
BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Joint Committee On Taxation Congress Of The United States

Information On Historic Preservation Tax Incentives

The Congress, through tax incentives included in the Tax Reform Act of 1976, sought to encourage private sector investments in the rehabilitation of historic structures. These tax incentives have proven to be an effective means for stimulating such investments. And, the cost to the federal government, in terms of foregone tax revenues, apparently has been small in comparison to the amounts invested in historic rehabilitations.

The National Park Service generally has administered the program in a satisfactory manner. On the other hand, IRS has encountered some tax administration difficulties--difficulties which were partially alleviated by the Economic Recovery Tax Act of 1981.



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GENERAL GOVERNMENT
DIVISION

B-214148

The Honorable Robert J. Dole
Chairman, Joint Committee on
Taxation

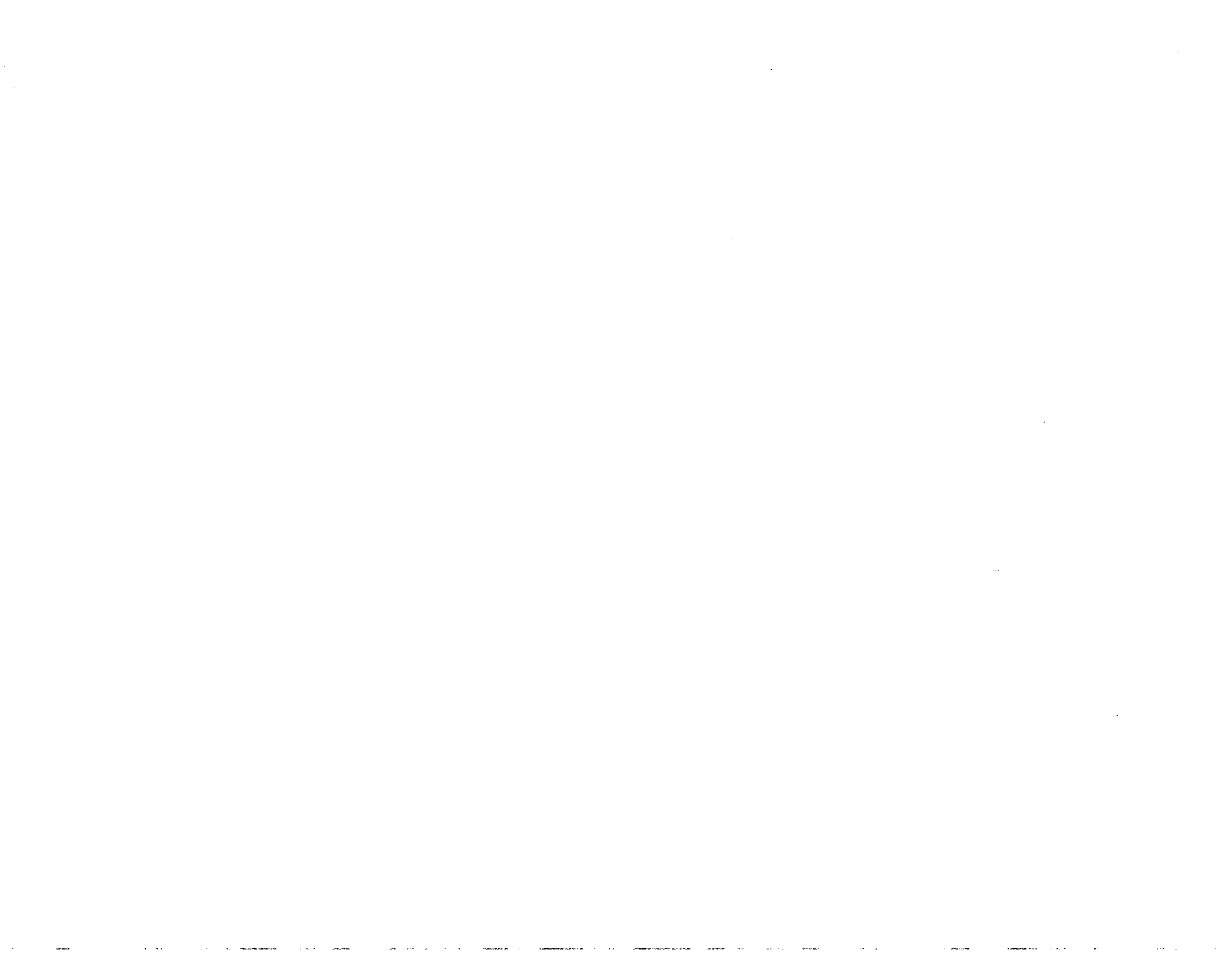
The Honorable Dan Rostenkowski
Vice Chairman, Joint Committee
on Taxation
Congress of the United States

This report, in response to your Committee's request, provides information on the tax provisions relating to the rehabilitation of certified historic structures authorized by the Tax Reform Act of 1976 and the Revenue Act of 1978. These tax incentives have stimulated investment in historic rehabilitations at a relatively low cost to the federal government. The National Park Service's administration of the provisions generally has proven satisfactory. In contrast, IRS has experienced some difficulties in seeking to administer these tax code provisions. Enactment of the Economic Recovery Tax Act of 1981, however, partially alleviated these difficulties.

As arranged with your Committee, we are sending copies of this report to other congressional committees; the Director, Office of Management and Budget; the Secretary of the Treasury; the Secretary of the Interior; the Commissioner of Internal Revenue; and other interested parties.

W. J. Anderson

William J. Anderson
Director



D I G E S T

Since 1966, the preservation of historic properties has been a stated national goal. The National Historic Preservation Act of 1966 served as a means for focusing attention on the need to preserve historic areas and structures. However, for various reasons, it did not fully achieve the intent of the Congress, at least during the first decade it was in effect.

Recognizing this, the Congress, through the Tax Reform Act of 1976, enacted a "tax expenditure" directed at encouraging preservation and/or rehabilitation of historic structures. The term tax expenditure refers to the revenue loss resulting from any federal tax provision which grants special tax relief designed to (1) encourage certain kinds of behavior by taxpayers or (2) aid taxpayers in special circumstances. This report provides information on the growing historic preservation tax expenditure. It was prepared at the request of the Joint Committee on Taxation.

Two federal agencies are responsible for administering the historic preservation program. The National Park Service in the Department of the Interior determines whether (1) structures are historically significant and (2) proposed or completed rehabilitation work conforms to the Secretary of the Interior's "Standards for Rehabilitation." The Internal Revenue Service (IRS) in the Department of the Treasury is responsible for assuring taxpayer compliance with the tax laws relating to historic structures. (See pp. 3 and 4.)

In performing this study, GAO (1) reviewed applicable laws, regulations, policies, procedures, records, and studies; (2) reviewed all applications for certification of historic structures and rehabilitation work which had been completed or were in process at the National Park Service as of December 31, 1979; (3) analyzed the most current tax returns

available at the time GAO began its work, that is, returns filed in 1980 by taxpayers who had applied for certification; (4) analyzed responses to a GAO questionnaire sent to a sample of taxpayers; (5) interviewed IRS, Interior Department, and state officials; and (6) reviewed pertinent IRS and Interior Department records. (See pp. 4 to 7.)

Various private and public sector groups have predicted a continuing growth in the use of the historic preservation tax incentives and a corresponding increase in foregone federal tax revenues. Thus, the Congress will be considering whether there is a need to change the federal tax laws affecting historic preservation. The data GAO developed should be of assistance to the Congress as it considers this matter.

TAX INCENTIVES HAVE STIMULATED THE REHABILITATION OF HISTORIC STRUCTURES

Since passage of the Tax Reform Act of 1976, the National Park Service's annual caseload of applicants requesting historic structure certifications and the number of historic structures actually rehabilitated have increased substantially. The National Park Service received 3,639 applications in fiscal year 1983--a five-fold increase over applications received during the first 2 years of the program. Statistical data developed by GAO and the opinions of taxpayers indicate that tax considerations have played a key role in stimulating private investments in historic preservation. (See pp. 8 to 10.)

The Committee on the Budget, United States Senate, estimated that the revenue loss for fiscal year 1978, the first complete year the tax incentives were in effect, was less than \$2.5 million. It is further estimated, however, that the revenue loss could reach \$210 million in fiscal year 1984 and could be as much as \$700 million in fiscal year 1988.

GAO's analysis of 243 projects showed that the involved taxpayers had generated an estimated \$27.1 million of historic structure

rehabilitation work for tax year 1979. The revenue loss to the Treasury that year and, conversely, the tax advantage to the taxpayers for this work was an estimated \$1.3 million, or about 5 cents in tax expenditures for every dollar of rehabilitation work generated. Thus, for the 243 projects, the federal government's costs for tax year 1979, in foregone revenues, were small compared to the total amounts spent on rehabilitations. (See pp. 13 and 14.)

Even though the federal government's costs for historic preservation projects seem relatively small, some taxpayers benefited more so than others from the historic structure tax expenditure provisions. Therefore, in assessing the utility of this (or any other tax expenditure), IRS needs to know who is benefiting and to what extent. GAO found that the benefits from this tax expenditure have accrued, for the most part, to individuals at the higher income levels and to partnerships and corporations at the higher asset levels. (See pp. 15 to 17.)

ADMINISTRATION OF THE HISTORIC STRUCTURES PROGRAM

To properly administer the historic structures program, three separate parties--states, the National Park Service, and IRS--have to coordinate their efforts while also effectively discharging their independent responsibilities. First, State Historic Preservation Officers review applications requesting certification of rehabilitation projects. The Officers recommend that the National Park Service approve or disapprove certification of structures as historically significant and that proposed or completed rehabilitation work conforms to Interior's standards for rehabilitation. The National Park Service, in turn, needs to make timely, accurate decisions on applications it receives. Subsequently, IRS needs to use National Park Service-generated data to ensure that tax benefits accrue only to those taxpayers who have received all necessary certifications. (See pp. 18 to 22.)

National Park Service
relies on the states

The National Park Service has come to rely more and more on the recommendations of State Historic Preservation Officers in deciding whether to certify structures and/or rehabilitations. This is in keeping with the administration's policy of transferring responsibilities, where feasible, to the states. During fiscal years 1978 through 1983, states depended on federal grants to fund their historic preservation/rehabilitation activities. The administration proposed to eliminate those grants for fiscal year 1984. However, the Congress rejected that proposal and provided \$26.5 million to the National Park Service for administration of the Historic Preservation Act of 1966.

By relying more and more on state recommendations in recent years and by taking various managerial initiatives, the National Park Service has been able to handle an increasing demand for certifications over the years. And it has done so without substantially increasing the size of the staff working in this area. (See pp. 25 to 27.)

IRS experienced some problems
with the tax incentives

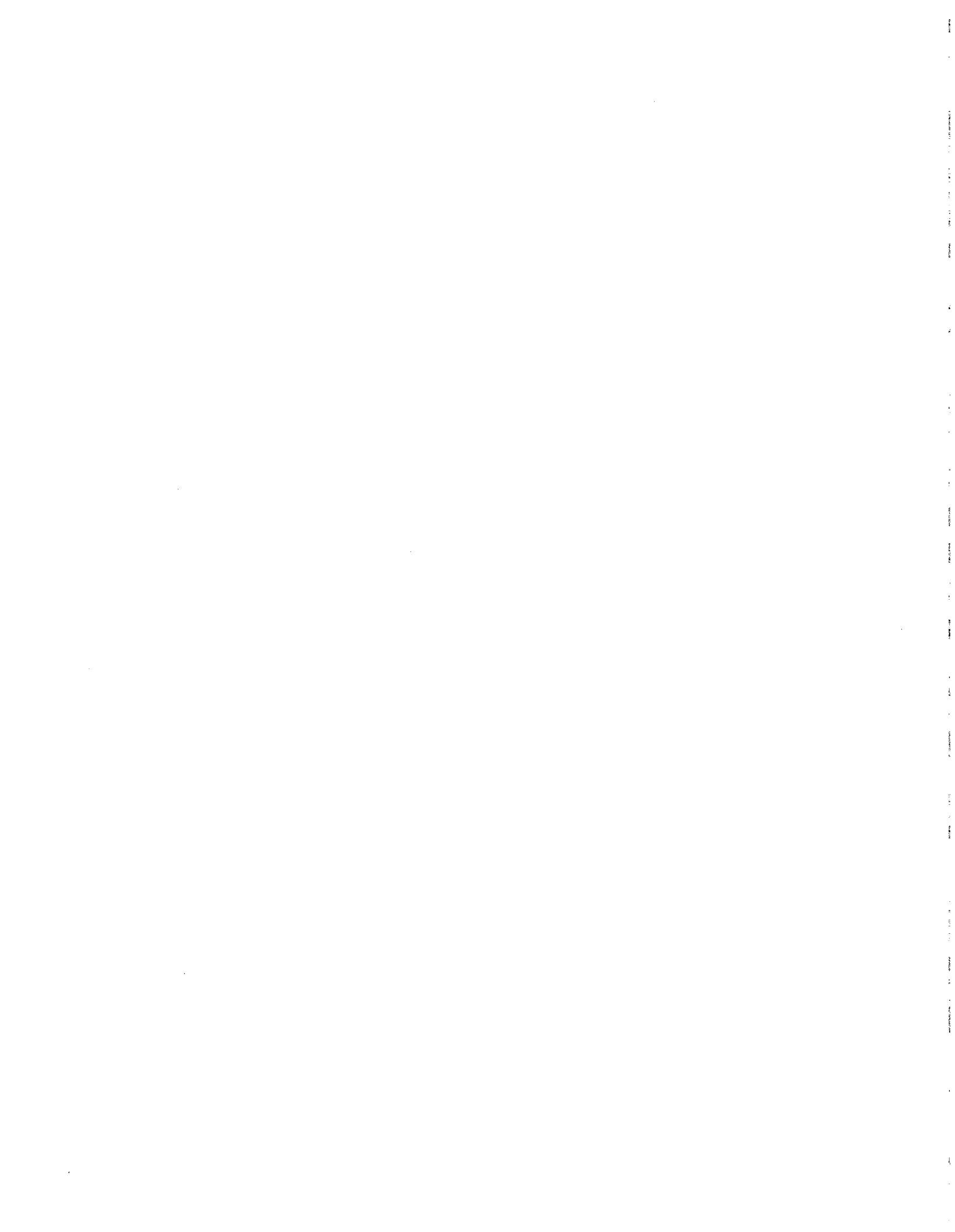
Due to the number and complexity of the various Internal Revenue Code provisions involved, IRS experienced some problems in administering the tax incentives. However, the Congress, through the Economic Recovery Tax Act of 1981, simplified the tax laws pertaining to historic structures and partially alleviated these problems--but three compliance issues remain. One compliance issue involves the non-reporting or underreporting of "recapture." With recapture, taxpayers who sell rehabilitated structures within certain time frames must pay additional taxes on prior year tax benefits to which they no longer are entitled. GAO estimates that, out of 806 projects, 10 of 25 taxpayers who had sold properties did not report or correctly calculate tax on amounts that should have been recaptured. (See pp. 32 and 33.)

