



# Back to Basics: Assessing LIHTC Casualty Loss - Part 1

by Scott Michael Dunn, CEO of Costello Compliance

**“I’ve already lost my property, will I lose tax credits, too?”**

Whether it is a kitchen fire that destroys a unit or a hurricane that takes out an entire apartment community, property damage events result in casualty loss. As far as major disasters, a review of three years FEMA data prior to the pandemic shows that there were roughly 305 areas affected by declared disasters, mostly resulting from storms and wildfires. These events potentially affect or destroy many affordable housing units.

On top of these major disasters, there are other losses that result from more localized events, such as the kitchen fire mentioned above. Owners, agents and investors may be forced to review the impact of casualty loss on their tax credits while a unit, building or property is offline after an event.

Considering all the above, it seems a good time to review IRS guidance on casualty loss as it applies to tax credit properties. What happens to the credits while the property is down? Also, will the additional penalty of tax credit recapture result? The answers will depend on how quickly the loss is restored and whether the loss resulted from a presidentially declared disaster or a lesser event.

Finally, what COVID-related provisions were made in 2021? We will discuss these issues in two parts.

**Part 1: Definition of casualty loss, where we find IRS guidance and casualty loss related to a presidentially declared major disasters.**

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 individual units or a building is:

1. not 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, as determined by the IRS.

As we will see, the exact length of this reasonable period must be below a maximum established by IRS guidance and is further delegated to the state tax credit agency in the case of major disasters. The maximum period itself is also different for declared disasters and other casualty losses.

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**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 due to seasonal weather heaving are NOT examples of casualty loss.*

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**“What happens to our credits until the loss is restored? Is there also recapture?”**

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 Procedure 2014-49 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.

## Frequently Asked Questions

**Question 1: Where do I find IRS guidance on casualty loss?**

**Answer:** At first, guidance on casualty loss relating to declared disasters was issued for specific major disasters. 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. Additional relevant history can be tracked in the following documents:

- IRS Publication 547
- Chief Counsel Advice Memorandum (CCAM) 200134006
- Rev Proc 95-28 (for disasters declared on or after 1/1/95)
- Rev Proc 2007-54 (for disasters declared on or after 7/2/07)
- CCAM 200913012
- The Sec. 42 LIHC Audit Technique Guide
- IRS Notice 2021-12 and 2022-62 (temporary COVID-related casualty loss provisions)

**Example:**

**Casualty Loss in a Declared Disaster**

A disaster is declared for an area in March 2022. A building is seriously damaged in the disaster. The latest the building can be restored and avoid disallowance of credits and recapture is 25 months later, or April 2024. The qualified basis that was applicable prior to the declaration of disaster will be used when calculating the allowable credit.

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.

**Question 2: What qualified basis will I use to calculate the credits while the building is down?**

**Answer:** When calculating the allowable credits during the reasonable restoration period, the building's qualified basis at the end of the taxable year immediately preceding the first day of the major disaster incidence period (a date determined by FEMA) should be used.

**Question 3: We got a carryover allocation of credits toward the end of last year, but a declared disaster hurricane just destroyed what we had built of the buildings. Is there any way to get more time to finish the buildings?**

**Answer:** Once a project receives a carryover allocation, there are two deadlines that owners must meet to continue to hold the right to claim credits. At least 10% of the reasonably expected costs must be spent within no more than 12 months of the carryover (the 10% test). Once that is accomplished, the building must be placed in service no later than the end of the second year following the allocation. In cases of declared disasters, the deadline to meet the 10% test is extended by six months for damaged properties. The deadline to place in service is extended one year to Dec. 31 of the year after the usual two-year deadline.



**Question 4:** My project was in lease-up and we intended to claim credits this year. Then a major declared disaster wildfire destroyed the buildings. What happens to the tax credits?

**Answer:** The state agency has the discretion to treat the allocation as a returned credit. If, however, they opt to allow the allocation to continue with the destroyed property, they may pause or “toll” the deadline for the beginning of the first year of the credit period. The tolling period must not extend beyond the end of the 25th month following the close of the month of the Major Disaster declaration. Owners may not claim any low-income housing credit during the restoration period of these first-year buildings.

**Question 5:** Will an 8823 be filed for my damaged building before it is restored when a declared major disaster is involved?

**Answer:** Probably not. Official guidance suggests that an 8823 resulting from major disaster casualty may not have to be submitted if the rebuild is within the state-allowed reasonable period. This is because there is no reduction in qualified basis.

**Next article:** “Am I out of luck for my tax credits if my disaster is not a major one?” The next article will discuss a contrasting situation when a major disaster is not involved. And more!

#### COVID-19 Update

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

If, for instance, the deadline fell on Aug. 1, 2021, it could be extended to Aug. 1, 2023. Alternatively, if the deadline would have been March 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.

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