of Historic Places
  - Property that contributes to the historic or architectural character of certified state or local historic districts
  - *Historically important land areas*, as defined by Treasury Regulation

Conservation Easement, term of art!

- Regulation term, Conservation Easement is an umbrella term covering:
  - Conservation Easements
  - Historic Preservation Easements
    - Façade Easements are a subset of HPE

An Issue of Timing

- Before July 25, 2006
  - Preservation easements could be limited to portions of the exterior facades.
- Pension Protection Act of 2006, Section 1213
  - National Register or Certified Local District buildings protect all facades and height.
  - "Preserves the entire exterior of the building (including the front, sides, rear, and height of the building)"
  - "prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior"

Elements of Protection

- All exterior features
- Pre 2006 (PPA), portions of exterior features
- Views and settings
- Horizontal additions
- Vertical additions
- All interiors
- Selected interiors or features of interiors
- Historic landscape
- Natural land features and characteristics

Easement Appraisal Assignments

- Atypical issues, problems, and methods
- Going forward, higher possibility of assignments with easements in place
- CE and HPE Assignments may have differing uses
  - For the taxpayer as charitable contribution
  - For holder of the easement to market for sale
  - To purchaser of easement as investment
  - To seller of previously encumbered land
  - To purchaser of previously encumbered land
  - For IRS as valuation specialist and court

Burden of knowledge and experience (competency) is on the engaged expert

A Bit of History

- Pre 1976
  - 1964 Revenue Ruling permitted deduction for restrictive easement in perpetuity to federal government
  - 1969 Code amended to limit deduction to entire interest and open space easements of 30 years or longer
  - 1972 amendment recognized open space conservation easements as an undivided interest, but preservation easements were not mentioned

- Conservation and Preservation Easement

  ERA One, 1976 – 1981
  - Tax Reform Act of 1976 recognized conservation and preservation easements as qualified partial interest deductions
  - Professional organizations began publishing articles, valuation methodologies were undeveloped, and few appraisers performing the valuations

A Bit of History

- Conservation and Preservation Easement
  ERA Two, 1981 -1988
  - Economic Recovery Tax Act of 1981
  - Code section 170(h) created
  - Treasury Regulation 1.170A-14 adopted in 1986
  - Conservation Easements and emergence of land trust movement
  - Preservation easements and the emergence of a historic preservation movement
  - The Hilborn Case of 1985 reportedly the origin of the 10% safe harbor rule for diminution
  - Increased volume of published opinions and treatises regarding easements

A Bit of History

- Conservation and Preservation Easement

  ERA Three, 1988 - 2003

  - Emergence of more sophisticated conservation/preservation organizations
  - Concerted drive to protect large family estates and farms
  - Emergence of a "market" for conservation land
  - Preservation easements declined in early 1990's as a result of commercial crash in the late 1980's
  - Tax Code changes and reduction in the investment tax credit to 20%
  - Preservation easements revived in late 1990's with market recovery
  - Increased interest in historic rehabilitation
  - Birth of the 15% rule out of Philadelphia survey and statement in the "Market Segment Specialization Program Analysis" (later rescinded)

A Bit of History

- Conservation and Preservation Easement ERA Four, 2003 - present
  - Expanded promotion of both easement types by private industry
  - The 15% rule held ground until 2004
  - Creation of state tax incentives – sale of tax credits
  - Wider spread exposure of easement abuses
  - Creation of the Issue Management Team in 2005
  - Development of industry sponsored training
  - Pension Protection Act of 2006
  - Definition of qualified appraiser and appraisal
  - Code 6695A penalty provision
  - Recognition of USPAP as generally accepted standard
  - Safe Harbor diminution (15%) for façade easements not acceptable

IRS Publication 561

- Drafted in 1987, updated in 2005 and 2007
- Cites the definition of Fair Market Value
- Admonishment against use of fixed formulas for FMV
- Price of subject acceptable measure of value if transaction is arms length and current
- Market change adjustments acceptable if supported

IRS Publication 561

- Four problems in measuring fair market value
  - Use of sales “made in a market that was artificially supported or stimulated”
    - Bargain Sale Deeds?
  - Careless selection of comparable sales
    - Fails the test of comparability
  - Consideration of unexpected future events
    - May not consider unexpected events happening after donation
      - Gravel pit demand after 70 year existing supply is gone
      - Subdivision development that our grandchildren’s grandchildren might see
    - May consider only the facts known or those reasonably expected
      - Subdivision or expansion plans in process and supported by demand and absorption
  - Using past events to predict the future – too much reliance on the past
    - Use of 2000 demographics and sales history to predict demand in 2007/2008

Value Distinctions

- Fair Market Value
  - The price that property would sell for on the open market
  - The price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.
- Market Value
  - The most probable price that the specified property interest should sell for in a competitive market after a reasonable exposure time, as of a specified date, in cash, or in terms equivalent to cash, under all conditions requisite to a fair sale, with the buyer and seller each acting prudently , knowledgeably, for self-interest, and assuming that neither is under duress.