A second compliance issue involves inappropriate tax benefit claims. For example, GAO estimates that, out of 1,144 projects, 8 of 39 taxpayers denied certification by the National Park Service nevertheless had claimed tax benefits on their federal tax returns. (See p. 34.)

The third compliance issue concerns "conservation easements." A conservation easement represents a contractual agreement, usually a recorded deed, between the property owner (the grantor) and a charitable organization (the grantee) receiving the easement. The deed records the property owner's promise to protect the existing character of the property, binding future property owners as well. IRS data shows that taxpayers generally overvalued their conservation easement deductions by an average of about 220 percent. (See pp. 34 and 35.)

AGENCY COMMENTS

IRS reviewed the report but had no specific comments. It did note, however, that the National Park Service will be supplying it with data which will help IRS identify incorrect tax benefit claims. The Department of the Interior stated that it concurred with GAO's findings as they apply to the National Park Service's administration of the program. (See pp. 40 and 41.)



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ABBREVIATIONS

GAO General Accounting Office
IRS Internal Revenue Service
NPS National Park Service .

CHAPTER 1

INTRODUCTION

Since 1966, the preservation of historic properties has been a stated national goal. Among other things, the National Historic Preservation Act of 1966 (Public Law 89-665, Oct. 15, 1966) authorized the Secretary of the Interior to:

- Expand and maintain a national register of districts, sites, buildings, structures, and objects significant in American history, architecture, archeology, and culture.
- Grant funds to states for the purpose of conducting comprehensive historic area and structure surveys and preparing plans for the acquisition, preservation, and/or development of historic properties.
- Establish a program of matching grants-in-aid to states for projects directed at preserving, for public benefit, properties that are significant in American history, architecture, archeology, and/or culture.

The act served as a means for focusing attention on historic areas and structures. However, for various reasons, it did not fully achieve the intent of the Congress, at least during the first decade it was in effect. For example, only small amounts of money were appropriated for grants under the law. Perhaps more important, however, was the fact that the tax laws then in effect discouraged preservation and/or rehabilitation of historic structures while encouraging new construction. Specifically, the tax laws permitted taxpayers to deduct demolition costs and any remaining depreciation on an existing structure in determining taxable income. Furthermore, taxpayers could also recover the costs of constructing new structures faster than they could recover the costs associated with a rehabilitated structure.

Recognizing this, the Congress, through the Tax Reform Act of 1976 (Public Law 94-455, Oct. 4, 1976), enacted a "tax expenditure" directed at encouraging preservation and/or rehabilitation of certified historic structures. The term tax expenditure refers to the revenue loss resulting from any federal tax provision which grants special tax relief designed to (1) encourage certain kinds of behavior by taxpayers or (2) aid taxpayers in special circumstances. This report, which was prepared at the request of the Joint Committee on Taxation, provides information on this growing historic preservation tax expenditure.

The tax provisions adopted in 1976 were meant to further the goals of preserving and rehabilitating historic structures and neighborhoods. The Congress believed that achievement of those goals depended on enlisting private funds in the preservation movement and that tax considerations would play an important role in determining whether the private sector would participate.

The Tax Reform Act of 1976 and subsequent amendments to the tax code specifically authorized taxpayers to amortize¹ historic structure rehabilitation costs over a 5-year period as opposed to the much longer periods previously required--15 to 30 years or longer. Alternatively, taxpayers could elect to use one of several other depreciation methods and/or could claim up to a 10 percent investment tax credit for rehabilitating a historic structure. However, effective January 1, 1982, the Economic Recovery Tax Act (Public Law 97-34, Aug. 13, 1981) repealed these historic structure related tax provisions and replaced them with a 25 percent investment tax credit.² The impact of this change on the administration of the Code provisions is discussed in chapter 3. In any case, however, since enactment of the Tax Reform Act of 1976, both individual and business taxpayers have been able to reduce their tax liabilities to a greater extent when rehabilitating certified historic structures.

In addition to tax incentives specifically designed to encourage rehabilitation of certified historic structures, the Tax Reform Act of 1976 also attempted to clarify existing tax provisions which sought to encourage preservation of historic properties and structures by placing certain easements (restrictions) on them. For example, after rehabilitating a certified historic structure, a taxpayer could enter into a written agreement with a charitable organization to place restrictions on the nature of future alterations to the structure. The organization would then assume responsibility for assuring adherence to the restrictions. In return for this easement, a taxpayer could

¹Amortize means to provide for the gradual recovery of costs by prorating them for depreciation purposes over a fixed time period.

²An investment tax credit permits a dollar-for-dollar reduction in the amount of tax owed. The 1981 act permits a tax reduction of 25 percent of the qualified rehabilitation expenditures incurred.

claim a deduction for a charitable contribution based on the valuation of the easement, thereby reducing taxable income.³

The various tax incentives historic structures offer taxpayers are discussed in detail in chapter 3 and appendix III.

The initial revenue loss associated with enactment of the historic preservation tax incentives occurred in 1978. At that time, the Committee on the Budget, United States Senate, estimated that the revenue loss for that year was less than \$2.5 million. For fiscal year 1984, however, it is estimated that the revenue loss would reach \$210 million and could be as much as \$700 million in fiscal year 1988.

NPS AND IRS ADMINISTER THE HISTORIC PRESERVATION PROVISIONS

Two federal agencies are responsible for administering the historic preservation tax provisions. The National Park Service (NPS) in the Department of the Interior determines whether (1) structures are historically significant and (2) proposed or completed rehabilitation work conforms to the Secretary of the Interior's "Standards for Rehabilitation." The Internal Revenue Service (IRS) is responsible for assuring taxpayer compliance with the tax laws relating to historic structures.

To be eligible to use the historic preservation tax incentives, taxpayers must first apply to NPS to have their structures designated as "certified historic structures" and to have completed rehabilitation work designated as "certified rehabilitations." A certified historic structure is a depreciable building or other structure either (1) listed in the National Register of Historic Places⁴ or (2) located in a registered

³The Tax Reduction and Simplification Act (Public Law 95-30, May 23, 1977) and the Tax Treatment Extension Act (Public Law 96-541, Dec. 17, 1980) modified and made permanent the provisions for charitable contributions made exclusively for conservation purposes.

⁴The National Register of Historic Places is the official list of the Nation's cultural resources deemed worthy of preservation. The Secretary of the Interior is responsible for maintaining a national register of historic districts, sites, buildings, structures, and objects significant in American history, architecture, archeology, and culture.

historic district⁵ and certified by NPS as being of historic significance to the district. A certified rehabilitation consists of improvements to or restoration of an existing certified historic structure which the Secretary of the Interior has approved as meeting certain prescribed standards for rehabilitation. These standards, discussed in greater detail in chapter 3, are designed to ensure preservation of the significant historical and architectural characteristics of a structure during the rehabilitation process. One standard, for example, provides guidance when deteriorated architectural features have to be replaced rather than repaired.

IRS' role in the administration of the provisions consists primarily of (1) providing guidance to taxpayers who wish to use the tax provisions and (2) ensuring compliance with the related tax laws. To determine compliance, IRS necessarily relies on the Department of the Interior to furnish it with information needed to identify those taxpayers who are eligible to use the tax incentives. IRS also needs such information to identify those taxpayers who applied for but were denied certification and, therefore, were not eligible to claim tax benefits.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective in performing this review focused on answering the following questions:

- How many taxpayers are using the tax provisions which provide incentives for historic preservation and what are the taxpayers' characteristics?
- Which tax provisions pertaining to historic structures were used by taxpayers and to what extent?
- How much do the tax provisions cost the federal government in terms of foregone tax revenues?
- What administrative problems have IRS, NPS, and/or the taxpayers encountered?

To achieve our objective, we (1) reviewed applicable laws, regulations, policies, and procedures pertaining to historic structures; (2) reviewed all applications for certification of

⁵A registered historic district is a district (1) listed in the National Register of Historic Places or (2) designated as such by a statute or ordinance of a state or local government. In the latter case, NPS must certify that the statute or ordinance has as its primary purpose the preservation of historically significant buildings. Moreover, the district must meet substantially all of the requirements set forth by NPS for qualification as a registered historic district.

historic structures and rehabilitation work which had been completed or were in process at NPS as of December 31, 1979; (3) analyzed tax returns filed in 1980 by taxpayers who had applied for certification; (4) analyzed responses to a questionnaire we sent to a sample of taxpayers who had applied to NPS for certification of their rehabilitation projects; (5) interviewed IRS and Interior officials at headquarters, regional, state, and/or district levels as well as various state officials; and (6) reviewed pertinent IRS and Interior Department records.

Our review was performed primarily at the national offices of NPS and IRS. But field work was conducted at NPS' Mid-Atlantic and Southeast Regional Offices located in Philadelphia, Pennsylvania, and Atlanta, Georgia, respectively. We selected these locations because, according to NPS officials, 75 percent of the processing of applications for certification of structures and rehabilitations was taking place at these offices when we initiated visits to these locations in June 1981. We interviewed officials and reviewed case files at these two locations and at the state historic preservation offices in Georgia, South Carolina, Pennsylvania, and Virginia. We also interviewed IRS district office officials in these same states.

We found it difficult to perform this review promptly in part because IRS could not readily identify tax returns containing a deduction and/or credit for historic preservation. Thus, to identify a sample of returns, we had to carry out the time-consuming process of developing a universe of potential users of the deductions and/or credits. We did so by manually extracting data from the applications for certification submitted to NPS for approval. Since 1979 represented the latest complete tax year at the time we were ready to request tax returns in May 1980, we established December 31, 1979, as the cutoff date for including applicants in our universe. We then requested tax returns filed in 1980 from IRS for a sample of applicants. But we experienced further delays in obtaining the requested tax returns because NPS data on applicants frequently proved insufficient for IRS tax return identification purposes.

From a universe of 1,144 applicants who applied to NPS for certification during the period October 4, 1976, through December 31, 1979, we requested tax returns for 751 applicants--all 440 of the applications on which NPS had taken final action (approved, denied, appealed, etc.) and 311 of the 704 applications still in process. The 311 applications were randomly selected from the universe of applications in process at the time. Because the findings in this report are based on 1979 taxpayer data, we cannot make projections for any other year. However, we believe that the findings are indicative of the compliance situation for the period from October 1976 through passage of the Economic Recovery Tax Act in October

1981, since most of the taxpayers used the 5-year amortization or accelerated depreciation deductions. Once claimed initially, the deductions generally continue to be claimed on the same basis in subsequent years. Also, during the period from 1976 to October 1981, the tax provisions remained constant and our sample involved those taxpayers who used the deductions and/or credits for the first time in 1979, as well as those taxpayers who initially claimed the deductions and/or credit in prior years.

The following table shows the number of applications we reviewed by type of NPS processing action and the number for which we analyzed tax returns. We were unable to analyze returns for all of the applicants we selected because IRS could not provide us with all of the returns we requested. IRS could not locate some returns because of the inadequacy of taxpayer identification data obtained from NPS and others were not available for different reasons; for example, the returns were being examined by IRS. Still, we were able to obtain tax returns related to 545 of the 751 NPS applications included in our sample. Our results are projectable only to the universe of returns which IRS could locate for the tax data in this report.

<u>Type of NPS action</u>	<u>Number of applications for certification in sample</u>	<u>Number of applicants for whom returns were available</u>	<u>Percent of applicants for whom returns were available</u>
Approved	391	302	77
Denied	24	18	75
Denied/ appealed/ reversed	25	17	68
In process	<u>311</u>	<u>208</u>	67
Total	<u>751</u>	<u>545</u>	73

We also sent a questionnaire to the 751 applicants in our sample who applied for certification of their rehabilitation projects to obtain their opinions on the (1) adequacy of the Department of the Interior's certification process and IRS' guidance on use of the tax provisions and (2) extent to which the tax provisions influenced their decisions to rehabilitate historic structures. For the 751 questionnaires we mailed, we received 606 responses--an 80 percent response rate. Similar to our tax data, the responses to our questionnaire are projectable only over the population of questionnaires received. Appendix IV contains details on our questionnaire results.

