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Family Office Insights

COVID-19 tax relief for individuals and family offices

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Claiming COVID-19-related stock and business losses on your 2019 tax returns

COVID-19 has had a significant impact on individuals, businesses, and family offices in a countless number of ways. But family offices and high-net-worth individuals who have incurred business and/or investment losses as a result of COVID-19 may find an unexpected option that may help bolster their cash positions.

It comes in the form of a "disaster relief" tax law provision that's been around for decades, section 165(i). Simply put, this disaster relief provision allows you to take certain losses you've incurred in 2020 and apply them in preparing your 2019 tax return.

This can have a number of potential benefits. For example:

1. You're able to take these losses a year earlier (on your 2019 return rather than your 2020 return), thereby achieving the cash flow benefits from taking a loss a year earlier.
2. If your effective tax rate was higher in 2019 than in 2020, these losses are potentially more valuable as they may offset higher-taxed income.
3. You're potentially able to increase the amount of net operating losses (NOL) on your 2019 tax return. This opens up the possibility of receiving enhanced NOL carryback benefits (including carrying back to years in which you maintained a higher effective tax rate).

Three criteria must be met for section 165(i) to apply:

How disaster relief works

— The president must declare that an area or region qualifies for emergency or disaster relief.

— You have to sustain a tax-deductible business loss within the disaster area.

— The loss must be "attributable to" the disaster.

Examples of COVID-19-related losses

Below are the types of deductible losses that may be attributable to COVID-19:

— The permanent closing of a store or business facility

— The sale or exchange of business property at a loss

— Abandonment of a business deal with capitalized costs

— Disposal of inventory, supplies, or other property that can't be sold

— Donation or repurposing of inventory for sale at a loss to the public

— Worthless securities including whether they're worthless or actually sold at a loss maybe to harvest tax losses

— Impaired securities under the mark-to-market method.

To be deductible, the losses must be associated with a trade or business or an activity you engage in to make a profit. The losses may be deductible as capital or ordinary losses.

COVID-19 losses differ from the usual disaster relief situation. Typically, section 165(i) comes into play when there's a natural disaster, like a hurricane or a tornado. Property is destroyed in an affected area, and businesses physically can't operate or are at risk of going under. The federal government then declares the city, state, or region to be a disaster area, and the affected businesses or individuals can take qualifying losses incurred in the year of the disaster and apply them to their prior year's tax returns.[1]

[1] If you make a section 165(i) election, you have to include all of your 165(a) losses attributable to COVID-19 on your 2019 return. In other words, you can't cherry-pick which losses to include.

With COVID-19, there's been no physical destruction of property. But it certainly has caused significant financial losses, many of which may be deductible under section 165(i) (see sidebar).

COVID-19 losses: Devil's in the details

On March 13, 2020, President Trump declared that COVID-19 was a nationwide emergency covering the entire United States, the District of Columbia, and U.S. territories. This satisfied the first element of section 165(i).

In the absence of guidance from the Internal Revenue Service (IRS), meeting the other criteria—establishing the location of the loss and whether it was caused by COVID-19—may be a little more challenging, and will depend on the type of loss that's being claimed.

Location of the loss: If you're dealing with losses associated with tangible property (the closing of a plant or building), it's pretty straightforward; it's the location of property. Assuming you or your family are U.S. taxpayers, and the property or business was located in the United States, you should be covered.

But if you took losses on a stock sale, it may pose different issues. For example, losses on stock of largely U.S.-based companies likely qualify for disaster relief. But stock of a multinational company may not, or may only partially qualify.

Was the loss COVID-19 related: This also may depend on facts and circumstances, and will require documentation and data to demonstrate the connection between COVID-19 and your losses.

Let's take a look at this simplified example of a 2020 stock loss. In December 2019, you held 3,000 shares of stock in a U.S.-based company trading at $100 per share. In January 2020, the stock went down to $90 per share. But in March 2020, the stock plunged to $10 per share, and you decided to cut your losses and sell it.

In this case, a compelling argument could be made that COVID-19 was the reason for $80 of the $90-per-share loss, and that $240,000 of your total $270,000 loss in 2020 ($300,000 - $60,000) could be deductible on your 2019 return.[2]

Determining COVID-19-related losses for other types of property will require different documentation. For example, if you incurred a loss because you terminated a transaction or closed a facility in 2020, you could document how and why COVID-19 prompted your actions and that the transaction was U.S.-based.

Documentation is key: The more documentation you can present tying your losses to COVID-19, the better the likelihood of qualifying for section 165(i) disaster relief.

[2] Subject to the normal limitations applicable to capital losses.

When do you need to make the election?

COVID-19-related disaster losses can be claimed for the 2019 tax year on either an original or an amended 2019 return. Individuals generally have until **October 15, 2021** to make the election. Pass-through entities, like S corporations and partnerships, make the election at the entity level. So the election due dates are tied to the entity's tax return filing deadline; for calendar year partnerships, elections can be made by **September 15, 2021**.

Final thoughts

COVID-19 is an unprecedented global event. And applying section 165(i) disaster relief to losses that are the result of a virus like COVID-19 is unprecedented and largely uncharted territory.

While documentation linking your losses to COVID-19 and also demonstrating that the loss was incurred in the United States will be necessary, it's unclear at this point exactly what information and level of proof the IRS will be looking for.

Rest assured that KPMG will be monitoring future guidance to help our clients get through these difficult times.

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