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2020-2021

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September 14, 2020

Hon. Charles P. Rettig  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Comments on COVID-19 and disaster losses under section 165(i)

Dear Commissioner Rettig:

Enclosed please find comments regarding the ongoing coronavirus disease 2019 (COVID-19) pandemic and the disaster loss election under section 165(i). These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Joan C. Arnold  
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury  
Colin Campbell, Attorney-Advisor, Department of the Treasury  
Michael J. Desmond, Chief Counsel, Internal Revenue Service  
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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**COMMENTS ON DISASTER LOSSES UNDER SECTION 165(i)**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Ryan Corcoran and Scott M. Levine. The following individuals provided substantial assistance in drafting these Comments: William Alexander, Joshua Brady, Carol Conjura, Jack Cummings, Mary Duffy, Lee Gay, Ellen MacNeil, George Manousos, Brian Peabody, Eric Solomon, David Strong, Christine Turgeon, and Joyce Welch. These Comments were reviewed by Ellen McElroy and Lisa Zarlenga of the Section’s Committee on Government Submissions and by Kurt Lawson, the Section’s Vice Chair of Government Relations.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date:             September 14, 2020

## I. EXECUTIVE SUMMARY

These comments are in response to the emergency declaration issued by President Trump on March 13, 2020, under section 501(b) of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the “Stafford Act”)<sup>1</sup> as a result of the coronavirus disease 2019 (“COVID-19”) pandemic.<sup>2</sup>

The emergency declaration instructs U.S. Department of the Treasury (“Treasury”) Secretary Mnuchin to provide tax deadline relief under section 7508A(a)<sup>3</sup> to all Americans adversely affected by the emergency. Section 7508A(a) authorizes the Secretary to postpone certain time-sensitive acts when the Secretary determines a taxpayer to be affected by a federally declared disaster or a terroristic or military action.

In addition to authorizing the Secretary to delay these acts,<sup>4</sup> a federally declared disaster activates certain relief provisions of the Code. These relief provisions include section 165(i), which provides an election for a taxpayer to claim a disaster loss in the taxable year immediately preceding the year of the disaster. Specifically, section 165(i) permits any allowable loss under section 165(a) and Treas. Reg. §§ 1.165-1 through 1.165-10 that occurred in the disaster area and is attributable to the federally declared disaster to be eligible for section 165(i) relief.<sup>5</sup> Section 165(i) was enacted in 1962 as a form of immediate disaster assistance,<sup>6</sup> and it is as important today as when originally enacted.

The COVID-19 pandemic is unlike previous federally declared disasters, in that it is not the result of a force of nature (*e.g.*, hurricane, tornado, fire, or flood). Further, disaster areas usually are contained geographically, while the COVID-19 disaster area is the entire United States and its territories. Moreover, the COVID-19 disaster is ongoing, causing a cascade of social and economic ills. Just as it is unclear how long the

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<sup>1</sup> Pub. L. No. 100-707, 102 Stat. 4689 (1988), codified at 42 U.S.C. §§ 5121-5207.

<sup>2</sup> Letter from President Donald J. Trump to Acting Secretary Chad Wolf, Secretary Steven T. Mnuchin, Secretary Alex M. Azar, and Secretary Peter T. Gaynor on Emergency Determination Under the Stafford Act (Mar. 13, 2020), available at: <https://www.whitehouse.gov/briefings-statements/letter-president-donald-j-trump-emergency-determination-stafford-act/>

<sup>3</sup> Unless otherwise indicated, all references to a “section” or “§” are to a section of the Internal Revenue Code of 1986, as amended, (the “Code”) and all “Treas. Reg. §” references are to the Treasury regulations promulgated under the Code, all as in effect (or, in the case of proposed regulations which remain outstanding, as proposed) as of the date of these Comments.

<sup>4</sup> *E.g.*, Rev. Proc. 2018-58, 2018-50 I.R.B. 990; Notice 2020-17, 2020-15 I.R.B. 590; Notice 2020-18, 2020-15 I.R.B. 592; Notice 2020-20, 2020-16 I.R.B. 660; Notice 2020-20, 2020-18 I.R.B. 742.

<sup>5</sup> Treas. Reg. § 1.165-11(b)(3).

<sup>6</sup> *See* 108 Cong. Rec. (Part 3) 4146 (Mar. 15, 1962). Section 165(i) was enacted by Pub. L. No. 87-427, 76 Stat. 51 (1962), as section 165(h), and later renumbered as section 165(i).

COVID-19 disaster will persist, the scope of relief available under section 165(i) with respect to the COVID-19 disaster is similarly uncertain.

The detrimental economic effects of COVID-19 mean that many taxpayers will seek the relief available under section 165(i). Relying on this relief provision offers possible cash flow benefits in that a taxpayer may reduce tax payments for 2019 and request a “quickie refund” of overpaid estimated taxes. Also, taking the disaster loss deduction into account in 2019 might create or increase a 2019 net operating loss (“NOL”) that may be carried back to a profitable tax year.

Because taxpayers are in the midst of finalizing 2019 return filings, we ask that guidance addressing ambiguities under section 165(i) be published as quickly as possible so that taxpayers may take confirmed positions on originally filed returns rather than with amended return filings. More importantly, absent definitive guidance from Treasury and the Service regarding the application of section 165(i), the resolution of these issues will occur on a case-by-case basis through examinations, which will be disadvantageous for both taxpayers and the government. A far better resolution would be the issuance of guidance establishing the parameters of this provision in this context.