Concerning taxpayers who claimed deductions for charitable contributions of conservation easements, IRS provided us with aggregate data on all returns it could identify at three district offices--Philadelphia, Atlanta, and Jacksonville--where revenue agents had questioned the value of the easement deductions. Our analysis of easements is based on that aggregate data.

We performed this review in accordance with generally accepted government auditing standards.

AGENCY COMMENTS

By letter dated January 5, 1984 (see app. I), the Commissioner of Internal Revenue stated that IRS had reviewed the report but had no specific comments to submit. IRS stated, however, that the National Park Service will be helping IRS identify incorrect tax benefit claims by (1) supplying IRS with a breakout of the total costs associated with the rehabilitation of a historic structure, (2) emphasizing the need to obtain accurate taxpayer identification numbers from all taxpayers requesting certification, and (3) providing IRS a list of those taxpayers denied certification.

The Department of the Interior, by letter dated January 16, 1984 (see app. II), stated that it concurred with the findings of the report as they apply to the National Park Service's administration of the program. It also stated that the data we developed on tax expenditures, gathered from actual tax returns, would be particularly useful to the administration and the Congress as they consider possible changes to federal tax laws affecting historic buildings.

CHAPTER 2

TAX INCENTIVES HAVE STIMULATED

THE REHABILITATION OF

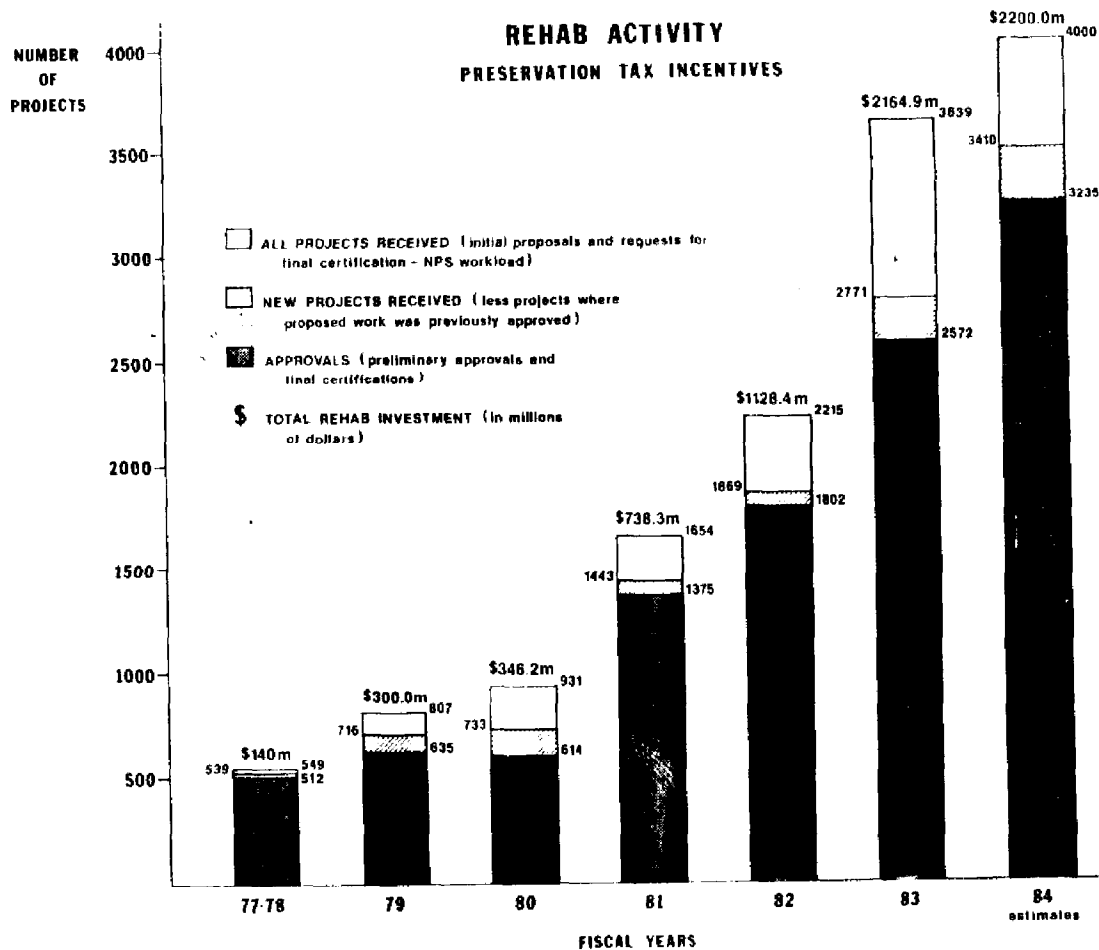
HISTORIC STRUCTURES

Since passage of the Tax Reform Act of 1976, there has been a substantial increase in both the number of applicants requesting historic structure certifications and the number of historic structures actually rehabilitated. Statistical data and the opinions of taxpayers indicate that tax considerations have proven influential in enlisting private funds into the preservation movement.

Moreover, besides promoting preservation and/or rehabilitation, the tax provisions have had the effect of reducing the Nation's rental housing shortage. In effect, the number of rental housing units has increased because historic rehabilitation work frequently has resulted in a shift in the use of structures from private residences to apartments or other kinds of rental units. Furthermore, the revenue loss to the federal government, in terms of foregone tax dollars, is estimated to have been substantially less than the dollar value of the rehabilitation work performed.

NPS HAS EXPERIENCED A SPURT IN PRESERVATION ACTIVITIES DUE TO TAX INCENTIVES

NPS' annual caseload of applications has steadily increased since passage of the Tax Reform Act of 1976 from a combined total of 549 applications in fiscal years 1977 and 1978, to 3,639 applications in fiscal year 1983--a five-fold increase over what it was during the first 2 years of the program. Moreover, NPS estimates that its caseload of applications will be 4,000 in fiscal year 1984. Similarly, the estimated dollar value of investments in rehabilitation work increased from a combined total of \$140 million for fiscal years 1977 and 1978 to over \$2.1 billion in fiscal year 1983. In the first quarter of fiscal year 1983 alone, 686 projects were approved, a 100-percent increase from the same quarter in fiscal year 1982 and more projects than were approved in the first 2 years of the program. The following chart illustrates the growth in NPS' certification activities.



Source: National Park Service, December 1983.

Besides experiencing an increased demand for certification of structures and rehabilitations, NPS has also experienced an increased demand for other certification actions relating to national historic districts, locally designated historic districts, and State and local statutes. NPS estimates, for instance, that at the end of 1976 there were about 1,200 national historic districts. By the end of fiscal year 1983, that number had risen to about 3,000.

As of March 1982, NPS has also certified 81 locally designated historic districts and 144 state and local statutes. In granting these certifications, NPS determined that the locally designated districts effectively had met the requirements for districts listed in the National Register of Historic Places and that the state or local statutes contained criteria which assure the preservation of historically significant buildings. The Senate Committee on the Budget currently estimates that these historic districts contain as many as 1 million buildings which potentially are eligible for special tax treatment.

Thus, there has been a spurt in historic preservation activities since the tax incentives were enacted. And, responses to our questionnaire indicate that the tax incentive provisions have played a role in taxpayers' decisions to rehabilitate historic structures and in the extent of the rehabilitations performed. We asked taxpayers who applied for certification of their rehabilitations as of December 31, 1979, how the tax incentive affected them. Our analysis of their responses, shown in the following table, illustrates that the majority would not have rehabilitated the structures to the same extent that they did had it not been for the tax incentives.

<u>Extent to which taxpayers would have or planned to rehabilitate historic structures without tax incentives</u>	<u>Percent of applicants</u>
To little or no extent	36
To some extent	20
To a moderate extent	19
To a substantial extent	12
To a very great extent	<u>12</u>
Total	<u><u>100^a</u></u>

^aTotal does not add due to rounding.

Besides the tax incentives, though, there are other reasons why investors and developers find rehabilitation an attractive alternative to new construction. These include the lower costs often associated with rehabilitation, the often faster construction time, the highly marketable amenities of older buildings, and the location of many older buildings in downtown or "in-town" areas.

HISTORIC REHABILITATIONS HAVE
ADDED TO THE RENTAL HOUSING SUPPLY

For several years, the Congress has been concerned about the condition and availability of rental housing units throughout the Nation. With passage of the Tax Reform Act of 1976, there was concern that rehabilitations of historic structures might further exacerbate the rental housing shortage problem; however, the rehabilitations have resulted in an increase in the number of available rental housing units.

In a 1979 report,¹ we pointed out that the Nation's rental housing market had reached a crisis stage. The primary factors responsible for this were low levels of moderately priced new private construction and losses of existing units through abandonments or conversions to condominiums. Other factors such as rapidly escalating operating costs and the increasing age of the existing rental stock were also having an effect.

Given the seriousness of the rental housing situation and the fact that various public and private sector officials had expressed concern over the potential impact of rehabilitation on rental housing, we sought to gather data on this issue. As shown in the following table, we were able to determine that most rehabilitation work was done on private residences, commercial buildings, and multi-use facilities. As previously discussed, our sample consisted of 751 of the 1,144 applicants who applied to NPS for certification from October 1976 through December 31, 1979. These sample results are projectable over the universe of 1,144 applicants.

<u>Type of property</u>	<u>Projected number of rehabilitations</u>	<u>Percent</u>
Private residences	458	40
Residential rental	48	4
Commercial/office	250	22
Industrial	88	8
Multi-use	274	24
Unknown	<u>26</u>	<u>2</u>
Total	<u>1,144</u>	<u>100</u>

¹Rental Housing: A National Problem That Needs Immediate Attention (CED-80-11, Nov. 8, 1979).

Although most rehabilitation work was done on private residences, commercial buildings, and multi-use properties, the most significant change in use of the properties after rehabilitation occurred in the residential area. For example, 193, or 42 percent, of the 458 structures used as private residences before rehabilitation had been or were expected to be converted to residential rental units. Furthermore, as shown in the following table, other types of property were also converted to residential rental units as well.

<u>Type of property before rehabilitation</u>	<u>Number of such properties involved</u>	<u>Number converted to or maintained as residential rental units</u>	<u>Percent converted or maintained</u>
Private residences	458	193	42
Residential rentals	48	28	58
Commercial buildings	250	24	10
Industrial	88	13	15
Multi-use	274	18	7
Unknown	26	5	19

Moreover, our analysis shows that the 1,144 applicants in our universe had properties which originally consisted of an estimated 1,444 housing units. After rehabilitation, these properties were expected to contain about 8,364 housing units, an estimated increase of about 480 percent. And, because most historic structures are located in the Northeast, that section of the country has benefited most in terms of rental housing gains. In fact, as shown in the following table, 10 states accounted for 94 percent of the expected increase in the supply of rental housing units.

Estimated
Number of Rental Housing Units
as of December 31, 1979

<u>State</u>	<u>Before rehabilitation</u>	<u>After rehabilitation</u>	<u>Increase</u>
Massachusetts	21	2,734	2,713
Connecticut	52	1,213	1,160
Maryland	64	984	920
Pennsylvania	50	718	668
New York	432	908	476
Louisiana	79	315	236
Mississippi	16	134	118
Maine	14	105	91
Rhode Island	35	119	84
Washington	<u>0</u>	<u>66</u>	<u>66</u>
Total	<u>763</u>	<u>7,296</u>	<u>6,532</u>

In addition to our statistics indicating an increase in residential rental units, NPS' records show that during fiscal years 1977 through 1982, the number of rental housing units increased from 5,451 to 25,948 under the program, an increase of almost 380 percent. NPS further estimates that at least 9,825 low and moderate income housing rental units are included in the total.

REVENUE LOSSES TO THE FEDERAL
GOVERNMENT SEEM SMALL IN RELATIONSHIP
TO THE DOLLAR VALUE OF REHABILITATION
WORK PERFORMED ON HISTORIC STRUCTURES

As previously discussed, NPS has experienced an increased demand for certifications of historic structures as well as a substantial increase in other certification activities. It seems clear, therefore, that the historic preservation provisions of the Tax Reform Act of 1976 are achieving their desired effect. The provisions are, of course, also costing the federal government money in the form of foregone tax revenues. However, the benefits derived seem to outweigh the tax loss.

Like the situation with any other tax expenditure, some taxpayers benefit to a greater extent from use of the historic preservation tax expenditure provisions than others. In this regard, we found that individual taxpayers generated the highest number of rehabilitations but that partnerships generated the greater dollar value of rehabilitation work. We also found, as might be expected, that both individual and business taxpayers at the higher income and asset levels, respectively, benefited more so than other taxpayers from this tax expenditure.

To obtain data comparing the amounts invested in rehabilitation projects and the associated federal government costs (foregone revenues), we obtained tax information which could be projected to 243 of the 1,144 applicants who claimed deductions and/or credits on their tax year 1979 returns. We were able to make this analysis for only 243, or 21 percent, of the 1,144 applicants because complete information was unavailable for the remaining applicants. We did not calculate the tax loss relating to any applicant for whom we could not obtain complete information.

Our analysis, when projected to the 243 projects, showed that the taxpayers involved had generated \$27.1 million of historic structure rehabilitation work for tax year 1979. The revenue loss to the Treasury that year and, conversely, the tax advantage to the taxpayers for this work was an estimated \$1.3 million, or about 5 cents in tax expenditures for every dollar of rehabilitation work generated. Thus, for the 243 projects, the federal government's costs for tax year 1979, in the form of foregone revenues, were small in comparison to the total amounts spent on rehabilitations.

