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Historic Preservation and the Law: Appraisals of Realty for Taxation

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The United States Supreme Court decision in *Penn Central*[1] will lead to a burgeoning of the historic preservation movement in the United States. Prior to that definitive ruling sanctioning the preservation concept, most jurisdictions treaded warily in the area, and most landmark designations involved nonprofit and government owned properties, with preservation agencies shying away, as much as possible, from designating privately owned structures. Now, the preservation movement will strike out more boldly and will begin to encompass, on a much wider scale, private property operated for profit. This change will give rise to new legal problems involving the courts, the legislatures, and the administrative arms of government. One problem that has been largely ignored must be confronted: how should privately owned property be assessed for local real property tax purposes when the property has been designated for landmark or historic district preservation? For the purposes of this article, assume the applicability of the New York City Landmarks Preservation Law,[2] the Real Property Tax Law of the State of New York,[3] and the New York City Tax Review Procedures[4] even though laws regarding landmarks, historic districts, and tax assessment differ in various states and municipalities throughout the country.

The problem of tax assessment of properties designated for landmark or historic district preservation does not exist where property is owned by the government or by religious, eleemosynary, educational, or other nonprofit, tax exempt owners. St. Patrick's Cathedral is on one of the most valuable blocks in the world, but it has no problem with respect to its real estate tax assessment.

Where taxable private property is designated, however, the following major considerations are presented: *first,* as long as the privately owned property is economically viable and its present use is the equivalent of its highest and best use, the designation of it for historic preservation presents no hardship because the use may continue undisturbed by the designation since the property is capable of remaining economically competitive;[5] *second,* when the landmark or historic district designation enhances the value of the structure by virtue of added prestige, no hardship is presented; but, *third,* if values in the area, as well as taxes, are increasing and the land could be redeveloped at a better "highest and best use" without the designation, the owner may encounter economic hardship as a result.

In this last situation, the owner may be able to resort to financial assistance supplied pursuant to relevant landmarks laws. Subsidy may be provided privately, by foundations, or by a government to maintain the property in its proper state for historic preservation. A good illustration is the former Astor Library on Lafayette Street in Manhattan which is now operated by Joseph Papp as The Public Theatres;[6] Furthermore, an owner may seek to transfer the air rights from his property. While relatively few cities have adopted this concept, transferable development rights may be sold and the payment for these rights may be sufficient to maintain the property. Financial aid may also be granted through a tax exemption or abatement to help preserve the property. Alternately, a government may resort to eminent domain, requiring the payment of just compensation for the taking. This approach is rarely resorted to because of the high cost involved. If all of the above fail, then permission must be given, after the lapse of the statutory period of time, to demolish the landmark or to make such other changes as are necessary to provide a fair return from the property. This provision is necessary to preserve the constitutionality of the statute.

The problems of taxing full value are well illustrated by reference to the landmark building in which this conference is being held, the home of the Association of the Bar of the City of New York. The dues for membership have risen sharply because the building is no longer tax exempt and taxes must be paid in full. If the dues exceed the ability of the members to pay, the only alternative would be to allow the property to be demolished; that is really the bottom line of the whole landmarks procedure and of the interrelationship of tax assessment and property valuation of landmarks. Since the taxes required to be paid on the property bear a direct and important relationship to ability to operate the property economically, the valuation for tax purposes becomes a crucial factor in the historic preservation syndrome. It is essential to understand the procedures and techniques available to deal with the valuation of historic property for tax purposes.

This paper will outline the conventional method of valuation of real property for tax purposes and the modification of these techniques to reflect the impact of landmark or historic district designation.

Assessment of each parcel of real property in a tax district is made each year by an assessor or a Board of Assessors and these valuations are placed on the public tax rolls on the taxable status date each year.[7] Even though all properties are required to be assessed in most states on the basis of full value or fair market value,[8] assessing properties at full value has always created difficulty. The factors of politics, subjective evaluations, and other deleterious elements have encroached upon the full value concept so that only rarely do assessments prevail at full value for all properties in a tax district. This problem is being dealt with as a result of the *Hellerstein* decision in New York[9] and similar decisions in many other jurisdictions throughout the country.