Qualified Appraiser?

- Treasury Regulation 1.170A-13
  - Holds self out as an appraiser
  - Qualified to appraise the property type (competent?)
  - Not the owner/taxpayer
  - Not a party to acquisition of the property
  - Not employed or related to the owner
- Notice 2006-96
  - Earned appraisal designation OR otherwise met minimum education and experience
  - Regularly performs appraisals for compensation
  - Not been prohibited from practice before IRS
  - License or Certification establishes minimum education

Competency?

- Guidance is from Uniform Standards of Professional Appraisal Practice (USPAP)
  - Competency is determined prior to accepting assignment
    - Ability to identify the problem to be addressed
    - Knowledge and experience to complete work competently
      - Type of property
      - The market
      - Geographic area
      - Intended use
      - Laws and regulations
      - Methodology
    - Recognition and compliance with appropriate laws and regulations
  - If not competent, must disclose to client and the recommended solution (withdraw?)
  - Describe in the report the lack of competency and solution
  - If discovered during the assignment, STOP, notify client, and same steps as above
- If competency issue cannot be resolved, the appraiser MUST withdraw from the assignment!

Scope of Work

- Every easement issue must be viewed as unique
- Market Analysis, Absorption and Highest and Best Use analysis is critical
- Architects and/or Engineers may be a necessary consultation
- Encumbered sale research is necessary, but may not lead to beneficial data
- Automatic shortcuts or fixed formulas are not acceptable analysis tools
- Sufficient time must be spent with the client to fully understand the problem
- Scope of work includes understanding of intended users, intended use, and what guidelines, code, regulation and rules apply
- Data requirements, methodology used, form and format should all be identified and noted as a part of the scope of work statement. Scope of work is the “blueprint” of the assignment.

Qualified Appraisal?

- Required Inclusions
  - Description of the property
  - Description of physical condition of the property
  - Date of charitable donation
  - Terms of agreements between donor and donee
  - Appraiser's name, address, TIN, and employer
  - Summary of appraiser's qualifications
  - Statement that appraisal was done for tax purposes
  - Date of appraisal report
  - Conclusion of Fair Market Value
  - Method of valuation used
  - Description of fee arrangement – no contingent fees

Qualified Appraisal?

- Timing Issues
  - No earlier than 60 days prior to easement donation
  - No later than taxpayer filing date for the year donation made
  - Retrospective appraisal effective date is the date of donation

The 8283 and Added Certification

- Required when easement value exceeds $5,000
- Must include the appraised value of the easement
- Must be signed by the appraiser
- The added certification:
  - "Furthermore, I understand that the false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701 (a) (aiding and abetting the understatement of tax liability). In addition, I understand that a substantial or gross valuation misstatement resulting from the appraisal of the value of the property that I know, or reasonably should know, would be used in connection with a return or claim for refund, may subject me to the penalty under section 6695A. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility."
- The appraisal must be attached to the return and include all exterior photographs and describe all development restrictions

OK, from the baby gallery!

BEEN HERE, DONE THIS?!

I could eat the wheels off a Buick!

Are we there yet?

Are we there yet?

How many minutes?

Drum, drum, drum . . .

Oh, this is looking better!

Are we there yet?

Can we stop?

How much longer?

Drum, drum, drum. . .

Now, this is the TICKET!!!!!!!!!!!!!

Jeeze, you said just another few minutes!

Yup (cowboy talk), it’s time for grub!!!

Easement Valuation Regulation

- Regulation 1.170A-14(h)(3)(i)
  - If there is a substantial record of sales of easements comparable to the donated easement . . . the fair market value of the donated easement is based on the sales prices of such comparable easements.
    - Direct sales comparison of easement sales
  - If no substantial record of market place sales is available . . . the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction
    - Direct sales comparison of unencumbered properties for the before value, direct sales comparison of easement encumbered properties for the after value
    - Percent diminution is generally a derivative of this approach

Easement Valuation Regulation

- Regulation 1.170A-14(h)(3)(i)
  - The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family . . . is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction.
    - For a partial encumbrance, this approach is a must!
    - Analysis of the larger parcel (contiguous family owned parcel) before and after
  - Enhancement may require separate appraisal analyses and conclusions.

