Back to Basics: Assessing LIHTC Casualty Loss - Part 2

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Part 2: Casualty losses that do not relate to a declared disaster & IRS provisions designed to assist victims of major disasters.

A reduction in qualified basis due to 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.
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 due to 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 that, because entire calendar years are involved, this is almost always a greater time than the 25 months allowed for 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 non-major disaster-related casualties.

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 due to 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 that the 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 end of the 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 cannot ever be claimed. Clearly, prompt restoration of units, ideally within the tax year, is the best plan to recover from casualty events.

COVID-19 Update

If the deadline for casualty loss restoration resulting from a non-declared disaster falls after April 1, 2020, IRS Notice 2022-52 extends the deadline to restore the earlier of 24 additional months, or Dec. 31, 2023.

If, for instance, the deadline fell on Sept. 1, 2020, it could be extended to Sept. 1, 2022. Alternatively, if the deadline would have been June 1, 2022, it can be extended only to the end of 2023. States continue to have the final say on this deadline and may be more restrictive.

"On the nightly news, I see the terrible plight of people whose housing was destroyed after the recent series of major disasters. Can we help these people?"

As we have seen in this series, the topic of casualty loss is closely aligned with major disasters. For this reason, IRS guidance on casualty loss also discusses ways that owners of any tax credit properties in the country may be able to assist persons displaced by such declared disasters.

Who can be helped?

States are allowed, but not required, to establish a policy to assist displaced persons by housing them in tax credit units regardless of whether they meet tax credit income limits. A displaced individual is a person who is displaced from his or her principal residence because of a major disaster and whose principal residence was located in a major disaster area designated by FEMA. If a displaced individual seeks housing at the property, the owner can house them, even if they do not qualify under the tax credit income limits or their eligibility cannot be verified. Important points are below:

- The state agency must provide written approval to the owner for use of the property to house displaced individuals and specify the date on which a temporary housing period for the property will end. The temporary housing period cannot exceed 12 months from the end of the month in which the President declared the major disaster, but a state can pick an earlier date.
- Existing tax credit tenants may not be evicted solely to provide emergency housing relief for displaced individuals.
- Gross rents for the tax credit units used to house displaced individuals cannot exceed the maximum tax credit rents.

For each displaced individual, the owners must get the following items in a statement signed by the displaced individual under penalties of perjury:

1. The name of the displaced individual.
2. The address of the principal residence at the time of the major disaster of the displaced individual.
3. The displaced individual's social security number.
4. A statement that he or she was displaced from his or her principal residence because of a major disaster and that his or her principal residence was located in a city, county, or other local jurisdiction that is covered by the President's declaration of a major disaster and that is designated as eligible for Individual Assistance by FEMA because of the major disaster.

In verifying household eligibility, extensive third-party verification is usually required. However, in this case the IRS proposes that self-certification is sufficient, thus eliminating unnecessary barriers to persons who may have difficulty locating paperwork after a disaster. States tax credit agencies will generally provide a form that they want to be used to gather this information in a format acceptable to the agency.

Example: Displaced Household

Jenny and Carol had their home destroyed in Hurricane Skitch in September. With only the clothes on their back, they travel to a state in the northern United States where relatives live. The state agency has allowed a temporary housing period that will end on Sept. 1 of the following year. Jenny and Carol provide self-certification of their displaced status and move into a vacant tax credit unit on Sept. 29. Both Jenny and Carol work with internet-based businesses, but their income is not verified, and there is no impact on the tax credits. The lease that the owners establish ends on Aug. 31 of the following year.

If a displaced individual continues to occupy a unit in the project at the end of the temporary housing period, the household's income status must be determined as though the household moved in on the day immediately following the end of the temporary housing period. For example, a unit is a market-rate unit beginning immediately after the end of the temporary housing period if the displaced individual was not tax credit qualified when they moved in and their income then exceeds the applicable income limit. If the project fails to comply with the minimum set aside requirement solely because a displaced household continues to live in a unit after the temporary housing period, a 60-day period is allowed for correction.

The emergency housing of displaced individuals in low-income units during the temporary housing period (and, if applicable, the 60-day correction period) does not cause the building to suffer a reduction in qualified basis (which would cause the recapture of low-income housing credits).

Example: Displaced Household After Temporary Period

Jenny and Carol are still in the tax credit unit toward the end of their lease in July, almost a year after Hurricane Skitch. Preparing for the end of the temporary housing period, the owner wisely verifies the household's income. They are then over the tax credit income limit. The owner serves notice that they will not renew the lease when it expires. The household moves out and returns to their original home by Sept. 1. The unit that Jenny and Carol were in retains the vacant tax credit status it had before the displaced household moved in.

Note: if the household had not moved out until Sept. 30, the unit would still have reverted to its original vacant tax credit status, as the over-income household moved out prior to the end of the 60-day correction period that started with the end of the temporary housing period on Sept. 1. If the owner has waited to verify income until Sept. 1, the termination of occupancy could still have been accomplished by the end of the 60-day correction period. If the household had not been moved by the end of the 60 days, the unit would not have counted as tax credit starting Sept. 1.

Frequently Asked Questions

Question 6: Will an 8823 be filed for my damaged building before it is restored when a major disaster is not involved?

Answer: Yes. Any reduction in qualified basis must result in report of noncompliance to the IRS on form 8823. Official guidance allows that an 8823 resulting from major disaster casualty may not have to be submitted, if the rebuild is within a reasonable period. This is because there is no reduction in qualified basis. However, that does not apply to other casualty loss. However, a state is likely to clarify the situation with the IRS when they submit the 8823.

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 assistance. Such designations are published by FEMA via the Federal Register.

Example: Casualty Loss NOT in a Declared Disaster

In March 2022, a fire that is not related to a major disaster seriously damages a building. The owner's tax year is a calendar year. If the building is restored by the last day of 2022, credits are allowed for all of 2022, and no recapture penalty will result. If the building is not restored by the last day of 2022, no credits can be claimed for the year, and the same is true with 2023 and 2024. Recapture, however, can be avoided for 2022 and 2023 by completing restoration in a reasonable period. The latest the building can be restored and avoid recapture in this case is December 2024, or 24 months from the end of the calendar year in which the casualty occurred.

Note: Although the maximum reasonable period is several months longer than the deadline for major disaster areas (which was April 2024), the key difference is that credits cannot be claimed until the unit or building is restored after a non-declared loss.

Question 7: My state has encouraged housing displaced individuals after the most recent disaster. What records do we need to keep?

Answer: Besides the certification from the displaced individuals mentioned above, the owner must maintain a record of the state agency's approval of the property's use for displaced individuals and the approved temporary housing period. The owner must also report to the state agency at the end of the temporary housing period a list of the names of the displaced individuals and the dates the displaced individuals began occupancy. The owner must also provide any dates displaced individuals ceased occupancy and, if applicable, the date each unit occupied by a displaced individual becomes occupied by a subsequent tenant.

COVID-19 Update

If medical personnel or other essential workers (as defined by state or local governments) provided services during the COVID-19 pandemic from April 1, 2020, to Sept. 30, 2021, these personnel may have been treated as if they were displaced individuals and they may have been provided emergency housing.

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