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Report No. 1458
January 21, 2022

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Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Thomas C. West, Jr.
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
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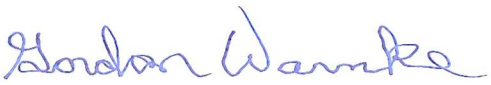
Re: Report No. 1458 – Report on the Application of Section 165(i) to Worthless Stock Dedcutions

Dear Mme. Batchelder and Messrs. West and Vallabhaneni:

I am pleased to submit Report No. 1458 of the Tax Section of the New York State Bar Association discussing the application of Section 165(i) to worthless stock deductions.

We appreciate your consideration of our Report. If you have any questions, please feel free to contact us and we would be happy to assist in any way we can.

Respectfully Submitted,



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Report No. 1458

New York State Bar Association Tax Section

Report on the Application of the Section 165(i) Election with Respect to Section 165(g) Worthless Stock Deductions "Attributable to" the COVID-19 Pandemic

January 21, 2022

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I. Introduction

This report ("**Report**") of the Tax Section of the New York State Bar Association ("**NYSBATS**")[1] requests guidance from the Internal Revenue Service (the "**IRS**" or "**Service**") and the Department of the Treasury ("**Treasury**") on issues relating to the application of Section 165(i)[2] to a worthless stock deduction under Section 165(g) (a "**WSD**")[3] by taxpayers affected by the ongoing coronavirus disease 2019 ("**COVID-19**") pandemic. In particular, this Report considers the following issues with respect to the application of Section 165(i) to a WSD: (i) the availability of a Section 165(i) election for a WSD; (ii) the required nexus between the WSD and the location of the disaster area affected by the COVID-19 pandemic; (iii) the proper determination of whether and the extent to which a WSD is "attributable to" a federally declared disaster like the COVID-19 pandemic; (iv) certain considerations related to determining whether the WSD is "otherwise allowable" as a deduction for the disaster year for purposes of Reg. §1.165-11(b)(3), including (a) issues associated with moving deductions into different taxable periods ("**time traveling**") and (b) the application of the unified loss rules ("**ULRs**") of Reg. §1.1502-36 to consolidated groups making a Section 165(i) election; and (v) the application of the Section 165(g)(3)(B) gross receipts test, taking into account the Section 165(i) election.

II. Summary of Recommendations

1. We recommend that Treasury and the Service clarify that taxpayers are permitted to make a Section 165(i) election with respect to deductions for worthless stock associated with the COVID-19 pandemic if the requisite conditions are satisfied.

2. We recommend that Treasury and the Service issue guidance providing that a shareholder electing to apply Section 165(i) to a WSD must establish that a significant portion of the worthless corporation's activities are located in the disaster area determined by reference to the location of business activities (*e.g.*, where the corporation's assets, revenue, management, or employees are located or derived from).

3. We recommend that Treasury and the Service issue guidance under Section 165(i) consistent with case law that the phrase "attributable to" implies a requirement of causation and means "due to, caused by, or generated by." In addition, although we did not reach a unanimous consensus regarding whether the Realization Model or the Apportionment Model (as discussed in Part IV.C.2) should be applied in determining whether a WSD is

[1] The principal authors of this Report are Larry Garrett, Randell Gartin, Martin Hamilton and Sean Webb, with substantial contributions from Brian Peabody. Helpful comments were received from Michael Alcan, William Alexander, Robert Cassanos, Peter Connors, Jiyeon Lee, Deborah Paul, Brian Peabody, Michael Schler, Shun Tosaka, Gordon Warnke and Libin Zhang. This report reflects solely the views of the NYSBATS and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] Unless otherwise indicated, all "**Section**" references are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "**Code**"), and all "**Regulations**" and "**Reg. §**" references are to the Treasury regulations promulgated thereunder.

[3] References to a WSD in this Report include a reference to the underlying loss, as the context may require.

attributable to a disaster, a clear majority supports application of the Realization Model.[4] Thus, we recommend that Treasury and the Service consider issuing guidance under Section 165(i) adopting the Realization Model.

5. We recommend that Treasury and the Service issue guidance adopting the Bifurcated Model (as discussed in Part IV.D.2) for purposes of determining whether a WSD disaster loss is otherwise allowable in the disaster year.

6. We recommend that Treasury and the Service provide guidance confirming that the ULRs under Reg. §1.1502-36 are applied in the disaster year (and not also in the preceding year) in the manner described in Part IV.E.2 (*i.e.*, the basis reduction rule of Reg. §1.1502-36(c) is applied *before* relocating the WSD disaster loss under Section 165(i) and the loss duplication rule of Reg. §1.1502-36(d) is applied in the disaster year, not the preceding year).

7. We recommend that Treasury and the Service issue guidance confirming that taxpayers are required to take into account the worthless corporation's disaster year gross receipts (in addition to the gross receipts from all prior years) in determining whether the gross receipts test under Section 165(g)(3)(B) is met.