Our recommendations are summarized below.

**A. Attribution of Losses to the COVID-19 Pandemic**

We recommend that Treasury and the Service issue guidance defining “attributable to” for purposes of section 165(i) as “due to, caused by, or generated by.” We also recommend that Treasury and the Service issue guidance clarifying that taxpayers may elect to apply section 165(i) to losses arising from worthless stock that otherwise are deductible under section 165(g) and are attributable to the COVID-19 pandemic.

**B. COVID-19 is an “Other Casualty” for Purposes of Treas. Reg. § 1.165-7**

We recommend that Treasury and the Service issue guidance expressly declaring that the COVID-19 pandemic is an “other casualty” for purposes of Treas. Reg. § 1.165-7, that losses arising from the COVID-19 pandemic satisfy the requirement of a sudden event, and that physical damage to property is not a prerequisite to claiming a casualty loss deduction.

**C. Scope of the Section 165(i) Election**

We recommend that Treasury and the Service issue guidance permitting taxpayers to elect to apply 165(i) on a transaction-by-transaction basis or, alternatively, to apply section 165(i) separately to each trade or business. Regardless of which approach is adopted, we recommend that taxpayers be allowed to make a disaster loss election for each tax year in which losses attributable to the COVID-19 pandemic are sustained.

## II. RECOMMENDATIONS

### A. Attribution of Losses to the COVID-19 Pandemic

As noted, section 165(i) allows a taxpayer that has experienced a loss occurring in a disaster area and attributable to a federal declared disaster to elect to deduct that loss in the preceding tax year. In general, a loss must be evidenced by a closed and completed transaction, fixed by identifiable events, and sustained during the taxable year.<sup>7</sup> Moreover, the amount of loss that may be claimed is limited to a taxpayer's basis in the affected property reduced by any insurance reimbursement. Unless the loss qualifies as a casualty loss, which is discussed further in Section II.B, below, the item claimed as a loss must be totally worthless or permanently withdrawn from the operations (whether through sale or exchange, abandonment, or placement in a supplies or scrap account, depending on the asset for which the loss is sustained).

The COVID-19 pandemic has been declared a nationwide emergency. Thus, assuming the requirements for authenticating a loss, which are well established, are satisfied, the remaining issue to claim a section 165(i) election is whether the loss is "attributable to" a federally declared disaster.

#### 1. Definition of "Attributable To"

We recommend that Treasury and the Service issue guidance defining "attributable to" for purposes of section 165(i) consistent with existing caselaw as "due to, caused by, or generated by."

The phrase "attributable to" is not defined in the context of section 165(i) or Treas. Reg. § 1.165-11. We were not able to uncover any specific case law or administrative guidance definitively addressing the standard for evaluating whether a loss is "attributable to" a disaster such as the COVID-19 pandemic. However, we believe that it is important that the phrase "attributable to" has been interpreted regularly in tax matters as meaning causal. The Tax Court in *Lawinger v. Commissioner* surveyed how the attribution standard had been applied by other courts for tax purposes.<sup>8</sup> The court noted that, although there is no single definition of "attributable to" in the tax law or otherwise, various decisions ultimately conclude that attribution connotes causation:

The term "attributable to" has no particular technical significance under the tax laws; nowhere in the [Code] is such term defined. The phrase "attributable to" is used, and has been interpreted, in various tax and nontax contexts. Under the definition of collapsible corporation under

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<sup>7</sup> Treas. Reg. § 1.165-1(b).

<sup>8</sup> 103 T.C. 428 (1994). At issue was whether the discharge of taxpayer's loans gave rise to taxable discharge of indebtedness income or whether the discharged indebtedness was "qualified farm indebtedness." Specifically, the court had to evaluate whether the taxpayer's gross receipts for a three-year period were attributable to a farming business.

section 117(m) of the 1954 Code, the Supreme Court interpreted “attributable to”, in the phrase “gain attributable to such property”, as “merely confin[ing] consideration to that gain caused or generated by the property in question”. *Braunstein v. Commissioner*, 374 U.S. 65, 70 (1963).<sup>9</sup> In interpreting the statutory language of section 165(i) of the 1954 Code that governs the ability of taxpayers to claim refunds or credits for property expropriated by the government of Cuba, the District Court of Mississippi held that the normal meaning of one thing to be attributed to another is that one thing is caused or brought about by that other thing. *Ogden v. United States*, 432 F.Supp. 214, 216 (S.D.Miss.1975), (citing Webster’s Third New International Dictionary), affd. 555 F.2d 134 (5th Cir.1977).<sup>10</sup> These interpretations are based on the conclusion that “attribute” or “attributable” connotes causation. See *National Association of Greeting Card Publishers v. United States Postal Service, et al.*, 462 U.S. 810, 823 (1983); *Watson v. Employment Sec. Commn. of North Carolina*, 432 S.E.2d 399, 401 (N.C.App.1993). For example, section 6663(a) provides: “If any part of any underpayment \* \* \* is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is *attributable to* fraud.” (Emphasis added.) Similarly, the accuracy-related penalty provision provides that the penalty applies “to the portion of any underpayment which is *attributable to*” negligence, substantial understatement of income tax, etc. Sec. 6662(b). *Thus, the plain meaning of ‘attributable to’ is simply due to, caused by, or generated by.*<sup>11</sup>

Decisions subsequent to *Lawinger* have relied on the court’s formulation of the meaning of “attributable to” and its broad equation with causation.<sup>12</sup> Because the

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<sup>9</sup> At that point in its *Braunstein* decision, the Supreme Court explained that the terms “gain” and “attributable to” in former section 117(m) “operate to limit its application to cases in which the corporation was availed of with a view to profiting from the constructed property by a sale or exchange of stock soon after completion of construction and in which a substantial part of the profit from the sale or exchange of stock in a given year was in fact generated by such property.”

