Rural Building Rehabilitation with Multiple Reviews and Owner's Small Business Use

SMALL PROJECT SCENARIO #2

This scenario is based on a real project, but details have been changed or omitted to protect the privacy of the owners.

Overview

A historic property in rural Oregon had suffered extensive fire damage and years of exposure to the elements, requiring substantial rehabilitation before it could be returned to productive use.

What made the project unique was that its historic designation provided important land-use flexibility while also introducing preservation requirements that shaped the rehabilitation. Because the property was listed in the National Register of Historic Places, local land use regulations allowed certain commercial uses that would not otherwise have been permitted on the site. This flexibility made it possible for the owners to relocate their wellness retreat business to the property and integrate it with other related business activities. At the same time, the rehabilitation was required to comply with preservation requirements that limited the extent of exterior alterations and expansion and guided the restoration of the property's historic appearance.

The project was subject to local historic design review as part of the land use approval process. In addition, the owners elected to pursue the federal 20% Historic Tax Credit (HTC), which required a separate review through the Oregon State Historic Preservation Office (SHPO) and the National Park Service (NPS) to ensure the project met the Secretary of the Interior's Standards for Rehabilitation. Although the local land use review process and the tax credit design review process focused on preserving the property's historic qualities and relied on similar preservation principles, they involved different agencies, decision-makers, procedures, and timelines.

As a result, the project team was required to navigate multiple preservation review processes while adapting the building for a new use. The design challenge was to restore character-defining features and historic qualities while accommodating modern building systems, accessibility improvements, life-safety requirements, and the operational needs of a contemporary wellness retreat center.

Rehabilitation Work Completed

The rehabilitation was extensive due to the severity of the fire and water damage. While the remaining historic features were repaired and retained, other building components had deteriorated beyond feasible repair and required replacement in a manner consistent with the historic character of the property.

The rehabilitation included:

- Replacement of damaged structural framing
- Replacement of windows and doors with historically appropriate units matching the historic appearance of the originals, as the originals were heavily damaged and could not feasibly be repaired
- Full roof replacement
- Repair and restoration of exterior materials and significant character-defining interior finishes based on historic photographs and surviving historic materials
- Installation of entirely new electrical, plumbing, and mechanical systems necessary to support the new use

Leveraging Oregon's Special Assessment Program

Before beginning rehabilitation, the owners applied for Oregon's Special Assessment of Historic Property Program. At that time, the building had relatively little assessed value due to the extent of the damage. By enrolling in the program before rehabilitation improvements were completed, the owners were able to take advantage of the property's low pre-rehabilitation assessed value and defer reassessment that would normally accompany a major construction project. This resulted in reduced property taxes during the 10-year special assessment period, creating a meaningful financial benefit during construction and the early years of operation.

Ownership Structure and Tax Considerations

The project was eligible for the HTC because it met the Secretary of the Interior's Standards for Rehabilitation, satisfied the Substantial Rehabilitation Test, involved an income-producing property, and was listed in the National Register of Historic Places.

One challenge remained: determining how the owners could effectively utilize the credits.

The property itself was held in a separate property-holding LLC—a common arrangement for real estate assets. However, this type of arrangement can create challenges when using HTCs because credits generated by real estate activities are often subject to passive activity limitations.

The owners worked with their CPA to evaluate whether the property-holding entity and operating business could be treated as a single economic unit for tax purposes. Because the activities shared common ownership, were operationally connected, and supported one another economically, the owners and their CPA determined that grouping was appropriate under applicable IRS rules. This allowed the rehabilitation activity to be treated as part of the owners' active business rather than as a passive investment activity.

As a result of the grouping election, the owners were able to use the HTC directly to offset tax liability associated with their active business income. The credits were claimed ratably over the five-year credit period. Without the grouping election, the credits would have been limited to offsetting income generated within the property-holding entity, significantly reducing their practical value to the owners.

Key Takeaways

- Historic status can provide benefits beyond tax credits. In some jurisdictions, historic properties may qualify for land-use flexibility or other regulatory incentives that can be as important to project feasibility as the tax credit itself.
- Local historic review and federal Historic Tax Credit review are separate regulatory processes. Even when they rely on similar preservation standards, they will involve different agencies, procedures, timelines, and approval requirements.

- Enrolling in Oregon's Special Assessment program before rehabilitation allowed the owners to take advantage of the property's low pre-rehabilitation assessed value and reduce property taxes during the early years of operation.
- Ownership structure and tax treatment can significantly affect an owner’s ability to use the HTC. Early coordination with a qualified tax advisor can help identify potential opportunities and limitations.
- In some situations, grouping a property-holding entity with an operating business may allow HTCs to be used more effectively and make direct use of the credit more viable.

Remember: Every project is different and tax outcomes depend on factors such as ownership structure, adjusted basis, income sources, and tax liability. Additionally, property tax benefits vary by property and land use incentives vary by jurisdiction.

Learn More

To learn more about the topics discussed in this scenario, please see the following resources in this toolkit:

- Module 2: *Understanding Direct Use vs. Syndication of HTCs*
- Module 3: *Understanding Passive Activity Limitations*
- Module 4: *Preparing for a Conversation with Your Tax Advisor*