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SUBJECT: Treatment of Casualty Losses Under Section 42(j)(4)(E)

Introduction

The following is in response to your memorandum dated February 8, 2001, concerning the treatment of casualty losses to low-income housing tax credit properties under section 42(j)(4)(E) of the Internal Revenue Code. Apparently, Examination previously informally advised the state housing credit agencies that:

- 1) the definition of "casualty loss" under section 42(j)(4)(E) would be the same as the definition utilized in Publication 547, Casualty, Disasters, and Thefts, and Publication 584, Casualty, Disaster, and Theft Loss Workbook (i.e., damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual). In reliance on Publication 547, Examination identified two years as a reasonable replacement period for the damaged property;
- 2) it was not necessary to report noncompliance on Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, at the time the owner decides to replace the property. Further, Examination informed state agencies that they should report noncompliance only when the owner has suffered a casualty loss and has not restored the loss through reconstruction or replacement within a reasonable period of time; and
- 3) owners may continue to take credits on units or buildings damaged by a casualty while they are being replaced.

Law

Section 42(j)(1) provides that if--(A) as of the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than (B) the amount of such basis as of the close of the preceding taxable year, then the taxpayer's tax under this chapter for the taxable year shall be increased by the credit recapture amount.

Section 42(j)(2) provides that the credit recapture amount in section 42(j)(1) is an amount equal to the sum of--(A) the aggregate decrease in the credits allowed to the taxpayer under section 38 for all prior taxable years which would have resulted if the accelerated portion of the credit allowable by reason of this section were not allowed for all prior taxable years with respect to the excess of the amount described in section 42(j)(1)(B) over the amount described in section 42(j)(1)(A), plus (B) interest at the overpayment rate established under section 6621 on the amount determined under section 42(j)(2)(A) for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved.

Section 42(j)(4)(E) of the Internal Revenue Code provides that the increase in tax under section 42(j) shall not apply to a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within a reasonable period established by the Secretary (emphasis added).

Rev. Proc. 95-28, 1995-1 C.B. 704, establishes the process under which temporary relief will be granted from certain provisions of section 42 of the Internal Revenue Code to owners of low-income housing projects (owners) and housing credit agencies (Agencies) in major disaster areas. Section 7.01 of this revenue procedure provides that an owner of a building (1) that is beyond the first year of the credit period, and (2) that, because of a disaster that caused the President to issue a major disaster declaration, has suffered a reduction in qualified basis that would cause it to be subject to recapture or loss of credit will not be subject to recapture or loss of credit if the building's qualified basis is restored within a reasonable period. The Agency that monitors the project for compliance with section 42 may determine what constitutes a reasonable period, but in no instance will it end later than 24 months after the end of the calendar year in which the President issued a major disaster declaration for the area where the building is located.

Section 7.02 of Rev. Proc. 95-28 provides that to determine the credit amount allowable during the reconstruction or replacement period, an owner of a building described in section 7.01 of this revenue procedure must use the building's qualified basis at the end of the taxable year that preceded the President's major disaster declaration.

Section 1.42-5(c)(1) of the Income Tax Regulations requires an owner to report any reduction in qualified basis to the state housing credit agency that monitors the

building for compliance. Section 1.42-5(e)(3) specifies that a change in eligible basis that results in a decrease in qualified basis is noncompliance that must be reported to the Service after a specified time for correction.

Discussion

The following discusses in the order of the above-mentioned points concerning Examination's informal advice to the state housing credit agencies:

1) We concur that the meaning of "casualty loss" under section 42(j)(4)(E) should be consistent with generally accepted tax principles under section 165. Under section 42(j)(4)(E), the Secretary is given the authority to provide guidance as to a reasonable period in which to restore a loss resulting from casualty and thereby avoid recapture of the section 42 credit. No guidance has been issued on this reasonable period, but a period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties. See section 1033. Additionally, we note that section 1.42-5(e)(4) permits the state housing credit agencies to allow up to a 6-month correction period for compliance violations. This regulatory provision, however, does not address the reasonable period for restoration of a casualty loss under section 42(j)(4)(E).

2) We disagree with the suggestion that state housing credit agencies should report noncompliance only when the owner has suffered a casualty loss and has not restored the property within the two-year period. Rather, state housing credit agencies must, as required by section 1.42-5(e)(3), report to the Service via Form 8823 any casualty loss that takes low-income property in whole or in part out of service and results in a reduction in qualified basis.

3) We find no support for allowing property owners to continue to claim credits on units while the units are not in service because of a casualty event. First, section 42(j)(4)(E) only specifies the avoidance of recapture on the accelerated portion during the replacement period, not the continuing ability to claim credits. Secondly, the relief under section 7.02 of Rev. Proc. 95-28 pertaining to the continuation of credits during the replacement period is conditioned on the area where the property is located being designated as a major disaster area by the President of the United States. Such an event is quite distinct from the general casualty loss situation confronting property owners.