<sup>10</sup> *Ogden* interpreted the phrase “attributable to” in a previous version of section 165(i), which addressed the ability of taxpayers to claim refunds or credits for property expropriated by the government of Cuba.

<sup>11</sup> *Lawinger*, 103 T.C. at 435 (added emphasis, added footnotes).

<sup>12</sup> See, e.g., *Stanford v. Commissioner*, 152 F.3d 450, 459 (5th Cir. 1998) (plain meaning of “attributable to” is “due to, caused by, or generated by” in the context of section 925(c)(1)(C)(i)). See also *Russian Recovery Fund Ltd. v. United States*, 851 F.3d 1253, 1261 (Fed. Cir. 2017) (interpreting whether a tax is “attributable to” a partnership item in section 6229(a) to mean “due to, caused by, or generated by”); *Keener v. United States*, 551 F.3d 1358, 1365 (Fed. Cir.) (interpreting whether an action for refund “attributable to partnership items” in former section 7422(h) to mean “due to, caused by, or generated by a partnership item”), cert. denied, 558 U.S. 825 (2009); *Electrolux Holdings, Inc. v. United States*, 491 F.3d 1327, 1331 (Fed. Cir. 2007) (interpreting whether a claim for credit or refund relates to an overpayment “attributable to” a net operating loss carryback in section 6511(d)(2)(A) to mean “due to, caused by, or generated by”).

attributable-to standard has been interpreted as “due to, caused by, or generated by” for tax purposes in a variety of divergent circumstances, we recommend that a similar approach should be used here. We appreciate that such a broad standard presents questions of proof, but questions of proof cannot be eliminated when losses are being claimed. Further, because this interpretation of the term has been used for a range of issues, we believe there is adequate experience and case law to address questions of substantiation.

Even though in many ways the COVID-19 pandemic differs from other federally declared disasters—that is, it was not caused by a force of nature, it does not result in physical property damage, and its duration is uncertain—in other ways, it is precisely like other federally declared disasters, especially with respect to the damages suffered by U.S. businesses as a result of COVID-19. It is unambiguous that certain business losses are due to, have been caused by, or were generated by, the COVID-19 pandemic. Such losses include, for example, business losses arising as a result of state-mandated shutdowns (*e.g.*, store closure costs and inventory scrapped due to spoilage); abandonment of leasehold improvements; permanent retirement of fixed assets; termination payments to cancel contracts, leases, or licenses; prepaid costs for cancelled events, travel, conferences; and prepaid raw materials or other items to fulfill a contract and the contract has been cancelled.

We recommend that Treasury and the Service treat such business losses in the same manner as losses that arise with any other federally declared disaster eligible for relief under section 165(i) to the extent that a taxpayer can demonstrate that the loss is due to, caused by, or generated by the pandemic.

## **2. Section 165(i) and Worthless Stock Deduction**

We recommend that Treasury and the Service issue guidance clarifying that taxpayers may elect to apply section 165(i) to losses arising from worthless stock that otherwise are deductible under section 165(g) and are attributable to the COVID-19 pandemic.

Section 165(g)(1) provides that, if any security that is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2)(A) provides that, for purposes of a worthless security deduction, the term “security” includes a share of stock in a corporation.<sup>13</sup> Section 165(g)(3) provides an exception from capital loss treatment for certain worthless securities in a domestic corporation affiliated with the taxpayer. A corporation is treated as affiliated with the taxpayer only if the taxpayer directly owns stock of the corporation that meets the requirements of section 1504(a)(2),

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<sup>13</sup> Section 165(g)(2)(B) and (C) also include within the definition of a security a right to subscribe for, or to receive, a share of stock in a corporation, and a bond, debenture, note, or certificate, or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Because this discussion focuses on the application of section 165(g) to losses with respect to stock of a corporation, we refer to the deduction as a “worthless stock” deduction.

and more than 90% of the aggregate of the corporation's gross receipts for all taxable years are from sources other than royalties, certain rents, dividends, certain interest, annuities, and gains from sales of stocks and securities.

The parameters of when a taxpayer may claim a worthless stock deduction are set forth in case law and rulings. In general, the taxpayer claiming a worthless stock loss under section 165(g) must prove that the stock in question had value at some point during the taxable year in which worthlessness is claimed but ceased to have both "liquidating value" and "potential value" by the end of that year.<sup>14</sup> A corporation lacks liquidating value when its liabilities exceed the value of its assets.<sup>15</sup> A corporation lacks potential value when there is no reasonable expectation that assets will exceed liabilities in the future.<sup>16</sup> Generally, a lack of potential value is established by showing that an identifiable event, such as bankruptcy, liquidation, the appointment of a receiver, or the cessation of normal business operations, effectively has destroyed the corporation's potential value.<sup>17</sup> In assessing whether a corporation lacks potential value, the standard applied by the Tax Court is whether a prudent businessperson would have considered the stock to be worthless by the end of the taxable year for which a worthless stock loss under section 165 is claimed.<sup>18</sup>