Of course, the above statistics pertain only to tax year 1979; the federal government anticipated further revenue losses from these same rehabilitations in subsequent years. This is because taxpayers generally accrue tax benefits from accelerated depreciation/amortization deductions over a period of years. Nonetheless, in the long run, the theoretical maximum cost to the federal government of deductions for any rehabilitation would total only 50 percent of the amount invested--and then only if the investor's marginal tax rate consistently remained at 50 percent, the highest tax rate under current law. To the extent that taxpayers with lower marginal tax rates take deductions for rehabilitations, the federal government's revenue losses would be proportionately less than 50 percent. On the basis of data we developed for tax year 1979, it appears that the actual revenue losses may well be less than 50 percent of the amounts invested in rehabilitations. Similarly, potential tax revenue losses associated with use of the investment tax credit cannot exceed 10 percent of qualified rehabilitation expenditures.

Even though the federal government's costs for those projects seem relatively low, the fact remains that some taxpayers benefited from the historic structure tax expenditure provisions while others did not. Therefore, in assessing the utility of this (or any other tax expenditure), it is important to know who is benefiting and to what extent.

Concerning those who benefited, we were able to obtain data on 410, or 36 percent, of the 1,144 applicants. We found that individual taxpayers accounted for the larger number of rehabilitations but that partnerships accounted for a greater dollar volume of rehabilitation work, as shown in the following table.

<u>Type of filer</u>	<u>Estimated number of projects</u>	<u>Percent of projects</u>	<u>Estimated amount of rehabilitation expenditures</u>	<u>Percent of total rehabilitation expenditures</u>
Partnerships	130	31.7	\$ 73,429,360	72.9
Individuals	258	62.9	20,272,856	20.1
Corporations	18	4.4	6,799,138	6.7
Small business corporations	<u>4</u>	<u>1.0</u>	<u>239,278</u>	<u>0.2</u>
Total	<u>410</u>	<u>100.0</u>	<u>\$100,740,632</u>	<u>100.0^a</u>

^aTotal does not add due to rounding.

Using adjusted gross income² for individual taxpayers and total assets for partnerships and corporations, we also determined the number of projects and the dollar amount of rehabilitation expenditures generated by taxpayers at various asset and income levels. Individual taxpayers at the higher income levels generated a much larger dollar value of rehabilitations than did taxpayers at lower income levels, as shown on the following page.

²Adjusted gross income consists of an individual taxpayer's total income (such as wages, salaries, interest, and dividends) reduced by amounts for items such as moving expenses or employee business expenses.

Individual Taxpayers

<u>Adjusted gross income</u>	<u>Estimated number of projects</u>	<u>Amount spent on rehabilitations</u> (millions)
Less than \$20,000	46	\$ 2.1
\$20,000 to \$39,999	67	4.7
\$40,000 to \$99,999	95	7.1
\$100,000 or more	48	6.0
Unknown	<u>2</u>	<u>.3</u>
Total	<u>258</u>	<u>\$20.2</u>

A similar situation existed for partnerships and corporations. As shown in the following table, the largest partnerships and corporations, in terms of total assets, generated the largest dollar volume of expenditures for rehabilitations.

<u>Total assets</u>	<u>Partnerships</u>		<u>Corporations</u>	
	<u>Estimated number of projects</u>	<u>Estimated amount spent on rehabilitations</u>	<u>Estimated number of projects</u>	<u>Estimated amount spent on re- habilitations</u>
		(millions)		(millions)
Less than \$100,000	91	\$20.5	5	\$0.9
\$100,000 to \$499,999	20	8.3	7	1.4
\$500,000 or more	19	44.6	5	4.4
Unknown	<u>0</u>	<u>0</u>	<u>1</u>	<u>0.1</u>
Total	<u>130</u>	<u>\$73.4</u>	<u>18</u>	<u>\$6.8</u>

Thus, the benefits associated with the historic preservation tax expenditure have accrued, for the most part, to individuals at the higher income levels and to partnerships and corporations at the higher asset levels. Not only do these higher income/asset taxpayers spend more on rehabilitations, but they may also benefit from tax deductions on a proportionately greater basis than do lower income/asset taxpayers. This is because taxpayers who have high marginal tax rates benefit more from tax deductions than do taxpayers with lower marginal tax rates.

CHAPTER 3

ADMINISTRATION OF THE

HISTORIC STRUCTURES PROGRAM

To properly administer the historic structures program, three separate parties--states, NPS, and IRS--have to coordinate their efforts while also effectively discharging their independent responsibilities. State Historic Preservation Officers have to review applications for certification and make recommendations as to whether NPS should approve or disapprove them. NPS, in turn, has to make timely, accurate decisions on applications it receives. Subsequently, IRS needs to use NPS-generated data to assure that tax benefits accrue only to those taxpayers who have received all necessary NPS certifications.

Over the past several years, NPS has come to rely more and more on the recommendations of State Historic Preservation Officers in deciding whether to certify structures and/or rehabilitations. This is in keeping with the administration's policy of transferring responsibilities, where feasible, to the states. During fiscal years 1978 through 1983, states depended heavily on federal grants as a means for funding historic preservation/rehabilitation activities, particularly State Historic Preservation Officer activities.

By relying more and more on state recommendations in recent years and by taking various managerial initiatives, NPS has been able to handle an increasing demand for certifications. And it has done so without substantially increasing the size of the staff working in this area.

IRS, on the other hand, experienced some problems in administering the various historic structure and related provisions of the tax laws. These problems were primarily attributable to the number and complexity of the various Internal Revenue Code provisions involved. However, the Congress, through the Economic Recovery Tax Act of 1981, simplified the tax laws pertaining to historic structures.

THE STATE/NPS CERTIFICATION PROCESS HAS PROVEN EFFECTIVE

Effective administration of the historic preservation tax incentive provisions depends, in the first instance, on timely decisions on and processing of certification applications by

State Historic Preservation Officers and by NPS. For the most part, taxpayers have been satisfied with the decision processes and timeliness of certification actions. However, NPS has gradually sought to shift more and more decisionmaking responsibilities to the states. The states in turn have been willing to assume additional responsibilities in part because federal grants could be used to fund State Historic Preservation Officer activities. For fiscal year 1984, however, the administration had proposed to eliminate such grants. And, if the grants had been eliminated, some states might have chosen not to fund these activities at fiscal year 1983 levels. This, of course, could have reduced the quality and timeliness of the certification process, thereby reducing the utility of the historic preservation tax incentives. The Congress, however, provided funds for such grants in the Department's 1984 appropriation, thereby eliminating this potential problem for that fiscal year.

Procedures for obtaining
certification of a historic structure
and/or related rehabilitation work

For a structure to qualify as a certified historic structure, it generally must be located in a registered historic district and be certified as significant to that district.¹ A registered historic district may be a National Register district which has been nominated and placed on the National Register or a district which is designated under a state or local statute or ordinance when both the statute and the historic district have been certified by NPS. Following are the criteria for listing a district or structure on the National Register:

"The quality of significance in American History, architecture, archeology, and culture is present in districts, sites, buildings, structures and objects of State and local importance that possess integrity of location, design, setting, materials, workmanship, feeling, and association, and

- (a) That are associated with events that have made a significant contribution to the broad patterns of our history; or
- (b) That are associated with the lives of persons significant in our past; or

¹In some cases, a particular building may in itself be a historic structure due to a particular event or series of events. For example, the early homes of former U.S. Presidents may not be located in historic districts but nevertheless may be certified as historic structures based on their own historic merit.

- (c) That embody the distinctive characteristics of a type, period, or method of construction, or that represent the work of a master, or that possess high artistic values, or that represent a significant and distinguishable entity whose components may lack individual distinction; or
- (d) That have yielded or may be likely to yield, information important in pre-history or history."

Because not all structures located in a registered district qualify as certified historic structures, the owner of a structure who wants to obtain tax benefits for rehabilitation work must apply for and obtain certification of the structure. To obtain certification of a historic structure and/or related rehabilitation work, a taxpayer submits a two-part application form (Historic Preservation Certification Application) to NPS through a State Historic Preservation Officer. The State Historic Preservation Officer, or a designated representative of this Officer, is the official within each state authorized to act as a liaison to NPS in the certification process. Part I of the form provides information for certifying the historic significance of the structure; part II provides descriptive information for use in deciding whether to certify the rehabilitation work.

Among other things, part I of the form must contain the following:

- Name of the owner of the structure.
- Name and address of the structure.
- Name of the historic district in which the structure is located.
- Current photographs of the structure.
- A brief description of the structure's appearance.
- A brief statement of the structure's architectural and/or historical significance.

Once such an application has been received, the State Historic Preservation Officer reviews the information provided and forwards it to NPS along with a recommendation as to whether the structure should be certified as historically significant to the district. The State Historic Preservation Officer uses the following NPS criteria in determining whether to recommend certification by NPS.

--A structure which contributes to the historic significance of a district is one which by location, design, setting, materials, workmanship, feeling, and association adds to the district's sense of time and place and historical development.

--A structure which does not contribute to the historic significance of a district is one which detracts from the district's sense of time and place and historical development. Also, if the structure's integrity or its original design or individual architectural features or spaces have been irretrievably lost, the structure is not considered appropriate for certification.

--Ordinarily, structures built within the past 50 years are not considered eligible unless a strong justification can be made concerning their historical or architectural merit or the historic attributes of the district are based on events which occurred less than 50 years ago.

In deciding whether individual structures meet the above criteria, State Historic Preservation Officers may rely solely on the information contained in the application or they can make site visits to inspect the structure. NPS in turn may make a decision based solely on the State Historic Preservation Officer's recommendation. Or, NPS may ask for additional information and/or conduct a site visit before reaching a decision. NPS bases its decision on the same criteria used by State Historic Preservation Officers and subsequently notifies the applicant/taxpayer of its decision.

For proposed and completed rehabilitations of historic structures, NPS also has final decisionmaking authority. A certified rehabilitation consists of improvements to or restoration of a certified historic structure which are consistent with the historic character of the structure or district in which it is located. The property owner must complete part II of the NPS application form and submit it to the State Historic Preservation Officer. The application may be for a proposed or a completed rehabilitation. For a proposed rehabilitation, the State Historic Preservation Officer reviews the project to determine whether it is likely to meet the Secretary of the Interior's "Standards for Rehabilitation." Those standards specify, among other things, that

--Every reasonable effort shall be made to provide a compatible use for a property which requires minimal alterations of the building, structure, or site and its environment.

- The distinguishing original qualities or character of a building, structure, or site and its environment shall not be destroyed.
- All buildings, structures, and sites shall be recognized as products of their own time. Alterations that have no historical basis and which seek to create an earlier appearance shall be discouraged.
- Deteriorated architectural features shall be repaired rather than replaced, wherever possible.
- The surface cleaning of structures shall be undertaken with the gentlest means possible.
- Every reasonable effort shall be made to protect and preserve archeological resources affected by or adjacent to any rehabilitation project.

For both proposed and completed rehabilitations, State Historic Preservation Officers recommend approval or disapproval to NPS. They base their decision on whether they feel the project will meet or has met the Standards for Rehabilitation. NPS then makes the final decision and so informs the applicant/taxpayer. When a proposed rehabilitation which has previously been given preliminary NPS approval is completed, the owner submits a written statement to the State Historic Preservation Officer. The statement must specify the project completion date and that, in the owner's opinion, the project meets the Secretary's standards and is consistent with the work described in the application form; photographs of the completed work must also be included. The State Historic Preservation Officer reviews the information and forwards it with a recommendation that NPS approve or reject the project. A site inspection may be made by the State Historic Preservation Officer and/or NPS. NPS then notifies the owner regarding its decision.

If the completed rehabilitation does not meet the Secretary's standards, NPS sends the applicant a letter explaining the reason(s) for disapproval. The applicant may appeal this decision to NPS. According to NPS data, since the Tax Reform Act was passed in 1976 and through fiscal year 1982, NPS approved over 90 percent of the rehabilitation certification requests it received.

The timeliness of and assistance given in the certification process has proven generally acceptable to taxpayers

There are three potential certification actions required of the State Historic Preservation Officer and NPS before taxpayers are eligible to take advantage of tax incentives. The three stages and the time frames established in the Code of Federal Regulations for completion of the certifications are as follows:

- Historic significance: The State Historic Preservation Officer has 45 days from the time that the property owner submits the required information to forward the information with a written recommendation to the Keeper of the National Register at NPS. Once this information is received, NPS has 30 days to issue a written notice to the property owner in the form of a Certificate of Significance or as a notice that the structure does not contribute to the historic significance of the district.
- Proposed rehabilitation: If the taxpayer's application covers rehabilitation work that has not commenced, the State Historic Preservation Officer has 45 days to determine if the project is likely to meet the Secretary of the Interior's Standards for Rehabilitation and to forward the application and recommendation to NPS. NPS normally has 45 days to determine if the proposed rehabilitation is consistent with the standards or to advise the owner of any revisions necessary to meet the standards.
- Completed rehabilitation: On a completed rehabilitation, the State Historic Preservation Officer has 30 days to forward a recommendation, together with the documentation furnished by the taxpayer, to NPS. Notification as to certification or disapproval is to be made by NPS within 15 days of receipt of the State Historic Preservation Officer's recommendation.