Ordinarily, in fixing an assessment, the land is valued first, usually based on comparable sales and leases where available or by use of the land residual method. The latter involves the development of a hypothetical "highest and best use" improvement, the capitalization of its net income to arrive at a total value, and the deduction of the cost of the hypothetical improvement, with the remainder representing the land value. There are three methods: comparable sales and leases, capitalization of net income, and reproduction costs less depreciation and obsolescence. Comparable sales and leases in appropriate cases is used most frequently. Under New York tax assessment procedure and in most other jurisdictions, the assessor must assess the land as if unimproved and then add the value of the improvement to make up the total.

The most important aspect of property valuation is rooted in two concepts: 1) highest and best use, and 2) capitalization of net income. The "highest and best use" requires consideration of how the property is capable of being developed as a result of zoning, the infra-structure, the nature of the community and all the complex factors that go into the totality of real estate development, in short, it involves a determination as to the best way to improve the land, obviously, always a subjective procedure.

The concept of capitalization of net income requires an estimate of the income that could be realized from the highest and best use of the property. Net income is determined by subtracting from the income the normal operating expenses, which are usually based on the operating expenses of comparable properties and do not include depreciation, mortgages, or liens. The resulting net income is then capitalized at a rate determined by an estimate of what return should be expected by an investment in this type of property based on market returns for comparable investments. Ten or twenty years ago, we capitalized at 5 percent for the land, 6 percent for the building. Today, the capitalization rates usually average above 10 percent. Depreciation and real estate taxes may be deducted as expenses or may be built into the capitalization rate.

If it can be shown that a property is assessed in excess of its full or fair market value, the assessment will be reduced either on protest[10] or in a tax review proceeding in court.[11]

Properties must be assessed equally. Thus, when it can be established that a particular property is assessed at a higher percentage of full value than other properties on the same tax roll, the owner is entitled to a reduction (even if his property is assessed at less than full value) on the ground of inequality. In New York, the State Board of Equalization and Assessments fixes an equalization rate for each tax district for each year. That rate is prima facie evidence of the rate of assessment for that district unless the contrary is proven at trial.[12]

If there is any violation of the statutory procedure for the fixing of assessed value, the assessment may be challenged upon a claim of illegality.[13] This basis is rarely used.

Assessors have the duty of fixing the assessment for each property in the district each year sometime before the tax assessment date (the taxable status date). The assessor is required to fix a value for the land as if unimproved and then a total value for the land and improvements. Any information that might be helpful in fixing value may be furnished to the assessor.

After the tentative assessment is fixed by the assessor and is published on the tax rolls, the taxpayer may object to the assessment on "grievance day" or during a "protest period." After any adjustment has been made and after the final assessment has been fixed, the taxpayer has a limited period of time within which to institute a court proceeding to review the correctness of the assessment. If the issue cannot be resolved by settlement, a trial will ensue on whatever ground of claimed invalidity the taxpayer has asserted, i.e., overvaluation, inequality, or illegality. Appeals, of course, may follow. The determination of the court governs the assessment for the year or years in question, but is not binding upon assessments for subsequent years.[14]

Proof of overvaluation is usually adduced through expert testimony. Each side produces its own experts, who testify, using the conventional techniques for appraising real property, as to the fair market value or full value of the property on the taxable status date (or dates, if there is more than one year under review). The techniques include consideration of comparable sales or leases,[15] capitalization of net income,[16] reproduction cost less depreciation and obsolescence,[17] and other factors relevant to the particular property.

Where the equalization rate of the State Board of Equalization and Assessment is accepted by all parties, it is multiplied by the fair market value or full value to produce the equalized assessment. Where the parties do not concede the correctness of the equalization rate, sample parcels in the tax district are selected, either by stipulation or by direction of the court, and are valued. These values are then compared with their assessments and a ratio is established which is extrapolated into an equalization rate fixed by the court after hearing the proof on both sides. This factor is then multiplied by the full value to fix the assessment.[18]

Proof is adduced as to the claimed illegality, and the court must determine the issue as a matter of law; this basis for challenging assessments is rarely used.

In applying the procedures described above to the problem of assessing a privately owned property which has been designated for historic preservation, we are confronted with the necessity of valuing the land as if unimproved and then placing a value on the total based on highest and best use of the parcel. When a landmark consisting of an inadequate improvement is involved, the owner cannot realize the highest and best use of the land. It would seem, therefore, inequitable to tax the land up to the full value of the highest and best use. If that were to be done, the government would be barring a use and at the same time taxing as if the use were available. Yet the mandate of the taxing statute is to value the land as if unimproved,[19] and it may be legally inappropriate to modify that value because of the nature of the improvement. That is our Catch 22.