Further, so long as the corporation has no liquidation value, shareholders have a degree of control over the timing of the identifiable event that effectuates the loss of the corporation's potential value. For instance, the Service has ruled that a deemed liquidation resulting from a "check-the-box" election is an identifiable event that fixes the shareholder's loss with respect to the liquidating corporation's stock, thus entitling the shareholder to a worthless stock deduction under section 165(g)(3).<sup>19</sup> A deemed liquidation effected by a check-the-box election is a common method by which a shareholder may claim a worthless stock deduction with respect to an insolvent corporation. This arises for multiple reasons, including the legal difficulty in formally liquidating a corporation under applicable law, business challenges associated with eliminating the legal entity and, for corporations that are members of consolidated groups, the unique timing rules under the consolidated return regulations (*i.e.*, Treas. Reg. § 1.1502-80(c)) that can defer a worthless stock deduction beyond the time when a loss

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<sup>14</sup> See, e.g., *Steadman v. Commissioner*, 50 T.C. 369, 376 (1968), *aff'd*, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970); *Morton v. Commissioner*, 38 B.T.A. 1270, 1278 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

<sup>15</sup> *Steadman*, 50 T.C. at 376-77.

<sup>16</sup> *Id.* at 376.

<sup>17</sup> *Id.* at 376-77; *Morton*, 38 B.T.A. at 1279.

<sup>18</sup> *Steadman*, 50 T.C. at 377.

<sup>19</sup> See Rev. Rul. 2003-125, 2003-2 C.B. 1243 (deemed liquidation resulting from election to be classified as disregarded entity); AM 2011-003 (Aug. 18, 2011) (deemed liquidation resulting from election to be classified as partnership). See also PLR 201830005 (Apr. 24, 2018); PLR 201548003 (Aug. 3, 2015); PLR 201115001 (Jan. 4, 2011); PLR 201011003 (Nov. 30, 2009).



would be recognized by a similarly situated corporation outside of a consolidated group.<sup>20</sup>

Treas. Reg. § 1.165-5 provides general rules relating to worthless stock deductions under section 165(g). In particular, Treas. Reg. § 1.165-5(b) and (c) confirms that both ordinary and capital worthless stock losses, respectively, are specific types of section 165(a) losses. Further, Treas. Reg. § 1.165-5(f) confirms that absent an identifiable event establishing worthlessness or a sale of the stock, the mere decline in the value of stock does not give rise to a deduction under section 165(a).<sup>21</sup> Thus, the mere decline in the value of stock, even if related to a casualty loss incurred by the corporation, does not entitle the shareholder to a casualty loss.

Consider the following example:

**Example 1:** Taxpayer is an individual citizen or resident of the United States. Taxpayer owns all of the stock of a domestic corporation (“Corp”), which, prior to the events described below, operated a business in the United States. Corp was indebted to various creditors.

On March 1, 2020, Taxpayer’s basis in the stock of Corp was \$1,000,000. The fair market value of the stock of Corp was \$200,000 taking into account its indebtedness.

As a result of the COVID-19 pandemic, Corp’s supply chain was significantly disrupted and/or demand for its products or services significantly diminished. As a result of this disruption, Corp underwent an identifiable event that established the worthlessness of its stock (*e.g.*, bankruptcy, liquidation, or the cessation of normal business operations).

Under the facts of Example 1, Taxpayer should be able to claim a worthless stock deduction under section 165(g)(1) (*i.e.*, a capital loss of \$1 million) for the 2020 tax year. Because that deduction is a loss under section 165(a), we believe that Taxpayer also should be entitled to treat the loss as arising in the 2019 tax year under section 165(i) as long as the stock loss is attributable to the COVID-19 pandemic (the Federally declared disaster). In our view, the causal relationship between the COVID-19 pandemic and the Taxpayer’s loss resulting from worthlessness of Corp’s stock (whether by bankruptcy,

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<sup>20</sup> Specifically, within consolidated groups, the loss may be deferred until such time when *all* of the subsidiary’s assets are treated as disposed of, abandoned, or destroyed. In many instances, it is impractical to meet this standard. In these cases, the shareholder corporation may claim a worthless stock deduction by filing an election to convert the insolvent subsidiary to a disregarded entity, thereby causing the insolvent corporation to cease to exist for Federal income tax purposes.

<sup>21</sup> The prohibition is repeated in Treas. Reg. § 1.165-4, which provides that “[n]o loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized under § 1.1002-1 upon the sale or exchange of the stock and except as otherwise provided in § 1.165-5 with respect to stock that becomes worthless during the taxable year.”

liquidation, or the cessation of normal business operations) in Example 1 should satisfy the section 165(i) “attributable to” requirement.

We believe that worthless stock deductions arising from check-the-box liquidations of insolvent members of a consolidated group also should be eligible for section 165(i), as demonstrated in the following example:

**Example 2:** Parent is the parent corporation of a consolidated group that files a calendar-year return. Parent owns all of the stock of a subsidiary member of the consolidated group (“Sub”), which, prior to the events described below, operated a business in the United States.<sup>22</sup> Sub was indebted to various creditors.

On March 1, 2020, Parent’s basis in the stock of Sub was \$1 million. The fair market value of the stock of Sub was \$200,000 taking into account its indebtedness.