Highest and Best Use Analysis

- Regulation 1.170A-14(h)(3)(ii)
  - If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed
  - This is analysis of the Market, Absorption, and Highest and Best Use.
    - A conclusion can only be supported with full financial analysis (return of and on investment) for all physically possible, legally permissible, financially feasible alternative uses.

Easement Valuation Regulation

- Regulation 1.170A-14(h)(3)(ii)
  - In the case of a conservation restriction that allows for any development, however limited, on the property to be protected, the fair market value of the property after contribution of the restriction must take into account the effect of the development.
  - In the case of a conservation easement such as an easement on a certified historic structure, the fair market value of the property after contribution of the restriction must take into account the amount of access permitted by the terms of the easement.

Valuation Specific Issues

Before Valuation

- Existing historic preservation regulations that already affect value
- Differences between National Register and state or local restrictions
- Highest and best use alternatives within historic restrictions before easement

After Valuation

- Limited "comparable" properties with similar easement restrictions
- Necessity to fully understand added easement restrictions
- Assessment of risk associated with preservation easement ownership

Procedural Steps, Eating the Elephant a Bite at a Time!

- Get, read and understand the easement document, preferably the final recorded copy
- Is the donee a valid entity?
- Purpose of the easement valid?
- Identify protected features of the property
- Identify unrestricted activities
- Identify restricted or eliminated activities
- Assess review and enforcement procedures
- Assess the strength of “perpetuity”
- Verify mortgage subordination
- Review baseline documentation

Assess the Easement Holder

- Strong enough to monitor and enforce the terms of the easement? Assess the track record of the donee organization
  - Historic performance may have a direct tie to market acceptance and value or value impact after encumbrance
- Financial strength of organization?
- Volume of easements in the portfolio?
- Dedicated easement endowment program?
- How is the endowment fund used?
- How large is the staff to monitor, maintain, and enforce easement restrictions?
- What is the interface process to the public?

Highest and Best Use Analysis

- Highest and best use is the fundamental building block of value
- Highest and best use cannot be analyzed until market analysis and absorption studies are complete
- Unlike most conservation easements, historic preservation easements have improvements in place that must be analyzed
- Highest and best use is always a financial analysis
  - Phase one tests for which of the five land uses is appropriate
  - Phase two tests for the ideal improvement
  - Identifies interim uses and projection of changes over time
- Highest and best use studies must include as vacant and as improved analysis in both, the before and after easement condition

HBU – As Vacant Before Easement

- The four tests are the constant, the results will vary from case to case, and period to period. Always market driven.
  - Legally permissible
    - What does current zoning allow (size, type, density)?
    - Can zoning be changed – at what cost and time?
    - Assemblage, TDR's possible?
  - Physically possible
    - Of what is or could be legal, what can physically be accommodated (set backs, parking, height, shade or sunshine planes, etc.)
  - Financially feasible
    - Of the uses that are legal and physically possible, which are financially feasible (any use generating value in excess of the land as if vacant is financially feasible)
  - Maximally productive for vacant land or dozer bait
    - Which of the financially feasible uses that remain generates the greatest return to the land (not necessarily the highest total value)

HBU – As Improved Before Easement

- The four tests are the constant, the results will vary from case to case, and time to time. Always market driven.
  - Legally permissible
    - What does current zoning allow (size, type, use, density)?
    - Can zoning be changed – at what cost and time?
    - Assemblage, TDR's possible?
  - Physically possible
    - Of what is or could be legal, what can physically be accommodated (expandable, rehab constraints, building code conditions)
  - Financially feasible
    - Of the uses that are legal and physically possible, which are financially feasible (any use generating value in excess of the land as if vacant after renovation [if necessary] is financially feasible)
  - Maximally productive as improved
    - Which of the financially feasible uses that remain generates the greatest return to the land (after renovation or change if required)

HBU – After the Easement

- The four tests are the same and applied to the land as if vacant and as improved
- Must now consider constraints of the preservation easement
  - Limitation on use
  - Limitation on size, vertical and horizontal additions and cost
  - Limitation on alteration and cost to change
  - Limitation on subdivision
  - Impact on TDR's if present
  - Maintenance requirements and associated cost
- If the improvements continue to add value, then determine if the use is interim subject to change, when, and at what cost within the easement limitations
- If not interim, do the current improvements remain as-is, need renovation, or alteration within the easement limitations