The difficulty may best be illustrated by hypothesizing that the Flatiron Building, a landmark located on 23rd Street and Fifth Avenue, were to be located instead at 57th Street and Park or Fifth Avenue. In its present location, it is unlikely that its site could be readily redeveloped into a higher and better use. Consequently, a designation requiring preservation of the building's exterior would have little significance in economic terms, except possibly, to enhance its value slightly by virtue of the prestige flowing from its designation as a landmark. At 57th Street and Park or Fifth Avenue, the building would be inadequate to realize the earning potential for the area. A land assessment based on 57th Street land values could create a double penalty on the owner who, while unable to employ the full potential of the land, would have to pay taxes as if he could.

On the other hand, it might violate the statute to assess the land at less than its full value solely because of the impediment to the highest and best use created by the historic preservation restriction. To assess at less than full value could result in the anomalous situation of one parcel's being assessed at $100 per square foot and an adjacent parcel, worth the same amount, being assessed at $500 per square foot because of the landmark designation of the first parcel.

The elimination of the requirement of the statute for a separate assessment of land, as if unimproved, might resolve this dilemma. Since there does not seem to be any reason for the separation of land and total assessment, because taxes are only paid on the total assessment, the change may be desirable.

Another difficulty may arise as a result of a landmark designation of a privately owned property that does not fully employ the zoning or development rights attaching to the site. Where the transfer or sale of the development rights (TDR) is permitted, as in New York[20] or Chicago,[21] the sums realized from a sale might contribute to the feasibility of maintaining the landmark. However, where the TDR is not permitted, the owner is deprived by the landmarks restriction of the use of these excessive zoning rights and yet is required to pay real estate taxes based upon the value of these rights under conventional land assessment practices. This dilemma was not resolved in the *Penn Central* case, even though TDR was considered,[22] because the subject was dealt with in a different context. New York remains one of the few places in the country where the transfer of development rights is permitted. Eight or nine years ago, John Costonis suggested the possibility of placing the development rights into a development bank and then permitting them to be allocated elsewhere or sold, to be appropriately used without violating the basic zoning applicable to the district.[23]

It has recently been suggested as a means of preserving landmarks that the federal Urban Development Action Grant (UDAG) funds might be used to purchase development rights and hold them in a development bank until they can be appropriately used.

Where designation enhances the value of the property, the assessor faces the question of whether to add an increment of value to the assessment because of the landmark's designation.

These dilemmas are typical of the problems which face assessors, owners, legislators, and the courts as historic preservation doctrine expands in the future under the umbrella of the *Penn Central* case in much the same manner as zoning doctrine developed, beginning 50 years ago in the wake of *Village of Euclid v. Ambler.*[24] The problem has many of the same elements as other situations that have arisen in the past where there has been distortion of the normal elements of real property valuation such as rent control, the depressed value of property during the 1930s, the continuance of nonconforming zoning uses and aesthetic or architectural values. Since courts and legislators have evolved acceptable solutions to these seemingly intractable problems, it seems assured that solutions will also be reached as to the problems of assessing properties designated in historic districts and as landmarks.

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1. Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978).

2. N.Y. GEN. MUN. LAW § 96-a (McKinney 1977 & Supp. 1981); NEW YORK, N.Y., ADMIN. CODE ANN. §§ 205-1.0 to 207-21.0 (Williams 1976 & Supp. 1981).

3. N.Y. REAL PROP. TAX LAW §§ 500-760 (McKinney 1972 & Supp. 1981).

4. NEW YORK, N.Y., CHARTER §§ 151-167, 1500-1527 (Williams 1976 & Supp. 1980); NEW YORK, N.Y., ADMIN. CODE ANN. §§ 153b-2.0 to 166-1.0 (Williams 1976 & Supp. 1981).