As a result of the COVID-19 pandemic, Sub’s supply chain was disrupted significantly and/or demand for its products or services diminished significantly. As a result of this disruption, on August 1, 2020, Sub’s assets were worth less than the amount of its liabilities, and therefore Sub lacked liquidating value. On that date, Sub converted to a limited liability company under state law and was classified as an entity disregarded as separate from Parent for federal income tax purposes.

Assume that, taking into account the provisions of Treas. Reg. §§ 1.1502-80(c) and 1.1502-36, Parent may claim a worthless stock deduction with respect to Sub’s stock under section 165(g)(3) (*i.e.*, an ordinary loss of \$1 million) for the 2020 tax year. For the reasons discussed in Example 1, under the facts of Example 2, we believe that Parent also should be entitled to treat the loss as arising in the 2019 tax year under section 165(i).

## **B. COVID-19 Is “Other Casualty” for Purposes of Treas. Reg. § 1.165-7**

We recommend that Treasury and the Service issue guidance expressly declaring that the COVID-19 pandemic is an “other casualty” for purposes of Treas. Reg. § 1.165-7, that losses arising from the COVID-19 pandemic satisfy the requirement of a sudden event, and that physical damage to property is not a prerequisite to claiming a casualty loss deduction.

### **1. Meaning of “Other Casualty” Satisfied**

A loss as a result of damage from “fire, storm, shipwreck, or *other casualty*” is allowed as a deduction under section 165(a) for the taxable year in which the loss is

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<sup>22</sup> Although additional issues are raised with respect to multinational corporations and foreign shareholders, these Comments are limited to domestic corporations and shareholders.

sustained.<sup>23</sup> As a general rule, casualty losses are considered losses arising from a hidden nature, and the taxpayer is powerless to prevent the damage due to the suddenness of the event causing the loss or otherwise unable to prevent the damage.<sup>24</sup> Further, a casualty loss is measured by comparing the value immediately before the casualty with the value immediately after the casualty, while limited to adjusted basis of the property. The fair market value before and after the casualty generally is ascertained by a competent appraisal.<sup>25</sup>

Treas. Reg. § 1.165-11(b) makes it clear that a disaster loss is not required to be a “casualty” loss, but instead may be any loss deductible under section 165, provided that “a disaster loss is a loss ... that is otherwise allowable as a deduction for the disaster year under section 165(a) and Treas. Reg. §§ 1.165-1 through 1.165-10.” Nonetheless, a taxpayer might still need to evaluate whether a particular disaster loss is a casualty loss within the meaning of Treas. Reg. § 1.165-7 such that a loss may be allowed for partial destruction or permanent reduction in value of damaged property. Otherwise, the taxpayer may recognize a loss only if property is disposed of in a closed and completed transaction or is completely worthless.

The term “other casualty” was added by the Revenue Act of 1916.<sup>26</sup> Treasury initially limited “other casualty” to an incident similar to a fire, storm, or shipwreck arising from a natural cause and not due to negligence. Then, in *Shearer v. Anderson*, the Second Circuit Court of Appeals found that such a restrictive construction was erroneous, and allowed a casualty loss deduction for damage to the taxpayer’s automobile sustained when it overturned on an icy road.<sup>27</sup> The court found that “‘casualty’ expresses rather the result than the cause of the damage, that is, the wreck itself rather than the lightning, storm, or the negligence or fault of some person, [may be considered] the ‘other casualty’ ... at least as clearly ejusdem generis (of the same kind) with shipwreck as with fire or storm.”<sup>28</sup>

While fires, storms, and shipwrecks obviously are casualty events, the scope of an “other casualty” is unclear. The statute and regulations do not explicitly define an “other casualty loss,” and the legislative history does not provide Congressional intent as to its meaning in this context. Interpreting the term “other casualty,” courts have limited casualty loss treatment to items similar to a fire, storm, or shipwreck. As such, casualty losses generally have not been allowed for items associated with progressive deterioration of property caused by ordinary wear and tear. According to one early decision, some of the losses that have been held to be deductible as from “other

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<sup>23</sup> See Treas. Reg. § 1.165-7(a).

<sup>24</sup> *Helvering v. Owens*, 305 U.S. 468 (1939).

<sup>25</sup> Treas. Reg. § 1.165-7(a)(2)(i).

<sup>26</sup> Pub. L. No. 64-271, § 5, 39 Stat. 756, 759.

<sup>27</sup> 16 F.2d 995 (1927).

<sup>28</sup> *Id.* at 996.

casualty” are: “loss occasioned by freezing and bursting of water pipes in a residence during the absence of the occupant; loss occasioned by the bursting of a boiler used in heating a taxpayer’s residence; damage to a factory from an earthquake; an extensive deep sinking of land caused by a subterranean disturbance; damage to trees caused by a sleet and ice storm; [and] loss from violent quarry blasting operations.”<sup>29</sup>

In Revenue Ruling 72-592, the Service summarized the requirements for a loss to qualify as an “other casualty” as a “complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected, and unusual nature.”<sup>30</sup> The Service explained that the meaning of each of these terms, as developed in court decisions, are the following: (i) a “sudden” event must be swift and precipitous and not gradual or progressive; (ii) an “unexpected” event is ordinarily unanticipated and occurs without the intent of the one who suffers the loss; and (iii) an “unusual” event is extraordinary and nonrecurring, does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred, and does not commonly occur in the ordinary course of the taxpayer’s day-to-day living.<sup>31</sup> Further, in *Maher v. Commissioner*,<sup>32</sup> the Tax Court noted that courts have interpreted an “other casualty” to mean an accident, mishap, or sudden invasion by a hostile agency, but that it excludes the progressive deterioration of property through a steadily operating cause. Like the Service’s view, the court clarified that an “other casualty” indicates a loss proximately caused by a sudden, unexpected, or unusual event.