HBU as Comparative Approach

Before Easement Restrictions

- A Select legal uses
- B Select legal physical uses
- C Measure value of potential uses
- D Determine which has the highest residual land value

After Easement Restrictions

- E Select legal uses
- F Select legal physical uses
- G Measure value of potential uses
- H Determine which has the highest residual land value

In some cases, D minus H may just be the value of the easement

Sales Comparison Approach

- Dependent on the availability of historic easement sales
  - Very limited in volume and analysis of easement specific differences is crucial
  - Most markets will have few if any confirmable transactions
- Dependent on the availability of historic easement encumbered property sales
  - Very limited in volume and analysis of easement specific differences is crucial
  - Most markets will have few if any confirmable transactions
- *The stark reality, scarcity of data may limit the reliability or eliminate the approach entirely!*

Cost Approach

- When sales data is extremely limited for sales comparison analysis, alternative methods must be considered
- Accrued depreciation will remain the single hardest element to analyze and measure
- Depreciation must be appropriately separated into physical deterioration, functional obsolescence and external obsolescence
- Focuses the land value analysis to reflect imposed impacts from the easement
  - Expansion limitations
  - Subdivision limitations
- Focuses the improvement value analysis to reflect imposed impacts from the easement
  - Residual external obsolescence
  - Residual functional obsolescence
- The approach may be completed as an element of the highest and best use analysis (scope of work and format issue)

Cost Approach Special Considerations

- Remember and watch for violations of the Principle of Consistent Use!
  - The value of the land at one use cannot be added to the value of the improvements for a different use
  - Would rarely be an issue, but easement analysis certainly opens the door
  - The existing improvement value can only be added to the residual value of the land in the as improved condition
- Depreciation analysis is always an issue of judgment
  - Even the tables require analysis and decision of what is appropriate
  - Economic Age life is generally too broad and inclusive to be meaningful
  - Modified Economic Age life is still a broad based inclusive method
  - Break Down Depreciation is likely the only viable solution in most cases
- Don't forget – Total economic life = effective age plus remaining economic life, therefor all forms of depreciation are combined!

Income Approach

- In cases of limited sales data the income methods may be the reliable choices. Must always reflect market trends relative to income and rates of return (capitalization and yield).
- Primarily based on the Principle of Anticipation adjusted to reflect Present Value
- Can be used to measure the value before and after the easement

Income Approach

- Must include sufficient information and support to show how the impact of the preservation easement is affecting the income approach units and elements of comparison
  - Market rent
  - Vacancy or Occupancy and stabilized levels
    - If not at stabilized occupancy, why not, cost and time to get there must be considered
  - Miscellaneous income and appropriate consideration (before or after vacancy)
  - Expenses and reserves for replacement
  - Capitalization rates
  - Yield rates or internal rates of return relative to DCF
- Remember the challenge is Fair Market Value, therefore, unless actual rent is equal to market rent the measure is based on market rent!
- There are no Safe Harbor Rates or Discounts, no TMB's or LOF's. Must show and support!

Income Approach Special Considerations

- Historic designation may already impact income and expense
  - Exercise care to not double adjust income or expenses
- Property taxes may be different with the designation and/or the easement
- The market may be multi-tired relative to cap or discount rates (yield rates) relative to historic designations and/or easements
- Expenses and reserves can be significantly impacted by imposed maintenance or replacement expenses
- Discounted cash flow is a viable approach when income and expense projections are reasonably measured
  - Time value analysis is typically loaded with subjective assessment
  - Support for assumptions is critical and must be market driven
  - Discount rates MUST be reflective of the risk of acquisition, holding and renovation when appropriate
  - Internal Rate of Return (IRR) analysis is an excellent test of reasonableness [acquisition cost and reversion value must be supportable]
- Subdivision development method must be shown as reasonable through market analysis and highest and best use!

Tomorrow and Forward

- Historic preservation easements are gaining in popularity
- Value added elements must be at risk or lost for preservation easements to be of value
- Value impacting issues are very complex and vary widely from one easement to the next
  - Is there really comparabilty between easements and sales?
- Our task is to read, understand, and assess no differently than conservation easements

Have I Worn You Out Yet??????????

I'm not sure about you, but I really need a break!

Thank you for the invite and your attention!