To determine whether a sample of applications for certification was being processed within the time frames established by the regulations, we analyzed a randomly selected sample which could be projected to 301 applications processed by State Historic Preservation Officers and NPS during the period January 1977 through mid-January 1982. We estimate that 56, or 19 percent, of the 301 applications were processed in accordance with the time frames set forth in the regulations. The remaining 245 projects exceeded established time frames by an average of 44 days. And the latter figure encompasses processing by both State Historic Preservation Officers and NPS. Furthermore, as discussed below, our questionnaire results show that taxpayers generally were satisfied with the timeliness of the certification process.

To determine how taxpayers felt about the timeliness of the certification process, we sent a questionnaire to each of the individuals or organizations who were listed as owners of the properties in our sample. As shown below, we estimate that about 74 percent of the applicants to which we could project our survey results were very satisfied or somewhat satisfied with the State Historic Preservation Officers' timeliness in processing requests for certification; about 70 percent were very satisfied or somewhat satisfied with NPS' processing. Only about 15 percent of the taxpayers questioned expressed dissatisfaction with state and/or NPS processing time frames.

Timeliness in Processing Applications

	<u>Very satisfied</u>	<u>Somewhat satisfied</u>	<u>Neither satisfied nor dissatisfied</u>	<u>Somewhat dissatisfied</u>	<u>Very dissatisfied</u>	<u>Total</u>
	(percent)					
State Officers:	52.9	21.0	10.1	9.6	6.4	100.0
NPS: Certification of historic significance	47.7	23.2	15.1	8.4	5.6	100.0
Certification of rehabilitation	47.4	20.3	17.1	8.9	6.2	100.0 ^a

^aTotal does not add due to rounding.

According to the questionnaire responses, taxpayers also were generally satisfied with the guidance they received from State Historic Preservation Officers and NPS on the requirements for obtaining certification of structures and rehabilitation work, as shown on the following page.

	<u>Guidance on structure's historic significance</u>		<u>Guidance on rehabilitation standards</u>	
	<u>State Officers</u>	<u>NPS</u>	<u>State Officers</u>	<u>NPS</u>
	----- (percent) -----			
Very satisfied	64.2	54.9	54.5	49.2
Somewhat satisfied	18.7	22.3	21.1	20.9
Neither satisfied nor dissatisfied	8.0	16.5	11.6	18.3
Somewhat dissatisfied	4.1	2.6	6.9	5.8
Very dissatisfied	4.9	3.7	5.8	5.7
Total	<u>100.0^a</u>	<u>100.0</u>	<u>100.0^a</u>	<u>100.0^a</u>

^aTotal does not add due to rounding.

Program improvements have enabled NPS to handle an increasing workload

Although states and NPS were generally successful in processing certification applications during the initial years of the historic preservation program, problems began to develop in fiscal year 1982. Specifically, staffing shortages and an increased volume of applications caused backlogs in certain NPS regional offices. In response in part to the certification request backlogs, the NPS Director established a study group to review the program and recommend improvements.

Among other things, the study group found that hiring freezes, less money, and reduced personnel ceilings had prevented NPS from achieving regional staffing goals. The study group pointed out that, meanwhile, the demand for certification of historic structures and rehabilitations had grown and was expected to continue to grow rapidly in future years. For example, in fiscal year 1981, NPS handled 2,712 certification requests--a 37-percent increase over the 1,974 requests received in fiscal year 1980. And for fiscal years 1982 and 1983, the study group estimated that NPS would be called on to handle 3,800 and 4,300 certification requests, respectively.

In light of its findings, the study group made several recommendations. For example, it recommended that NPS consolidate historic preservation functions in five rather than the then existing eight regional offices. The group felt that such a consolidation would result in the concentration of critical professional personnel where they were needed, thus enabling NPS to maintain its program with fewer people and lower operating costs. The study group further noted that NPS could reduce its workload by relying more heavily on State Historic Preservation Officers' recommendations.

According to NPS officials, implementation of the above two recommendations has enabled the agency to deal effectively both with the backlogs that had developed and with the continuing increase in demand for certifications. NPS officials further noted that the concept of increased reliance on State Historic Preservation Officers coincided well with the way the program had evolved over the years. In this regard, they noted that, at the outset of the program in 1977, NPS had exercised strong controls over the certification decision-making process. Gradually, however, as states gained experience working with the historic preservation regulations and procedures, they developed expertise and were able to make appropriate recommendations to NPS.

For fiscal year 1984, however, the administration had made a proposal which could have reversed the trend toward further NPS reliance on State Historic Preservation Officer recommendations. That is, in its fiscal year 1984 budget request, the Interior Department had proposed to eliminate federal funding for state historic preservation activities. In prior years, this funding--in the form of federal grants--enabled many states to afford to pay large portions of the costs of historic preservation activities. For example, in fiscal year 1983, the State of Pennsylvania earmarked over \$1 million for historic preservation activities--\$446,962 in state funds and \$611,817 in federal grants. Similarly, in that same year, the State of Georgia earmarked \$629,000 for historic preservation activities, 50 percent of which was derived from federal grants. In total, for fiscal year 1983, NPS grants to states for historic preservation activities amounted to \$21.5 million.

If the Interior Department's proposal had been approved by the Congress, it is uncertain whether the states would have funded historic certification activities. The Interior Department apparently had recognized that possibility and had requested an increase of 29 positions and \$1.2 million for NPS' fiscal year 1984 historic preservation certification activities. As an indirect offset to this increased federal expenditure, NPS also planned to begin charging fees for certification actions. For fiscal year 1984, NPS had estimated that 8,125 certification requests would generate \$1.6 million in fees which could be deposited as miscellaneous receipts in Treasury Department accounts.

According to NPS officials, these proposed program revisions were not specifically designed with a view toward reducing states' involvement in the historic preservation program. NPS officials noted that states would have the option of retaining or even expanding their current program responsibilities--but without federal funding.

In fiscal years 1982 and 1983, the Interior Department proposed to eliminate federal grants for historic preservation activities, but the Congress rejected the proposals and appropriated funds for the grants. The Congress took the same action with the fiscal year 1984 proposal. On November 4, 1983, the President signed the Department's appropriation act which provides \$26.5 million to carry out the provisions of the Historic Preservation Act of 1966.

RECENT LEGISLATIVE CHANGES SHOULD
FACILITATE IRS' ADMINISTRATION OF THE
HISTORIC PRESERVATION TAX INCENTIVES

Tax incentives for the preservation of historic structures were first authorized by the Congress in 1976. And, as previously mentioned, they have achieved their desired effect of stimulating private sector interest in preserving and rehabilitating historic structures. For several years, however, IRS experienced some difficulties in seeking to effectively administer this tax expenditure. That is, problems arose in large part because the provisions were complex, requiring that taxpayers choose from among several possible Internal Revenue Code options. IRS thus faced the difficult task of ensuring that taxpayers adhered to the differing requirements associated with the various options.

Recognizing that the complexity of the historic preservation tax code provisions were causing administrative problems, the Congress moved to simplify them through enactment of the Economic Recovery Tax Act of 1981. Still, some tax compliance problems were not eliminated by the 1981 act. These involve (1) "recapture" of tax credits, (2) inappropriate tax benefit claims, and (3) overvaluation of conservation easement deductions.

The historic preservation sections of
the Internal Revenue Code caused tax
administration problems for IRS

With passage of the Tax Reform Act of 1976 and the Revenue Act of 1978, private investors began exhibiting an increasing interest in the preservation and/or rehabilitation of historic structures. Unfortunately, however, the historic preservation tax incentives included in those acts were complex. As a result, taxpayers experienced difficulties in seeking to comply with the tax laws and IRS found it difficult to effectively administer the provisions.

Complexity of the 1976 provisions

Before 1976, taxpayers were afforded no specific tax incentive to rehabilitate historic structures. With enactment of the 1976 law, however, taxpayers were afforded the opportunity to choose between two different tax incentives.

--Taxpayers could amortize (write off), over a 5-year period, certain amounts invested in the rehabilitation of historic structures. Previously, such investments were written off over the useful life of the structure-- a period of time that could involve 15 to 30 years or more.

--Alternatively, taxpayers who "substantially rehabilitated"² a historic structure could elect to use an accelerated depreciation method not previously available to them. That is, certain taxpayers were authorized to depreciate the residual value of the structure before rehabilitation through use of the "sum-of-the-years' digits" or "150 percent declining balance" methods. Previously, only the "straight line" or "125 percent declining balance" methods could be used. Appendix III explains these depreciation methods in more detail.

Subsequently, through the Revenue Act of 1978, the Congress authorized use of a 10 percent investment tax credit as an added incentive that could be used by certain taxpayers for historic structures. The credit could be taken in conjunction with the accelerated depreciation provisions of the 1976 act but did not apply when taxpayers elected to use the 5-year amortization approach.

²In general, a "substantially rehabilitated" structure is one whose rehabilitation costs exceed the pre-rehabilitation cost basis of the structure. A certified rehabilitation is considered "substantial" if the amounts added to the capital account exceed the greater of (1) the adjusted basis of the property or (2) \$5,000.

In addition to these tax incentives, the Tax Reform Act of 1976 and subsequent legislation made permanent and attempted to clarify previous legislation pertaining to deductions for charitable contributions made for conservation easements. A conservation easement is a contractual agreement, usually a recorded deed, between the property owner (the grantor) and a charitable organization (the grantee) receiving the easement. The deed records the property owner's promise to protect in perpetuity the existing character of the property, binding future property owners as well. The grantee of the easement is typically given the right to inspect the property or structure at any time and to enforce the easement.

In passing the legislation, the Congress recognized the value of easements in furthering four conservation goals, one of which is related to historically significant land areas and structures. A historic conservation easement usually refers to a restriction placed on alterations that may be made to the facade or the interior details of a certified historic structure. Easements, however, may also be used to protect historically important land areas. The other conservation goals include the preservation of recreation areas, natural habitats, and scenic spaces.

To encourage the use of conservation easements, the Congress has provided a tax deduction to easement donors equal to the reduction in property value experienced after the imposition of the easement--the so called "before and after test." Reductions in the property value are generally the case because the land is no longer available for its "highest and best use." Highest and best use in this context usually refers to the realistic development potential of the land in terms of commercial or expanded residential use. This reduction in property value, which is determined by the donor or a paid appraiser, is viewed as a donation of a partial interest in real property (noncash contribution) and may be deducted from the donor's adjusted gross income when calculating taxable income.

Tax administration difficulties encountered

To determine whether taxpayers in our sample were complying with the various Internal Revenue Code provisions relating to historic preservation and to evaluate IRS' compliance program, we analyzed data that could be projected to 545 tax returns filed with IRS in 1980. We estimate that the 545 returns pertained to 400 separate properties. The number of returns exceed the number of properties because multiple tax returns were filed for certain properties by, for example, the various partners in partnerships. The tax returns were selected from the universe

of 1,144 applicants who applied to NPS for certification from program inception through December 31, 1979. We found that IRS and/or taxpayers had experienced difficulties with four aspects of the historic preservation tax incentives.

First, we estimate that tax returns pertaining to 53, or about 5 percent, of the 1,144 applicants contained claims for tax benefits under mutually exclusive Internal Revenue Code sections. That is, the taxpayers had claimed the 10 percent investment tax credit along with 5-year amortization or had claimed both 5-year amortization and the accelerated depreciation provision. As discussed on page 36, however, the Economic Recovery Tax Act will, over the long term, have the effect of eliminating this as a problem area for IRS. That act simplified the historic structure tax provisions of the Internal Revenue Code. Thus, with respect to the above problem, IRS generally will only have to be concerned about rehabilitation expenditures made before January 1, 1982--the effective date of the new law.

Second, we found that taxpayers sometimes received excessive benefits from the historic preservation tax incentives. In this regard, taxpayers who claim benefits under certain tax code provisions, such as accelerated depreciation deductions on certified historic structures, may have to pay additional taxes on the portion considered to be a "tax preference amount." The tax preference amount--or special tax benefit--for amortization of certain rehabilitation expenses claimed under the 5-year write-off is the result obtained by subtracting the straight-line depreciation over the normal useful life of the improvement from the amount of the amortization. For example, if the normal useful life of improvements made to a certified historic structure was 20 years and the cost was \$100,000, the straight-line depreciation would be \$5,000 per year. But when a taxpayer elects to use the 5-year write-off, the amount of the annual deduction would be \$20,000. The difference between the two amounts--\$15,000--is the tax preference amount that the taxpayer must consider when calculating the minimum tax. That tax calculation is designed to assure that higher income taxpayers do not totally shelter their incomes from taxation.

IRS requires individual taxpayers to file Form 4625, "Computation of Minimum Tax--Individuals," if the amount of any one tax preference item or the total of several tax preference items is more than \$10,000;³ corporations have similar requirements. In the case of partnerships and small business corporations, IRS requires that they report the tax preference amounts to their partners and shareholders, respectively, for inclusion on individual tax returns.

³For a taxpayer who is married and files a separate tax return, the amount is \$5,000.

We estimate one or more taxpayers associated with 58, or 5 percent, of the 1,144 projects either did not take the minimum tax into account or underreported tax preference items, as shown in the following table.

<u>Type of filer</u>	<u>Estimated number of returns</u>	<u>Estimated amount of unreported or underreported tax preference</u>
Individuals	34	\$ 578,055
Partnerships	20	602,362
Corporations	2	148,293
Small business corporations	2	<u>24,097</u>
Total		<u><u>\$1,352,807</u></u>

Of the estimated 34 individual taxpayers included in our sample who did not report or underreported tax preference items, we estimate that 30, or 88 percent, should have filed Form 4625 along with their Form 1040--but did not do so. In these instances, the historic preservation tax deduction alone was sufficient to activate that filing requirement. Similarly, of the estimated 20 partnership returns on which tax preference items were unreported/underreported, we estimate that 7, or 35 percent, contained tax preference amounts large enough to require one or more of the partners to file a minimum tax form based solely on the tax preference amount pertaining to historic structures. But none of the partnerships had reported these amounts to the partners and only one partner had filed the minimum tax form. We did not attempt to determine how the one partner obtained the data needed to complete the minimum tax form.