We believe that the COVID-19 pandemic may properly be characterized as an “other casualty.” Losses attributable to COVID-19 are extraordinary and nonrecurring. These losses go well beyond losses incurred by most taxpayers in day-to-day living. Additionally, these losses align with how the term, “other casualty” has been interpreted in case law and administrative guidance. The facts and circumstances surrounding the pandemic satisfy the suddenness requirement and allow for a casualty loss even though the pandemic might not result in any physical damage.

## 2. Suddenness Requirement Met

Whether an event is determined to be an “other casualty” often hinges on whether the element of suddenness is present. Courts have reached different results based on whether suddenness is governed by a precipitating event or by the lapse of time between

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<sup>29</sup> *Keenan v. Bowers*, 91 F. Supp. 771, 774 (E.D.S.C. 1950).

<sup>30</sup> 1972-2 C.B. 101.

<sup>31</sup> The “day-to-day living” rule first appeared in the legislative history of the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, which amended section 165(c)(3), dealing with personal casualty and theft losses, to impose a \$100 minimum loss requirement. S. Rep. No. 88-830, reprinted in 1964-1 C.B. (pt. 2) 505, explained that “[y]our committee agrees with the House that in the case of nonbusiness casualty and theft losses it is appropriate in computing taxable income to allow only the deduction only of those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living.”

<sup>32</sup> 76 T.C. 593 (1981), *aff’d*, 680 F.2d 91 (11th Cir. 1982).

the precipitating event and the loss proximately caused by that event. For example, one approach is that an event is sudden because of a precipitating event. This approach was applied by the court in *Shopmaker v. United States*, which held that an invasion of termites resulting in destruction of property was a casualty event.<sup>33</sup> In *Shopmaker*, the court identified the casualty as the *invasion* of the premises by termites. The court characterized this event as a comparatively quick or sudden operation qualifying as a casualty although the resulting damage could extend over a period of months or years.<sup>34</sup> The *Shopmaker* court cited *Burkett v. Commissioner*, in which sand from wooden foundations under a house were washed away during a hurricane.<sup>35</sup> Although it took two years for the foundation posts to sink, the loss was determined to be a sudden casualty, which occurred when the sand was initially disturbed by the hurricane.

Another approach is to determine suddenness by the length of time between the event and the loss. The Tax Court in *Maher*<sup>36</sup> and the Service in Revenue Ruling 87-59<sup>37</sup> applied this approach, in each case disallowing a casualty loss for the death of trees following an insect infestation and concluding that a nine- to ten-month period between the precipitating event of the infestation and the destruction of the trees was not sufficiently sudden. However, in *Black v. Commissioner*, when the Service attempted to rely on the second approach to prevent a casualty loss claim, the Tax Court refused to accept the Service's argument.<sup>38</sup> Specifically, the Service argued that, although a single tree might have been killed within a relatively short period of time following an infestation, which would qualify for a casualty loss, it was not possible for a grove of trees to die so quickly and thus, could not be considered sudden, and disallowed the claimed casualty loss. However, the court found that "it is immaterial whether the death of the trees resulted from the tunnels by the beetles or the fungi carried by the beetles. In either event, it is the sudden onslaught of the southern pine beetles which caused the trees to die." The court pointed out "the term 'other casualty' has been interpreted to mean 'some sudden invasion by a hostile agency,' but excluding the progressive deterioration of property through a 'steadily operating cause.'"<sup>39</sup>

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<sup>33</sup> 119 F. Supp. 705 (E.D. Mo. 1953) (finding that invasion and destruction occurred within five months, but noting that "the damage and the time it takes for the termites to effect it should not be confused with their initial invasion and determining what is the casualty.").

<sup>34</sup> See also *Buist v. United States*, 164 F. Supp. 218 (E.D. S.C. 1958).

<sup>35</sup> T.C. Memo. 1951-290, 10 T.C.M. (CCH) 948 (1951).

<sup>36</sup> 76 T.C. at 600.

<sup>37</sup> 1987-2 C.B. 59.

<sup>38</sup> T.C. Memo. 1977-337, 36 T.C.M. (CCH) 1347 (1977).

<sup>39</sup> *Id.* at 1351 (citing *Burns v. United States*, 174 F. Supp. 203 (N.D. Ohio 1959), *aff'd per curiam*, 284 F.2d 436 (6th Cir. 1960) (holding the death of elm trees from Dutch Elm disease not to be caused by a casualty within the meaning of section 165(c)(3)); *Hoppe v. Commissioner*, 42 T.C. 820 (1964), *aff'd*, 354 F.2d 988 (9th Cir. 1965) (holding the destruction of property by dry rot does not result in a sudden casualty loss under section 165(c)(3)).

