Longtime Nonprofit Owner-Occupant Rehabilitates Their Historic Building

SMALL PROJECT SCENARIO #4

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

Overview

For decades, a historic theater served as a venue for films, lectures, educational programs, and other community events. The building's systems had reached the end of their useful lives, while interior finishes also required restoration and refurbishment. Because the building was listed in the National Register of Historic Places, the ownership organization explored whether the federal Historic Tax Credit (HTC) could help fund a portion of the rehabilitation.

As the project team began evaluating options, it became clear that the building's ownership and occupancy would significantly affect how the HTC could be structured and used. Because the theater had long been owned and occupied by the nonprofit, the project was faced with HTC syndication and utilization challenges that do not arise in every tax credit rehabilitation.

The Challenge

As a nonprofit, the theater did not have federal income tax liability to use the HTC directly. To monetize the credit, the organization explored bringing in an outside investor who could use the credits in exchange for providing equity to help finance the rehabilitation. To do so, the project would need to be structured so that a newly formed taxable entity owned the building during the rehabilitation and throughout the five-year tax credit period. The investor would participate in that taxable ownership structure and, in return for its investment, receive the Historic Tax Credits. The nonprofit would then lease the building back so it could continue operating the theater.

This general type of investment structure is commonly used to monetize HTCs and can work well for many projects, including certain nonprofit-sponsored projects, such as the housing project described in Small Project Scenario #3. However, when a nonprofit has long owned and occupied the same historic building and intends to continue occupying and operating it after rehabilitation, special IRS rules apply. When structuring the investment, a lease back to the nonprofit owner-occupant may be treated as a "disqualified lease" if the transaction does not satisfy applicable IRS requirements. When that happens, the project cannot monetize the Historic Tax Credits through a typical tax credit investment structure, even though the rehabilitation itself otherwise qualifies for the credit.

Evaluating Potential Solutions

The theater's project team worked with experienced advisors to evaluate alternative ownership and operating structures. Several concepts were explored to determine whether the project could comply with IRS requirements while still allowing the nonprofit to continue fulfilling its mission and building rehabilitation goals. These concepts included:

- Modifying the lease structure through alternative lease terms and durations to address IRS requirements, while accepting increased legal, financing, and operational uncertainty.
- Restructuring ownership and occupancy so that larger portions of the building were occupied by unrelated third parties.
- Using an alternative ownership and operating structure that avoided leasing the building back to the nonprofit during the compliance period, while temporarily shifting building operations into the taxable ownership structure.

Each option involved important tradeoffs related to legal complexity, taxation, governance, business finances, operational control, and risk allocation. As a result, there was no simple "off-the-shelf" solution. Determining whether any of these approaches was appropriate required careful analysis. Ultimately, the theater nonprofit determined that pursuing the credits was not the most practical financing strategy and instead focused on expanding its capital campaign and other funding sources to complete the project.

Remember: Others may reach a different conclusion based upon their circumstances. The appropriate solution depends on the nonprofit's goals, governance, financing needs, risk tolerance, and the specific facts of the project.

Key Takeaways

While every project is unique, this scenario demonstrates several important considerations that apply to longtime nonprofit owner-occupant projects:

- Historic Tax Credits can often be successfully used in nonprofit-sponsored projects, but because nonprofits cannot use the credits directly, these projects require a structure that allows a taxable entity or investor to utilize them.
- Additional IRS rules may significantly complicate that structure when a nonprofit has long owned and occupied the same historic building and intends to continue occupying and operating it after rehabilitation.
- Early coordination with experienced HTC attorneys, tax advisors, and related consultants is essential to evaluate potential structures before major project decisions are made.

Legislative Note

This scenario reflects current federal HTC law as of 2026. Legislative changes have periodically been proposed that would make it easier for nonprofits to monetize the credits. If and when such changes are enacted, such changes could significantly alter how projects like this one are structured.

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*
- Small Project Scenario #3 - *Nonprofit Housing and Layered Financing in a Main Street Community*