Although the problem of unreported or underreported tax preference amounts may have some tax consequences in the form of foregone federal tax revenues, the problem should resolve itself over the long term. The Economic Recovery Tax Act of 1981 replaced the existing tax incentives with a special tax credit which is not a tax preference item. Thus, with respect to the tax preference/minimum tax problem, IRS generally will have to be concerned only with those taxpayers whose rehabilitations were underway before January 1, 1982.

The third problem area we noted pertains to the fact that the Internal Revenue Code provides for the "recapture" or recovery of any excess tax benefits that have accrued to taxpayers who sell rehabilitated historic structures within certain time frames. As previously discussed, a taxpayer who elects to amortize a \$100,000 investment over 5 years receives a special benefit equal to \$15,000 in deductions each year (\$20,000 less the \$5,000 that would have been allowable via straight line depreciation for a building with a useful life of 20 years). However, if the taxpayer was to sell the structure before 20 years had elapsed, there would be a tax consequence in the form of recapture. For example, if the taxpayer sold the structure after only 10 years, the amount to be recaptured would be computed as follows:

Total depreciation claimed during first 5 years	\$100,000
Less: amount of depreciation allowable under straight line method (\$5,000 x 10 years)	<u>50,000</u>
Depreciation amount subject to recapture	<u><u>\$ 50,000</u></u>

In the above example, the taxpayer is required to include the \$50,000 as ordinary income on the tax return filed for the year in which the structure was sold. And, depending on the individual's tax bracket, the amount of tax due on that \$50,000 could be substantial--as much as \$25,000, for example, for a taxpayer in the 50 percent tax bracket. Moreover, recapture applies not only to the 5-year amortization provision but also to the use of accelerated depreciation and to the 10 percent investment tax credit which can be used alone or in conjunction with accelerated depreciation. However, the recapture rule for the investment tax credit does not apply to structures held for more than 7 years.

Of the 806 projects to which we could project our data, we estimate that only 25 of the properties had been sold. But an estimated 10, or 40 percent, of the 25 taxpayers who filed tax year 1979 returns pertaining to the properties did not report or correctly calculate tax on amounts that should have been recaptured. We were unable to compute the tax effect of this form of underreporting but, as demonstrated in the above example, the amount of tax involved could be substantial. And, unlike some of the other problems we noted in the administration of the historic structure Code provisions, the recapture problem will not

resolve itself over time. This is because, as discussed on page 37, the Economic Recovery Tax Act of 1981 amended but did not delete recapture requirements.

The fourth area of concern relates to inappropriate tax benefit claims. We found that taxpayers claimed tax benefits for

- items not eligible for inclusion in costs related to structure rehabilitation,
- rehabilitations of properties which did not qualify for tax benefits because they were ultimately maintained as or converted to personal residences, and
- rehabilitations which did not meet Interior Department standards and which were denied certification.

Because not all of the expenses associated with the process of rehabilitating a historic structure qualify for special tax benefits, taxpayers are required to carefully compute the eligible amounts. For example, costs incurred for reinforcing the existing foundation of a building would qualify for special tax benefits. But, costs incurred for items such as landscaping, carpeting, and furniture would not qualify. Regarding use of the 5-year amortization provision, only eligible rehabilitation costs may be written off in that time frame, and not the costs of the structure itself. That is, taxpayers must keep eligible rehabilitation costs separate from the cost basis of the structure in calculating the deduction.

We estimate, however, that taxpayers associated with 59, or 5 percent, of the 1,144 projects for which tax data was available claimed tax benefits for unallowable items. There was no strict pattern to the unallowable items claimed, but available data showed that on an estimated 24, or 41 percent, of the 59 projects, the taxpayers included the cost of the structure in the calculation of the 5-year amortization deduction.

Of the 24 returns, an estimated 15 taxpayers reported structure and rehabilitation costs as a single amount. For the remaining nine, we were able to separately identify the different costs. We estimate that the nine taxpayers claimed a total of \$146,226 in tax write-offs of which \$110,934, or 76 percent, consisted of costs associated with acquisition of the structures. These taxpayers generally can deduct a reasonable annual amount for depreciation on the structures, but not at rates that would result in a complete write-off over 5 years.

Also, we found that other taxpayers had claimed special tax benefits for historic structures rehabilitated but ultimately used as personal residences. When tax benefits are claimed, the renovated historic structure is to be used for some commercial purpose, for example, a business, rental unit, etc. Nevertheless, we estimate that 30, or about 3 percent, of the taxpayers associated with the 1,144 projects included in our sample claimed tax benefits on rehabilitated buildings ultimately used as private residences.

Finally, we found that a few taxpayers apparently had claimed extensive tax benefits for rehabilitations denied certification by NPS. Specifically, we estimate that 39 tax returns had been filed on properties denied certification by NPS. And, of these 39 tax returns, 8, or 21 percent, contained rehabilitation related tax benefit claims. The investment amounts claimed on the eight returns totaled an estimated \$245,468 for returns filed in 1980, or an average of \$30,684 per return.

On another matter, we noted that our sample did not contain any taxpayers who had claimed a deduction for a conservation easement. We therefore asked IRS to provide us with data on all conservation easement deductions that it had audited at its Philadelphia, Atlanta, and Jacksonville district offices. IRS was able to provide data on 42 cases which included tax years 1974 through 1980. With the exception of one case, IRS disagreed with the amount of the valuations claimed by the taxpayers. The data showed that the taxpayers generally overvalued their conservation easement deductions by an average of about 220 percent. The overvaluations ranged from an average of 127 percent in the Atlanta district office to an average of 268 percent in the Philadelphia district office. The table below shows the total amounts of overvaluation that IRS had found in each of the three district offices.

District office	Number of cases	Amount of deduction		Difference	Percent over-valued
		Claimed by taxpayer	Allowed by IRS		
Philadelphia	26	\$ 7,557,800	\$ 2,054,100	\$ 5,503,700	268
Jacksonville	2	767,000	300,000	467,000	156
Atlanta	13	46,233,057	20,390,127	25,842,930	127
Total	41	\$54,557,857	\$22,744,227	\$31,813,630	

The problem of taxpayer valuations differing from IRS valuations is not restricted to conservation easements alone. In at least three other situations involving taxpayer valuations of noncash items, IRS has found that deductions have been overstated. In each case, IRS felt it reasonable to assume that the limited number of returns audited represented only a small part of the total potential problem.

The first situation is the recent appeals case of United States v. Brigham Young University, where IRS audited 162 persons who had claimed a deduction for noncash charitable contributions to Brigham Young University. These audits revealed that, in each case, the individual had overvalued the gift for tax purposes. IRS figures show that the total claimed value of the gifts was \$18 million, of which approximately \$16 million was disallowed.

The second situation involves the valuation of art prints. In 1981, IRS reviewed 427 individual art prints, donated by 350 taxpayers, with an aggregate taxpayer-asserted valuation of \$72,758,000. The IRS study team recommended downward adjustments of the valuation of all 427 prints. These recommended downward adjustments in deductions totaled \$71,437,000.

Another example of the problems inherent in valuing certain noncash items is discussed in our 1979 report⁴ on the personal casualty and theft loss tax deduction. In that report, we pointed out the difficulties in valuing such deductions. In the tax cases we reviewed, taxpayers claimed a total of \$538,494 in casualty and theft loss deductions. IRS allowed only \$169,937 of the amounts claimed.

Viewed together, these three examples of overvaluations and the evidence presented on conservation easements lead us to conclude that the valuation of noncash items is an area that is potentially subject to extensive taxpayer abuse, and as such, warrants close scrutiny by IRS.

In sum, IRS has experienced a variety of difficulties in seeking to assure compliance with the historic preservation tax incentives of the Internal Revenue Code. Fortunately, however, as discussed in the following pages, certain legislative changes enacted as part of the Economic Recovery Tax Act of 1981 should facilitate IRS' task in the future.

⁴The Personal Casualty and Theft Loss Tax Deduction: Analysis and Proposals For Change (GGD-80-10, Dec. 5, 1979).

Legislative changes have reduced
tax administration difficulties

Among other things, the Economic Recovery Tax Act of 1981 simplified the tax laws governing historic structure rehabilitations and further improved the incentive for private sector investment in such rehabilitations. As a result of the simplification, IRS' tax administration task has been facilitated.

Effective January 1, 1982, the Economic Recovery Tax Act repealed all of the tax incentives--5-year amortization, accelerated depreciation, and the 10 percent investment tax credit--enacted in prior years. In lieu of those incentives, the act provided for a 25 percent investment tax credit for certified historic structures. The credit is limited to "substantially rehabilitated" structures which are at least 30 years old. The act defines a substantial rehabilitation as one which costs at least \$5,000 or, in the case of a lesser investment amount, one which is equal to the value of the structure less accumulated depreciation. The act also contained various other tests and rules relating to the credit, some of which are discussed below as they pertain to the tax administration problems we identified through our sample.

As discussed on pages 30 to 34, we identified four major tax administration concerns relating to (1) taxpayer use of mutually exclusive Internal Revenue Code sections, (2) non-reporting of tax preference amounts, (3) "recapture" of tax deductions/credits, and (4) inappropriate tax benefit claims.

The Economic Recovery Tax Act has had differing effects on each of these four problem areas. For example, the act eliminated the first problem as an area of continuing concern to IRS. This is because taxpayers no longer need to choose from among these several different methods for computing tax benefits. Instead, they may only use the 25 percent investment tax credit.

Concerning the tax preference reporting and compliance problem, the act has reduced compliance enforcement concerns. This is because the new 25 percent investment tax credit for historic structures is not a tax preference item. Thus, IRS needs only to be concerned with those taxpayers who incurred rehabilitation costs before January 1982 and then only if the taxpayer continues to take historic structure related tax deductions over a period of years.

The act also simplified--but did not eliminate--the recapture requirements of the historic preservation tax incentives. That is, under the new law, if a qualified rehabilitated building is held by the taxpayer for longer than 5 years after the rehabilitation is completed and the building is placed in service, there is no recapture. If the property is disposed of after a holding period of less than 1 year after it is placed in service, 100 percent of the credit is recaptured. For properties held between 1 and 5 years, the recapture amount is reduced by 20 percent per year.

Thus, the recapture compliance problem is still a matter of concern. This is true for properties rehabilitated under both past and current law. And the recapture compliance problem is one which could become much more significant--from a revenue loss standpoint--in future years. This is because the amounts invested by taxpayers in historic structure rehabilitations are expected to grow to \$400 million or more annually by tax year 1985, thereby generating a high dollar value of tax credits potentially subject to recapture.

Incidentally, IRS already has experienced serious recapture related compliance problems with another provision of the Internal Revenue Code. Under Code section 167(k), IRS has found that a small number of cases involving non-reporting of recapture have resulted in a relatively large amount of tax due. The intent of section 167(k) is to encourage the rehabilitation of low-income housing by permitting taxpayers to depreciate expenditures up to \$20,000 per dwelling unit over a 5-year useful life rather than the previously typical 20- to 25-year periods. As is the case with the amounts claimed for historic rehabilitations, taxpayers who use section 167(k) are subject to recapture provisions upon disposal of the property.

In response to our concerns⁵ and concerns expressed by members of the Congress, IRS did a study to measure taxpayer compliance levels in recapturing (1) depreciation claimed under Code section 167(k) and (2) accrued but unpaid expenses on Department of Housing and Urban Development involved multi-family housing projects. IRS reviewed cases of defaults, foreclosures, and ownership changes pertaining to properties on which taxpayers had taken deductions under section 167(k) but had not complied with the recapture provisions. IRS has estimated that its review of about 238 tax year 1978 returns has or will result in disallowed deductions totaling about \$10.3 million and estimated additional taxes totaling \$2.7 million, or an average of \$11,335 per return.

⁵Audit activities resulting in GAO report entitled Analysis of Multi family Assigned Mortgages (CED-80-43, Jan. 16, 1980).

Finally, the Economic Recovery Tax Act may not affect the problem of inappropriate tax benefit claims. Taxpayers may continue to claim tax benefits for (1) properties rehabilitated for ultimate use as taxpayers' personal residences and/or (2) rehabilitations not certified by NPS. Regarding the latter problem, IRS already is getting the data it needs from NPS to develop a stronger compliance program. Specifically, IRS currently receives copies of all certification related approval and denial letters sent by NPS to taxpayers. Thus, IRS can readily identify those rehabilitations for which NPS has denied certification. Currently, IRS refers denial notices to its district offices for evaluation. Districts, however, may or may not examine related tax returns, depending on workload.

Regarding taxpayer overvaluation of deductions on conservation easements, there is no readily available means to identify Form 1040 returns containing these deductions. Therefore, neither we nor IRS know the extent of the problems. Taxpayers claiming a deduction for a conservation easement do so under the contributions section of Schedule A. But because there is no line specifically designated solely for conservation easement deductions, the deduction may be combined with other types of deductions and may not be readily distinguishable from others claimed by taxpayers.

Currently, IRS has an informal system for identifying abusive conservation easement deductions. These deductions are identified by IRS revenue agents during routine reviews of returns selected for audit. In these instances, an agent can question the valuation and request that an IRS real estate appraiser ascertain the "correct" value of the conservation easement. In addition, the appraiser may conduct an on-site inspection of the property. And, as previously noted, when agents have questioned valuations, they have found that taxpayers generally have overvalued the deductions.