Further, the court in *Rosenberg v. Commissioner* noted that suddenness is a question of fact and a comparative determination.<sup>40</sup> The court concluded that a termite infestation and damage occurring over a period of months or a year was a sudden event compared to the otherwise expected 25- to 50-year life of the building. Similarly, in Revenue Ruling 79-174, the Service found that the loss from the death of pine trees by an attack of beetles is a casualty loss within the meaning of section 165(c)(3).<sup>41</sup> According to the ruling, the attack was sudden because it was “of a swift and precipitous nature and not gradual or progressive.” Because the trees were killed in only ten days, the Service determined the attack was sudden. In addition to being sudden, the event must also be unusual or unexpected to qualify as a casualty. Because “there were no known attacks in epidemic proportions of southern pine beetles in the area of the taxpayer's residence, the event was both unusual and unexpected.”

Under either approach, the COVID-19 pandemic satisfies the suddenness requirement for a casualty loss. Just as the courts in *Shopmaker* and other decisions have found the sudden onset of a precipitating event supports a casualty loss, the COVID-19 pandemic is similarly sudden. The identification of the virus was followed almost immediately by state-mandated closures in March 2020, causing casualty losses. Moreover, the lapse of time between the precipitating event, the pandemic, and losses is similarly sudden. As the Service pointed out in Revenue Ruling 79-174, the event causing a casualty loss is sudden when it is “swift and precipitous,” as it has been with the COVID-19 pandemic. The pandemic came on quickly, and business losses shortly followed. Relying on the Service’s analysis in the ruling, the pandemic, previously unknown, unquestionably meets the unusual and unexpected requirements of a casualty loss. Accordingly, we recommend that Treasury and the Service issue guidance clarifying that losses arising from the COVID-19 pandemic satisfy the requirement of a sudden event eligible for casualty loss treatment.

### **3. Physical Damage Not Required**

Casualty loss deductions generally are limited to the diminution of value attributable to physical property damage.<sup>42</sup> For example, the Tax Court in *Taylor v. Commissioner* denied a casualty loss deduction, noting “this court has traditionally held that physical damage to property is a prerequisite to deducting a casualty loss under section 165.”<sup>43</sup> The cases cited, as well as *Taylor*, generally dealt with a casualty event

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<sup>40</sup> *Rosenberg v. Commissioner*, 198 F.2d 46 (8th Cir. 1952).

<sup>41</sup> 1979-1 C.B. 99.

<sup>42</sup> See, e.g., *Caan v. United States*, 83 A.F.T.R.2d (RIA) 99-1640 (C.D. Cal. 1999) (finding that O.J. Simpson’s neighbors could not claim a casualty loss deduction for diminution in property value attributable to Simpson’s accusation as a suspect in the murders of Nicole Simpson and Ron Goldman.); *Kamanski v. Commissioner*, 477 F.2d 452 (9th Cir. 1973) (concluding that California mud slide did minor damage to taxpayer’s property but demonstrated the existence of dangerous soil conditions; court disallowed deduction for loss of market value resulting from “buyer predictions that future casualties would cause further damage,” explaining that “the claim of loss must await the event”).

<sup>43</sup> T.C. Memo. 2019-102, 118 T.C.M. (CCH) 156 (2019).

(e.g., flood, hurricane, landslide, etc.) that resulted in no physical damage to the property at issue, and where the reduction in value was only temporary buyer resistance and not a permanent decline in value. As such, the court refused to find that a casualty loss deduction was allowed.

However, depending on the facts and circumstances, casualty loss deductions may be available where “there was evidence of permanent actual loss aside from physical damage.”<sup>44</sup> For example, in *Finkbohner v. United States*,<sup>45</sup> the Eleventh Circuit Court of Appeals found a casualty loss was available for the loss of market value as a result of a flood, the “loss of fair market value due to ‘buyer resistance’ and not to physical damage.” Although there was very little property damage resulting from the flood, the court allowed a casualty loss deduction for the loss of market value attributed to the fact that the property had been flooded. As the court explained:

[The loss] is something that exists right now. Since the loss of value from this and other causes is permanent, there will not be any recovery of it as fears for the future become less acute. A lower value plateau is reached, which will be the “value before” if another catastrophe occurs. Therefore, the owner when the next catastrophe occurs will not be able to claim a casualty loss founded upon it. It must be claimed right now if it is going to be at all.

Similarly, there are losses attributable to the COVID-19 pandemic that must be claimed now, if at all. Accordingly, we recommend that Treasury and the Service issue guidance that, if a taxpayer can demonstrate a permanent decline in the fair market value of property that is attributable to COVID-19, as compared with its value prior to the pandemic, a casualty loss may be claimed, even when the loss is not attributable to physical damage. As with other casualty loss claims, taxpayers may be required to produce formal valuations to demonstrate the fair market value declines to secure a casualty loss to make an election under section 165(i).

### **C. Scope of Section 165(i) Election**

We recommend that Treasury and the Service issue guidance permitting taxpayers to elect to apply 165(i) on a transaction-by-transaction basis or, alternatively, to apply section 165(i) separately to each trade or business. Regardless of which approach is adopted, we recommend that taxpayers be allowed to make a disaster loss election for each tax year in which losses attributable to the COVID-19 pandemic are sustained.

#### **1. Transaction-By-Transaction Election**

Section 165(i)(2) provides that, if an election is made under this subsection, the casualty resulting in the loss shall be treated for purposes of this title as having occurred

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<sup>44</sup> *Finkbohner v. United States*, 788 F.2d 723, 727 (11th Cir. 1986).

