



Back to Basics: Casualty Loss

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This series covers the basics of tax credit compliance and how to research answers to questions tax credit professionals have in their daily practice. This Basics article focuses on casualty loss. With hundreds of declared disasters the last few years, as well as other events that damage or destroy tax credit units every year, this is a timely topic. *Additionally, there have been developments related to COVID-19 that relate to existing casualty loss guidance.* Note that, in keeping with the “Basics” theme, this will not be an in-depth discussion, but will provide an outline of the topic, as well as documents for further research.

Guidance on Casualty Loss

IRS Publication 547 and Chief Counsel Advice Memorandum (CCAM) 200134006 are good places to start.

At first, guidance on casualty loss relating to declared disasters was issued for specific major disasters. For instance, Revenue Procedure 95-28 was for disasters declared on or after Jan. 1, 1995, and Revenue Procedure 2007-54 was for disasters declared on or after July 2, 2007. However, after a series of individualized disaster instructions, in 2014 guidance applicable to all future major disasters declared on or after Aug. 21, 2014, was issued in Revenue Procedure 2014-49 for tax credits and Revenue Procedure 2014-50 for bonds.

CCAM 200913012 and the §42 Audit Technique Guide also provide some guidance on the topic.

For breaking news, IRS Notice 2020-53 provides COVID-19-related provisions.

Definition of Casualty Loss

A casualty loss is the damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected or unusual. Property damage is not considered a casualty loss if the damage occurred during normal use, the owner willfully caused the damage or was willfully

negligent, or if it was progressive deterioration such as damage caused by termites. Major storms, flooding and wildfires often result in casualty loss. Leaking pipes that eventually result in mold and property destruction and gradual deterioration of parking lots because of seasonal weather heaving are not examples of casualty loss.

Result of Casualty Loss

Usually, a building will be subject to tax credit recapture if, as of the close of any tax year after the first year in the compliance period, the qualified basis of the building is less than it was as of the close of the prior tax year. Qualified basis is reduced when an individual unit or a building is not:

1. Housing tax credit-qualified residents,
2. The residents are not paying program-appropriate rent, or
3. The units are not habitable and not reasonably up to HUD's Uniform Physical Conditions Standards (UPCS) or local code.

The third item is where property damage events potentially affect tax credits. However, an exception to the general rule exists if the reduction in qualified basis results from a casualty loss, and the loss is replaced or reconstructed within a reasonable period. The exact length of this reasonable period has a maximum possible period established by IRS guidance and is further delegated to the state tax credit agency. The maximum period itself is different for declared disasters than for other casualty losses.

1. Declared Disasters

When disasters warranting assistance from the federal government occur, the Robert T. Stafford Disaster Relief and Emergency Assistance Act gives the president authority to issue a major disaster declaration for affected areas. Following the declaration, the Federal Emergency Management Agency (FEMA) may designate specific cities, counties or other local jurisdictions as eligible for *individual assistance*.

What happens to the credits until the loss is restored? Assume that a building's qualified basis is restored within a reasonable period. If a building that is in a FEMA major disaster area suffers a reduction in qualified basis because of the disaster, the building *will not be subject to tax credit recapture and may continue to claim credits during the restoration period*. What constitutes a reasonable period is determined by the state tax credit agency that monitors the building. However, the period *may not extend beyond the end of the 25th month following the close of the month of the major disaster declaration*. It is important to note that Revenue Procedures 2014-49 and -50 changed the allowable period from what had been included in earlier technical guidance and differs from the time frame for other casualty losses, which is

24 months from the end of the calendar year in which the casualty occurred. Therefore, the declared disaster has a more restrictive maximum deadline. *As a COVID-19-related measure, if this deadline fell anywhere after April 1, 2020, IRS Notice 2020-52 extended this deadline to Dec. 31, 2020.*

There are special provisions for temporarily housing persons who are displaced by a disaster without having to be tax credit qualified. *IRS Notice 2020-53 applied similar provisions to allow non-qualified emergency medical and other essential workers (as defined state or local government) to be housed.*

2. Casualty Loss that is Not a Result of a Declared Disaster

A reduction in qualified basis because of casualty loss that is unrelated to the declared major disaster is handled differently than loss resulting from declared disasters in two major ways:

1. The disallowance of credits, and
2. The reasonable period to restore.

If the building's qualified basis is restored within a reasonable period, the building will not be subject to the usual penalty called recapture. However, the owner cannot continue to claim credits on any units that are out of service because of the casualty event. *A reasonable period for the restoration of the building's qualified basis is 24 months from the end of the calendar year in which the casualty occurred.*

Note: Because entire calendar years are involved, this is almost always a greater time than the 25 months allowed after major disasters. Keep in mind, however, that this only relates to avoiding recapture. Unlike major disaster losses, tax credits cannot be claimed during the restoration period for nonmajor disaster-related casualties. *As a COVID-19-related measure, if this deadline fell anywhere after April 1, 2020, IRS Notice 2020-52 extended this deadline to Dec. 31, 2020. As the non-declared disaster rule was applied to calendar years, this only serves as a benefit when states imposed stricter requirements than the federal max timeframe.*

Declared disaster loss rules are more favorable in that they do not disallow credits while the units are out of service. However, it is important to know that it is possible for a building suffering a reduction in qualified basis because of a non-declared casualty event not to lose any credits. This is because tax credits after the first year are determined for the entire year based on which units are habitable on the last day of the tax year. Therefore, if a building owner with a calendar tax year were to suffer a casualty loss early in the year and the restoration of the damaged units was

completed prior to Dec. 31, the owner can claim a full year’s credits on the restored units.

Note: Units are not required to be necessarily inhabited on the last day of the year, but any vacant units on the last day of the year that were occupied by qualified tenants prior to the casualty event must be continually marketed to rent them to low-income tenants, per the tax credit Unit Vacancy Rule.

The unfortunate “flip-side” of the rule regarding the last day of the year is that, if the owner fails to restore the damaged units by year-end, no credits would be allowed on the units for the year. This is particularly painful for a property when a loss occurs late in the year and units cannot be restored in time. Although credits will be allowed upon restoration until the end of the building’s credit period, credits that are disallowed prior to restoration can never be claimed. Clearly, prompt restoration of units, ideally within the tax year, is the best plan to recover from casualty events.

Type of Loss:	Disallowance	Recapture	Max “Reasonable Period”
Declared			
& restored in reasonable period	No	No	25 months after declaration
& not restored in reasonable period	Yes	Yes	
Nondeclared			
& restored in reasonable period	Yes	No	24 months after end of year of casualty loss
& not restored in reasonable period	Yes	Yes	

Result of Casualty Loss on Tax Credits

Casualty Loss Checklist

Question	Result
Can the loss be restored before the end of the tax year?	No credit loss or recapture will result
If the loss is a result of a declared natural disaster:	
Can it be restored by earlier of 25 months after the loss or state deadline?	No credit loss or recapture will result
If the loss is <u>not</u> the result of a declared natural disaster:	
Can it be restored by earlier of 24 months after end of loss year or state deadline?	Credits cannot be claimed until year of restoration, but recapture can be avoided

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