In response to the Senate Committee on Finance's concern about the lack of a data base on the nature and scope of conservation easements, IRS has begun a 5-year study which will involve the identification of tax returns claiming a conservation easement deduction of \$5,000 or more for tax years 1981 through 1985. IRS plans to identify taxpayers who claim the conservation easement deduction as follows. Beginning with tax year 1981, all Forms 990, Schedule A,⁶ filed by tax-exempt organizations include the following question: "During the year did you receive any qualified conservation contribution whose value was more than \$5,000? If "Yes," attach a schedule as described in the instructions." The instructions include a request that the donee organization list the donor's name and address and social security number. Using this information, IRS

⁶Form 990, Schedule A, "Organizations Exempt Under 501 (c) (3)."

can check the donor's tax return and obtain details on the donated easement. The goal of IRS' study is to compile statistical data on the number and characteristics of the conservation easement deductions it identifies.

- - - -

In general, IRS has been hesitant to devote much in the way of resources to compliance problems relating to historic rehabilitations. This is because relatively few taxpayers have claimed these special tax benefits in comparison to the millions of tax returns filed annually. Nevertheless, if use of the recently enacted 25 percent historic rehabilitation investment tax credit increases as predicted for future years, IRS may need to revise its examination strategy to better ensure compliance with the tax laws governing the credit.

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to comment on your draft report entitled "Information on Historic Preservation Tax Incentives." We have reviewed the report and have no specific comments to submit regarding the report text.

We would like, however, to mention that we understand informally from the National Park Service (NPS) that they will be supplying us with a breakout of the total costs associated with the rehabilitation of a historic structure. In addition, they are also emphasizing the need to obtain accurate taxpayer identification numbers from all taxpayers requesting certification of historic structure rehabilitations. This information as well as a listing of denied certifications will facilitate the Service's ability to identify and prevent incorrect tax benefit claims and will ensure that the Service can effectively locate tax returns claiming tax benefits for rehabilitations denied certifications by NPS.

With kind regards,

Sincerely,





United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

F4217(230)

Mr. J. Dexter Peach
Director, Resources, Community and
Economic Development Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

This is in response to the General Accounting Office (GAO) draft report, "Information on Historic Preservation Tax Incentives."

The report examines how Federal tax laws affecting historic preservation activities have been administered by the National Park Service (NPS) and the Internal Revenue Service. We concur with the findings of the draft report as they apply to the NPS administration of the program and are pleased that the report finds the Park Service's performance "satisfactory." Much of the information gathered by the GAO, such as the average size of projects, usefulness of the incentives, types of owners, etc., is similar to data gathered by the Department in its 1979 study, "Federal Tax Provisions to Encourage Rehabilitation of Historic Buildings An Assessment of Their Effect," and the just-released report by the Advisory Council on Historic Preservation, "Federal Tax Law and Historic Preservation." The hard data on tax expenditures, gathered from actual tax returns, will be particularly useful to the Administration and Congress as they consider possible changes to Federal tax laws affecting historic buildings.

Because the draft report identifies no specific problems with the NPS administration of the project and contains no recommendations for remedial action, we do not have any additional comments to make at this time.

Sincerely,

G. Ray Arnett
Assistant Secretary for Fish and
Wildlife and Parks

DESCRIPTION OF THE TAX
INCENTIVES FOR HISTORIC PRESERVATION

Section 2124 of the Tax Reform Act of 1976 and section 315 of the Revenue Act of 1978 amended the Internal Revenue Code of 1954, as amended, to provide the following incentives for historic preservation and disincentives for demolition.

Section 191(a) provided a
5-year write-off of
rehabilitation expenses

Section 191(a) permitted owners of certified historic structures to amortize (write off) the amortizable basis (certain amounts expended) pertaining to the costs of completing a certified rehabilitation of these structures. These costs were amortized over a 60-month period rather than depreciated over their actual useful life. At the same time, allowable depreciation deductions of the basis of the historic structure may be continued during the amortization period.

The expenditures to be amortized, such as the costs of modern plumbing, electrical wiring, and heating and air conditioning systems, may be made only on depreciable structures used in a trade or business or for the production of income in order to be eligible. Therefore, if a certified historic structure is a private residence which includes a separate rental apartment, for example, only that portion of the costs of the certified rehabilitation which is attributable to the rental apartment may be amortized over 5 years. This provision applied to additions to the capital account made after June 14, 1976, and before June 15, 1981.

Section 167(o) permitted use of
accelerated depreciation on
substantially rehabilitated structures

Only certified historic structures which were "substantially rehabilitated" were eligible for the benefits of section 167(o). In general, a "substantially rehabilitated" structure was one whose rehabilitation costs exceeded the pre-rehabilitation basis of the structure. A certified rehabilitation was considered "substantial" if the amounts added to the capital account exceeded the greater of (1) the adjusted basis of the property or (2) \$5,000.

Before enactment of section 167(o), the pre-rehabilitation basis in the certified historic structure could be depreciated via the 125 percent declining balance method¹ for residential real estate with a remaining useful life of 20 years or more, or straight line for shorter-life residential and commercial real estate, depending on the use of the structure. Under section 167(o), the pre-rehabilitation basis could be depreciated via the sum-of-the-years' digits method for residential real estate or via the 150 percent declining balance method for commercial real estate. This section could not be used with section 191(a). It applied to additions to the capital account made after June 30, 1976, and before July 1, 1981.

Sections 280B and 167(n)
provide disincentives to
demolish certified structures

Ordinarily, investors who acquire, without the intent to demolish, a building which is not a certified historic building and is not located in a registered historic district may deduct the cost of demolition. Section 280B, however, provides that investors may not take a deductible loss if they demolish a certified historic structure or any other building located in a registered historic district, even if they acquired it without an intent to demolish the building. If they do demolish the building, they must add the cost to the capital account of the underlying land which is not depreciable. They, therefore, cannot deduct the costs from current income. This provision is effective for demolitions commencing after June 30, 1976, and before January 1, 1984.

¹In general, taxpayers are allowed to depreciate the cost of income-producing property by deducting from income a portion of the cost of the property each year over the useful life of the property. The three most common methods to determine the appropriate rate of depreciation are straight line, declining balance, and sum-of-the-years' digits. Under the straight line method, an equal amount of the cost of the property is allowable as a deduction each full year. The percentage rate is determined by dividing 100 percent of the cost by the useful life of the property. Thus, a property with a 20-year useful life will have a constant straight line rate of depreciation of five percent a year.

Under appropriate circumstances, taxpayers may use depreciation methods such as the 125 percent declining balance method or the sum-of-the-years' digit method to accelerate the recovery of cost above the straight line rate. The use of these methods provides for larger depreciation deductions in the earlier years of a property's use than are allowed in the later years.

Section 167(n) limited depreciation to the straight-line method on a structure which replaced a demolished certified historic structure or other building located in a registered historic district. This applied to structures constructed in whole or in part or used on a site which was occupied by a certified historic structure or by any structure located in a registered historic district. This limitation also applied to non-certified historic structures which have been substantially altered and located in a registered historic district. The provision applied after June 30, 1976, and before January 1, 1982.

There is an exception to the above rule. Investors are permitted to take a deduction or can use the appropriate rates other than straight line if they obtain a certification from the Secretary of the Interior that the building is not of historic significance to the registered district in which it is located. The certification should be obtained before the beginning of the demolition or alteration, but if, in good faith, the investors are unaware of the requirement before the demolition or the alteration, they can take the tax benefits. Such a good faith determination is made by the Secretary of the Interior.

Section 48(g) provided a 10 percent investment tax credit for rehabilitation of structures

Generally, buildings were not previously eligible for the investment tax credit. However, section 315 of the Revenue Act of 1978 amended the Code to provide a new tax incentive to encourage the rehabilitation of older buildings. Code section 48(g) provided for a 10 percent investment tax credit for qualified rehabilitation expenditures incurred after October 31, 1978, and before January 1, 1982, subject to the following:

- The building had to be at least 20 years old and at least that amount of time must have elapsed between the date of rehabilitation and the date the building was placed in service in connection with an earlier rehabilitation for which the rehabilitation credit was allowed.
- The rehabilitation had to be substantial, and at least 75 percent of the existing external walls of the building were to remain in place as external walls after the rehabilitation.

--The credit had to apply to buildings used for industrial and commercial purposes (such as factories, office buildings, warehouses, and stores) but not to residential rental properties.

--The credit had to apply to certified historic structures as well as other buildings. On historic structures located in registered districts, however, the taxpayer had to have the rehabilitation certified by the Secretary of the Interior.

--The credit could be used with section 167(o) but not with section 191(a).

Section 170(f)(3)(B) provides a tax deduction for historic preservation easements

Section 170(f)(3)(B) allows taxpayers to take a charitable deduction for an easement on real property granted in perpetuity or a partial interest in real property granted to a charitable organization exclusively for conservation purposes. In essence, an easement is an agreement between property owners and grantees in which the owners promise to protect the existing character of the property; the agreement binds future owners as well. The owners restrict their rights in the property in various ways, such as promising not to (1) subdivide the property, (2) alter any portion of the facade of a building so as to detract from its historically or architecturally significant appearance, or (3) destroy the scenic attractiveness of a historic site.

Economic Recovery Tax Act of 1981 provides 25 percent investment tax credit

The Economic Recovery Tax Act of 1981 became law on August 13, 1981, and substantially changed the tax treatment of real estate investment, including rehabilitation of historic structures. Effective January 1, 1982, the act repealed the 10 percent investment tax credit and replaced it with a 25 percent credit for a certified historic rehabilitation. The new credit is available for both depreciable nonresidential and residential buildings and only on buildings which have been substantially rehabilitated. This means that the qualified rehabilitation expenditures during the 24-month period ending the last day of the taxable year must exceed the greater of either the adjusted basis of the property (cost of the building plus capital improvements, less depreciation) or \$5,000.

The act did not affect Code section 280B pertaining to capitalization of demolition costs nor section 170(f)(3)(B) pertaining to easements. However, it repealed the following other historic preservation tax provisions:

- 60-month amortization of certified historic structures rehabilitation expenditures under Code section 191(a),
- accelerated depreciation of expenditures on substantially rehabilitated certified historic structures under Code section 167(o), and
- denial of accelerated depreciation on a building constructed or reconstructed on the site of a demolished or substantially altered certified historic structure under Code section 167(n).

Generally, the act applies to qualified rehabilitation expenses incurred after December 31, 1981. However, where expenditures occur both before and after this date, expenditures before January 1, 1982, can qualify for either the 10 percent credit and/or the accelerated depreciation under Code section 167(o) or the 5-year amortization under section 191(a). Expenditures incurred on or after January 1 can qualify for the new 25 percent investment tax credit.



U.S. GENERAL ACCOUNTING OFFICE

SURVEY OF TAXPAYERS' USE OF TAX INCENTIVES FOR THE REHABILITATION OF HISTORIC STRUCTURES

INTRODUCTION

The purpose of this questionnaire is to help us determine (1) how effectively Federal agencies administer the historic preservation provisions of the Tax Reform Act of 1976 and the Revenue Act of 1978, and (2) the effects these provisions have on the preservation of historic structures.

As you know, the Federal tax laws contain several provisions that act as incentives and disincentives to preserve buildings and other structures of historic significance. The Internal Revenue Code provides incentives under Section 191 which allows certain rehabilitation expenses to be amortized over a 60-month period; Section 167(o) which permits accelerated depreciation of the costs of rehabilitating structures; Section 48(g) which allows an investment tax credit for up to 10 percent of rehabilitation expenses; and Section 170(f)(3)(B) which allows a charitable contribution deduction for historic preservation easements. Provisions intended to deter the destruction of historic buildings are Section 167(n) which restricts depreciation to the straight-line method on buildings that replace certified historic structures, and Section 280B

which denies deductions for demolition costs or losses. You may want to refer to these definitions in responding to the questionnaire.

Please answer all of the questions in terms of the historic property identified in paragraph 2 of the attached letter. (NOTE: Please complete the questionnaire even if you no longer own or have part interest in this structure.) The owner of this property should personally fill out the questionnaire and, if needed, obtain the advice of others knowledgeable about the property.

The questionnaire is numbered only to aid us in our follow-up efforts and will not be used to identify you with your response. The numbers printed within parentheses throughout the questionnaire assist our keypunchers in coding responses for computer analysis. Please disregard these numbers.

Please return the completed questionnaire in the enclosed, self-addressed envelope within 10 days. If you have any questions, you may call Robert Korinchak or Christopher Heppe, collect, at (202) 376-0023.