<sup>45</sup> *Id.*

in the taxable year for which the deduction is claimed. Treas. Reg. § 1.165-11(c) further provides that an election made pursuant to section 165(i) for a disaster loss attributable to a particular disaster applies to the entire loss sustained by the taxpayer from that disaster during the disaster year. This language is ambiguous as to whether it is a reference to each loss or all losses attributable to a disaster.

The COVID-19 disaster is an extraordinary situation in that taxpayers will undoubtedly sustain losses under section 165(a) within the disaster area that are attributable to the COVID-19 disaster. Because the disaster will not cause physical damage to property, however, the determination of whether a loss is attributable to COVID-19 will be based on all the facts and circumstances, including the taxpayer's intent and the timing of the loss (*e.g.*, permanently closing a facility due to loss of business directly related to the disaster). Given that the disaster area covers the entire United States, the potentially wide variety of potential losses that will be attributable to the disaster, and the highly uncertain duration of the disaster, requiring that the election be applied to all losses arising from the COVID-19 disaster could lead to significant uncertainty in the application of the election.

For this reason, an all-or-nothing requirement for making the section 165(i) election likely would lead to controversy. For example, by making the election available on a selective basis, taxpayers owning multiple properties or properties in multiple locations will have an opportunity to make the election when there is greater certainty regarding loss of value. Similarly, taxpayers might choose to make the election for one class of assets (*e.g.*, inventory property) where substantiation will be simpler, while avoiding making the election for property where substantiation will be more complicated. Making the election where the loss can more readily be substantiated will lead to less potential controversy.

Additionally, smaller taxpayers might avoid making an election if the election is an all-or-nothing requirement. Because there will be cost and complication of developing substantiation for any property for which a section 165(i) loss election is being made, smaller taxpayers might find such an election cost-prohibitive.

While not authoritative, the Service came to an analogous conclusion regarding the segregation of losses for purposes of section 165(i) in FSA 2774.<sup>46</sup> In this FSA, the Service determined whether aggregation was required for disaster losses with respect to two separate floods that occurred in the Missouri portion of the Mississippi River basin in the same year. The Service determined that taxpayers are not required to aggregate all casualties for a particular year under the section 165(i) election stating:

[I]t would be incongruous to provide that a taxpayer must aggregate all casualties for a particular year for purposes of making the section 165(i) election. Doing so would require either (i) not deducting the first disaster loss on the Year 1 return, and instead filing an amended Year 1 return at

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<sup>46</sup> 1994 FSA LEXIS 666 (Apr. 1, 1994).



the close of Year 2 in order to claim a deduction in Year 1 for all disaster losses occurring during Year 2 (thereby defeating the immediate infusion of cash concept of section 165(i); or (ii) permitting the taxpayer to claim an immediate deduction for the first disaster loss on the Year 1 return (preserving the cash infusion concept), but requiring the taxpayer to amend the Year 1 return to reflect any other disasters occurring later in Year 2. Because neither approach is sound as a matter of either tax policy or tax administration, we are reluctant to ascribe such an intent to an otherwise straightforward relief provision.

The FSA concludes that section 165(i) is to apply for this purpose on a disaster-by-disaster basis. Similarly, due to the ongoing potential for losses to be sustained as a result of the COVID-19 pandemic, the election under section 165(i) should provide flexibility for taxpayers.

There are a number of existing statutory and regulatory tax elections that provide taxpayers with a significant degree of latitude and choice as to the scope of the election. Examples include section 59(e) (election to amortize otherwise deductible section 174(a) expenses in any amount selected by the taxpayer), section 174(b) (project-by-project election), section 475 (security-by-security identification of securities as exempt from the mark-to-market method), Treas. Reg. § 1.263(a)-4(e)(4)(iv) (election to capitalize employee compensation, overhead, and de minimis costs on a transaction-by-transaction basis), and section 453 (transaction-by-transaction election out of the installment method).

We believe the policy reasons explained above justify a rule that provides for similar flexibility with respect to the scope of the section 165(i) election as it applies to the COVID-19 disaster. We recommend that the election explicitly be made available on a transaction-by-transaction basis. By allowing this election on a transaction-by-transaction basis, such an approach will better ensure that taxpayers that claim the election more fully substantiate losses, which will minimize challenges to such elections during examinations. More importantly, such an approach will allow all COVID-19 casualty losses to be claimed, even if losses occur in more than one tax year.

## **2. Alternative Recommendation**

If the above recommendation is not adopted, we recommend in the alternative that any guidance issued on section 165(i) permit taxpayers to apply the election separately to each trade or business of the affected taxpayer.

Although section 165(i) and the regulations indicate that the election is made by a “taxpayer,” the election involves the timing of a certain class of deductions and therefore would appear to have the requisite characteristics to be considered an “accounting method” election. With respect to alternative permissible accounting methods, section 446(d) generally permits taxpayers to apply different permissible accounting methods to distinct trades or businesses within a single taxpayer. The guidance for determining what constitutes a single trade or business is long-standing and would provide a logical

demarcation, consistent with accounting methods in general, for limiting the scope of the election if the election is required to be made for all COVID-19 related losses.

### **3. Annual Election**

Section 165(i) applies to the entire loss sustained by the taxpayer from that disaster during the disaster year. Because it is uncertain how long the pandemic will continue, taxpayers might be in the unfortunate position of incurring losses over more than one tax year. Thus, we recommend that taxpayers be allowed to make a disaster loss election for each tax year in which losses attributable to the COVID-19 pandemic are sustained. We believe that such an approach would be more administrable for both taxpayers and the Service.