5. The American Standard Building located at 40 West 40th Street is an example of this.

6. One of my early historic preservation cases involved a building which was the first library in the United States, financed by the Astors in the mid-19th century. Located on the fringe of Greenwich Village, it became obsolete. My client signed a contract to purchase the property. He based the price on the fair market value of the land if he could demolish the building and construct an apartment house. I received a call from Frank Gilbert saying that the Landmarks Commission thought that the property should be preserved. He asked if the client would take a profit for flipping the contract (assigning the contract for sale) rather than taking title. I talked to the client, and he agreed as long as he could make a reasonable profit. Frank and I negotiated a figure. The building became Joseph Papp's theater, now famous as the home of the Papp theaters in New York for the last ten years. Papp had decided to build some experimental theaters downtown. He spotted this property and went to the Landmarks Commission. They were designating it as a landmark. When he expressed his ideas to them, they asked him to get foundation and private support for buying and altering the building. The Landmarks people never told us what the purpose was. They just negotiated quietly. This is one of the best stories about how an imaginative process of landmark preservation can overcome economic barriers to landmark preservation.

7. N.Y. REAL PROP. TAX LAW § 302(1) (McKinney 1972); NEW YORK, N.Y., CHARTER § 1510 (Williams Supp. 1981).

8. N.Y. REAL PROP. TAX LAW § 306 (McKinney Supp. 1981).

9. Hellerstein v. Assessor of Islip, 37 N.Y.2d 1, 332 N.E.2d 279, 371 N.Y.S.2d 388 (1975).

10. N.Y. REAL PROP. TAX LAW § 512 (McKinney Supp. 1981); NEW YORK, N.Y., CHARTER § 164 (Williams 1976).

11. N.Y. REAL PROP. TAX LAW § 700 (McKinney 1972); NEW YORK, N.Y., CHARTER § 166 (Williams 1976).

12. N.Y. REAL PROP. TAX LAW § 720 (McKinney 1972 & Supp. 1980); Ed Guth Realty Inc. v. Gingold, 41 A.D.2d 479, 344 N.Y.S.2d 270 (4th Dep't 1973), *aff'd*, 34 N.Y.2d 440, 315 N.E.2d 441, 358 N.Y.S.2d 367 (1974); 860 Executive Towers, Inc. v. Board of Assessors, 53 A.D.2d 463, 385 N.Y.S.2d 604 (2d Dep't 1976), *aff'd mem. sub nom.* Pierre Pellaton Apts., Inc. v. Board of Assessors, 43 N.Y.2d 769, 372 N.E.2d 801, 401 N.Y.S.2d 1013 (1977); *but see* ch. 476 [1978] N.Y. Laws, which defers the applicability of the inequality concept under certain circumstances until Dec. 31, 1980, and recent statute extending to 1981.

13. N.Y. REAL PROP. TAX LAW § 706 (McKinney Supp. 1981).

14. N.Y. REAL PROP. TAX LAW §§ 512, 720 (McKinney 1972 & Supp. 1981). *See* Lome v. Tax Comm'n, 19 Misc. 2d 803, 192 N.Y.S.2d 787 (Sup. Ct. N.Y. County 1959), *aff'd*, 11 A.D.2d 773, 204 N.Y.S.2d 910, *appeal denied*, 11 A.D.2d 948, 206 N.Y.S.2d 551 (2d Dep't 1960).

15. People *ex rel.* Parklin Operating Corp. v. Miller, 287 N.Y. 126, 38 N.E.2d 465 (1941).

16. People *ex rel.* Gale v. Tax Comm'n, 17 A.D.2d 225, 233 N.Y.S.2d 501 (1st Dep't 1962).

17. McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 159 N.E.2d 902 (1928).

18. Ed Guth Realty, Inc. v. Gingold, 41 A.D.2d 479, 334 N.Y.S.2d 270 (4th Dep't 1973), *aff'd*, 34 N.Y.2d 440, 315 N.E.2d 441, 338 N.Y.S.2d 367 (1974).

19. N.Y. REAL PROP. TAX LAW § 502(3) (McKinney 1972).

20. NEW YORK, N.Y., ZONING RESOLUTION art. I, ch. 2 § 12-10 (1978).

21. CHICAGO, ILL. MUNICIPAL CODE, ZONING ORDINANCE ch. 194A, art. 3.2 (1970).

22. Penn Cent. Transp. Co. v. City of New York, 42 N.Y.2d 324, 366 N.E.2d 1271 397 N.Y.S.2d 914 (1977), *aff'd*, 438 U.S. 104 (1978).

23. Costonis, *The Chicago Plan: Incentive Zoning and the Preservation of Urban*

Landmarks, 85 HARV. L. REV. 574, 590 (1972).

24. Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926).