1. In terms of this property, do you consider yourself to be an owner of an income-producing property, a developer, or a lessee? (Check all that apply.) (5-8)
- | | |
|----------------|-------------------------------------------------------------------|
| <u>Percent</u> | 1. <input type="checkbox"/> Owner of an income-producing property |
| 87 | |
| 27 | 2. <input type="checkbox"/> A developer |
| 5 | 3. <input type="checkbox"/> A lessee |
| 7 | 4. <input type="checkbox"/> Other (specify) _____ |
| <u>Percent</u> | |
2. Do you currently own or have part interest in this structure? (9)
- | | |
|----|---------------------------------|
| 92 | 1. <input type="checkbox"/> Yes |
| 8 | 2. <input type="checkbox"/> No |
3. Approximately when was the original structure built? (10-13)
- _____ (year)
4. When you applied for certification of the rehabilitation work, to what extent were the other structures in the neighborhood rehabilitated or in the process of being rehabilitated? (Check one.) (14)
- | | |
|----------------|-----------------------------------------------------|
| <u>Percent</u> | 1. <input type="checkbox"/> To a very great extent |
| 6 | |
| 14 | 2. <input type="checkbox"/> To a substantial extent |
| 25 | |
| 23 | 3. <input type="checkbox"/> To a moderate extent |
| 28 | |
| 4 | 4. <input type="checkbox"/> To some extent |
| | |
| | 5. <input type="checkbox"/> To little or no extent |
| | |
| | 6. <input type="checkbox"/> No basis to judge |

5. From which of the following sources did you first learn about the tax incentives for the rehabilitation of historic structures? (Check one.) (15)
- | | |
|----------------|-------------------------------------------------------------------------------------------|
| <u>Percent</u> | 1. <input type="checkbox"/> Tax preparer or attorney |
| 11 | |
| 32 | 2. <input type="checkbox"/> Preservation/historic organization (local, state, national) |
| 10 | 3. <input type="checkbox"/> News media |
| 8 | 4. <input type="checkbox"/> Housing industry (e.g., realtors, architects, builders, etc.) |
| 3 | 5. <input type="checkbox"/> IRS publication/regulation/ruling |
| 1 | 6. <input type="checkbox"/> Department of Interior publication/conference |
| 5 | 7. <input type="checkbox"/> State Historic Preservation Office publication/conference |
| 12 | 8. <input type="checkbox"/> "Word of mouth" |
| 16 | 9. <input type="checkbox"/> Other (specify) _____ |
| 2 | 10. Unknown |

<p>6. How satisfied or dissatisfied are you with IRS's guidance (tax return instructions, regulations, or personal contacts) in your use of the tax incentive provisions for historic structures? (Check one.) (16)</p>		<p>9. If the tax incentives had not been available, to what extent would you have rehabilitated or planned to rehabilitate this structure anyway? (Check one.) (23)</p>	
<u>Percent</u>		<u>Percent</u>	
14	1. <input type="checkbox"/> Very satisfied	36	1. <input type="checkbox"/> To little or no extent
30	2. <input type="checkbox"/> Satisfied	20	2. <input type="checkbox"/> To some extent
25	3. <input type="checkbox"/> Neither satisfied nor dissatisfied	20	3. <input type="checkbox"/> To a moderate extent
6	4. <input type="checkbox"/> Dissatisfied	12	4. <input type="checkbox"/> To a substantial extent
6	5. <input type="checkbox"/> Very dissatisfied	12	5. <input type="checkbox"/> To a very great extent
19	6. <input type="checkbox"/> No basis to judge	<p>10. Disregarding the investment tax credit (48(g)), we are interested in your opinion regarding the adequacy of 167(o) as an incentive. If Section 191 did not exist, how adequate or inadequate would 167(o) be to encourage you to rehabilitate historic structures? (Check one.) (24)</p>	
<p>7. Which, if any, of the following tax incentives did you use in filing a tax return for tax year 1979? (Check all that apply.) (17-21)</p>		<p>11. Did you/are you receiving any Department of the Interior grants through your State Historic Preservation Office to help you rehabilitate the structure? (25)</p>	
<u>Percent</u>		<u>Percent</u>	
55	1. <input type="checkbox"/> Section 191-5 year amortization of rehabilitation expenditures	4	1. <input type="checkbox"/> More than adequate
18	2. <input type="checkbox"/> Section 167(o)-accelerated depreciation	27	2. <input type="checkbox"/> Adequate
11	3. <input type="checkbox"/> Section 48(g)-investment credit for rehabilitation expenses on commercial property at least 20 years old	33	3. <input type="checkbox"/> Marginally adequate
1	4. <input type="checkbox"/> Section 170(f)(3)(B)-charitable contribution deduction for historic preservation easement	25	4. <input type="checkbox"/> Inadequate
29	5. <input type="checkbox"/> None (CONTINUE)	11	5. <input type="checkbox"/> Very inadequate
		<p>(GO TO QUESTION 9)</p>	
<p>8. Which of the following reasons best explains why you chose not to claim the above tax incentives in tax year 1979? (Check one.) (22)</p>		<u>Percent</u>	
49	1. <input type="checkbox"/> Project not yet eligible for tax benefits	10	1. <input type="checkbox"/> Yes
7	2. <input type="checkbox"/> Certification denied	90	2. <input type="checkbox"/> No
6	3. <input type="checkbox"/> Concern about Section 1250 and Section 47 (recapture provisions)-recovery of the appropriate amounts of depreciation upon the sale of a certified historic structure		
2	4. <input type="checkbox"/> Concern that the tax incentive legislation for historic structures would not be re-enacted upon its expiration in 1981		
34	5. <input type="checkbox"/> Other (specify) _____		
2	6. Respondents checked two or more of the reasons		

We are interested in your experience with State and Federal officials in the process of obtaining certification of your historic structure and rehabilitation work. The three questions below ask about your satisfaction or dissatisfaction with the assistance provided by the staff in the State Historic Preservation Office and in the U.S. Department of the Interior (DOI) in terms of timeliness and guidance in processing your application and meeting DOI structure and rehabilitation standards.

12. In getting your application for historic certification processed, were you satisfied or dissatisfied with the assistance provided you by the State Historic Preservation Office in the following areas? (Check one for each row.)

	Very satisfied	Somewhat satisfied	Neither satisfied nor dissatisfied	Somewhat dissatisfied	Very dissatisfied	Not Applicable	
	1	2	3	4	5	6	
1. Guidance in applying for certification of structure's historic significance	64	19	8	4	5	-	(26)
2. Guidance in meeting DOI standards for rehabilitation work	54	21	12	7	6	-	(27)
3. Timeliness in processing application	53	21	10	10	6	-	(28)
4. Other (please describe)	50	4	-	21	25	-	(29)

13. In the following areas, please indicate your satisfaction or dissatisfaction with the assistance provided by the staff of the U.S. Department of the Interior in getting your structure certified historically significant -Part I of the application. (Check one for each row.)

	Very satisfied	Somewhat satisfied	Neither satisfied nor dissatisfied	Somewhat dissatisfied	Very dissatisfied	Not Applicable	
	1	2	3	4	5	6	
1. Guidance in applying for certification of structure's historic significance	55	22	16	3	4	-	(30)
2. Timeliness in processing application	48	23	15	8	6	-	(31)
3. Other (please describe)	39	3	-	7	51	-	(32)

14. In the following areas, please indicate your satisfaction or dissatisfaction with the assistance provided by the staff of the U.S. Department of the Interior in getting your rehabilitation work certified -Part II of the application? (Check one for each row.)

	Very satisfied	Somewhat satisfied	Neither satisfied nor dissatisfied	Somewhat dissatisfied	Very dissatisfied	Not Applicable	
	1	2	3	4	5	6	
1. Guidance in meeting DOI standards for rehabilitation work	49	21	18	6	6	-	(33)
2. Timeliness in processing application	48	20	17	9	6	-	(34)
3. Other (please describe)	37	-	-	27	36	-	(35)

15. Would you have decided to demolish this structure rather than rehabilitate it if the tax disincentives under Section 280B and 167(o) had not existed? (Check one.) (36)
- Percent
- 5 1. Definitely yes
 - 6 2. Probably yes
 - 8 3. Undecided
 - 20 4. Probably no
 - 49 5. Definitely no
 - 12 6. No basis to judge

16. Would you use the tax incentive provisions for historic structures if you purchased, under similar ownership, another eligible structure? (Check one.) (37)
- Percent
- 1 1. Definitely no
 - 3 2. Probably no
 - 7 3. Undecided
 - 30 4. Probably yes
 - 58 5. Definitely yes
 - 1 6. No basis to judge
- (CONTINUE)
- (GO TO QUESTION 18)

17. Why wouldn't you use the tax incentive provisions if you purchased, under similar ownership, another eligible structure? (Check one.) (38)
- Percent
- 37 1. Concern about Section 1250 and Section 47 ("recapture provisions")—recovery of the excess depreciation and/or investment tax credit upon the sale of a certified historic structure
 - 8 2. Does not provide a sufficient tax shelter for income
 - 3 3. Concern that the tax incentive legislation for historic structures would not be re-enacted on its expiration in 1981.
 - 20 4. "Red tape"—the burden of obtaining certification
 - 22 5. Other (specify) _____
 - 10 6. Respondents checked more than one reason.

18. How many other historic structures do you own or have part interest in that have been certified? (NOTE: If you do not know the answer to this question, check "Not known.")
- (39-40)
- Number of structures Not known

19. How many other historic structures do you own or have part interest in that might be eligible for certification, but which you have not yet chosen to be certified? (NOTE: If you do not know the answer to this question, check "Not known.")

(41-42)

Number of structures Not known

(If you entered "0" or checked "Not known", go to question 21.)

20. Which of the following reasons best explains why you chose not to obtain certification for the rehabilitation of these historic structures? (Check one.) (43)

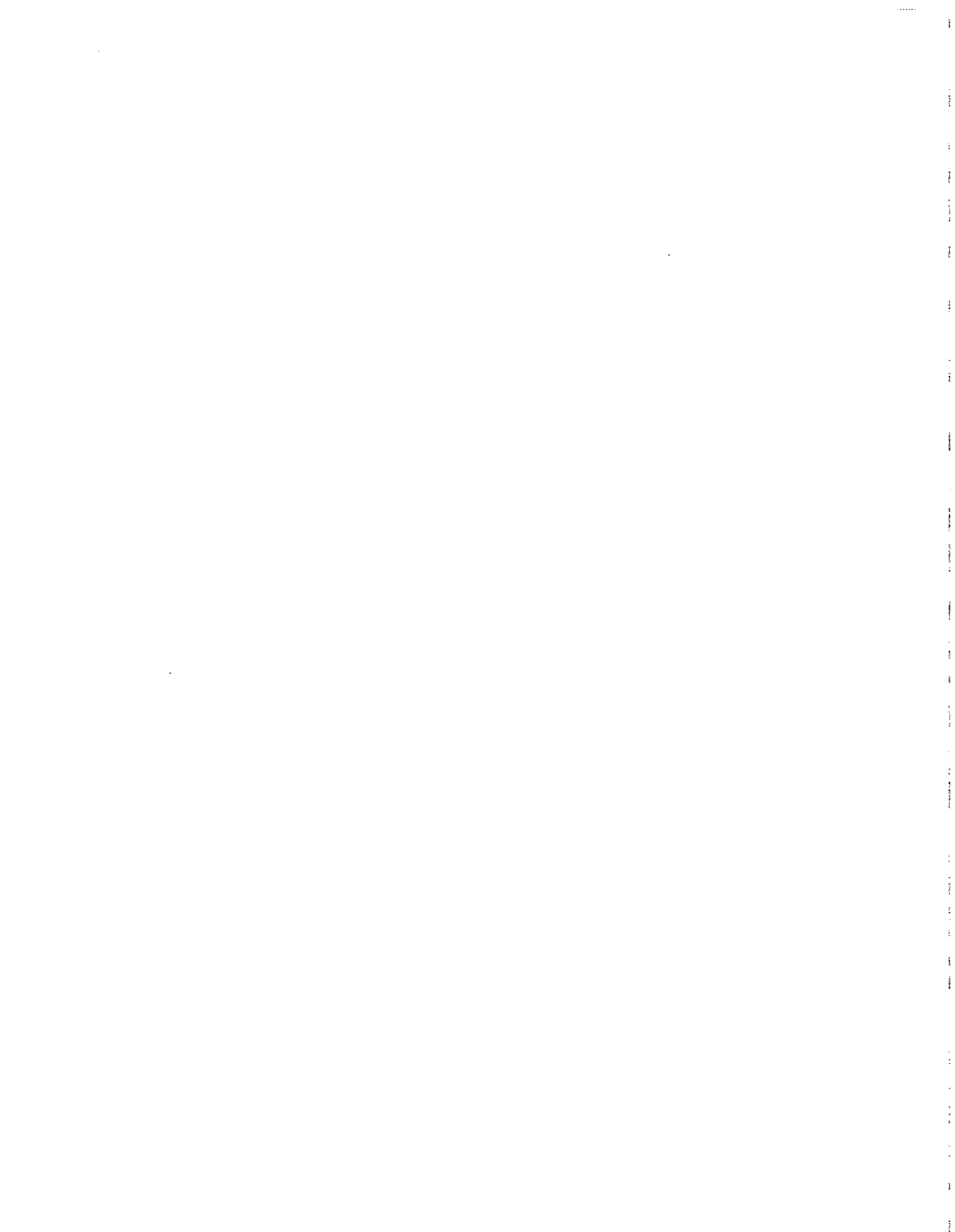
- Percent
- 15 1. Concern about Section 1250 and Section 47 ("recapture provisions")—recovery of excess depreciation and/or investment tax credit upon the sale of a certified historic structure
 - 14 2. Does not provide a sufficient tax shelter for income
 - 8 3. Concern that the tax incentive legislation for historic structures would not be re-enacted on its expiration in 1981.
 - 24 4. "Red tape"—the burden of obtaining certification
 - 20 5. Other (specify) _____
 - 13 6. More than one reason checked.
 - 6 8. Funding problems.

Would you please give us your telephone number if we need to contact you for additional information?

(Area code) Number

21. If you have any comments or recommendations concerning the tax incentive or disincentive provisions for historic structures, please use the space provided below. (44)

THANK YOU FOR YOUR COOPERATION



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