III. Background

On March 13, 2020, in Proclamation 9994, then-President Trump issued an emergency declaration under Section 501(b) of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "**Stafford Act**"),[5] beginning on March 1, 2020, in response to the COVID-19 pandemic.[6] On February 24, 2021, President Biden issued a notice to continue the national emergency declared in Proclamation 9994 concerning the COVID-19 pandemic.[7]

The Code has several provisions that are applicable to federally declared disasters. One such provision is Section 165(i), which allows affected taxpayers to make an election to claim disaster losses in the taxpayer's taxable year immediately preceding the taxable year in which the losses

[4] Please note that our recommendation regarding the application of the Realization Model is solely with respect to WSDs, and we express no view as to whether the Realization Model should be applied with respect to sales or other loss triggering events for which other considerations may apply.

[5] Pub. L. No. 100-707.

[6] Proclamation 9994—Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID–19) Outbreak, 85 Fed. Reg. 15337 (March 18, 2020), also available at https://www.federalregister.gov/d/2020-05794/page15337.

[7] Notice on the Continuation of the National Emergency Concerning the Coronavirus Disease 2019 (COVID-19) Pandemic (February 24, 2021), available at https://www.whitehouse.gov/briefing-room/presidential-actions/2021/02/24/notice-on-the-continuation-of-the-national-emergency-concerning-the-coronavirus-disease-2019-covid-19-pandemic/. This notice was issued pursuant to 50 U.S.C. 1622(d), as otherwise the national emergency would have terminated on March 1, 2021. This Report assumes that the continuation of the national emergency by President Biden means that a single national emergency continuously existed since the effective date set forth in Proclamation 9994.

attributable to the disaster arise.[8] Current Section 165(i) was enacted in 1962 to provide taxpayers affected by disasters an election allowing meaningful tax relief for losses attributable to the disasters,[9] and this election continues to be an important tool for providing disaster assistance to taxpayers.

The COVID-19 pandemic is an ongoing federally declared disaster that continues to present unique societal and economic challenges to individual and business taxpayers. Additionally, these challenges have taken on a number of different forms during the pendency of the national emergency – *e.g.*, stay-at-home orders, labor disruptions resulting from the direct and indirect effects of the COVID-19 pandemic, trade disruptions due to the effects of the pandemic in other countries, the direct and indirect effects of the COVID-19 pandemic on consumer behavior, governmental moratoriums on evictions, and the limitation or suspension of certain ordinary governmental operations (such as court closings). These challenges all create the significant possibility of substantial losses by taxpayers that resulted directly or indirectly from the COVID-19 pandemic.

Further, the challenges of the COVID-19 pandemic are substantially greater, and indeed economically systemic, in ways that are different than other natural disasters. The type, magnitude, and timing of losses suffered by taxpayers as a result of the COVID-19 pandemic will differ from those caused by other types of natural disasters (*e.g.*, hurricanes, tornadoes, floods, and wildfires) in at least three significant ways:

(1) most losses will not stem from direct physical damage to property by the disaster, but instead will result from one or more precipitous declines in economic activity during the COVID-19 pandemic;

(2) the COVID-19 pandemic has been ongoing since March 1, 2020, and when the disaster will end remains unknown, as opposed to natural disasters, which typically have a shorter duration; and

(3) the COVID-19 pandemic disaster area covers the entirety of the United States, the District of Columbia, and all US territories, whereas other natural disasters typically are centered in, and the consequent damage is contained within, a particular state or region.

These differences will likely lead to significant uncertainty for taxpayers about, among other things, the proper application of the Section 165(i) election. Further, a potentially large number of taxpayers may wish to avail themselves of the disaster relief under Section 165(i) either for the 2020 or 2021 taxable year, including with respect to worthlessness of stock that is associated with

[8] Another example is Section 7508A, which authorizes the Secretary of the Treasury (the "**Secretary**") to toll certain taxpayer deadlines when the Secretary determines that a taxpayer is affected by a federally declared disaster.

[9] Section 165(i) was enacted by Pub. L. No. 87-426 as Section 165(h), and later renumbered and revised as Section 165(i) by the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. For a more detailed discussion of the legislative history of Section 165(i), *see* Part IV.D.1., *infra*.

the economic damage caused by the COVID-19 pandemic.[10] By taking a COVID-19 pandemic loss into account in 2019 (or potentially in 2020), taxpayers may receive tax refunds by reducing their 2019 tax liability (or as regards 2021 losses, 2020 tax liability), potentially of substantial value where the effects of the pandemic resulted in the taxpayer having little to no 2020 (or 2021) tax liability, or create or increase a net operating loss ("**NOL**") or net capital loss that can be carried back to offset taxable income in earlier years.[11]

The effect of a Section 165(i) election – and indeed, the effect of Section 165 as a whole – for losses arising from worthless stock adds an additional layer of complexity to the COVID-19 pandemic disaster loss analysis. As a practical matter, essentially all economic activity within the COVID-19 pandemic disaster area has been affected to one degree or another by the pandemic during the pendency and continuation of the emergency. Section 165(i) provides that losses occurring in a disaster area and "attributable to" the disaster are eligible for the benefits of the election. However, there are complex, and arguably unique, issues relating to the intersection of stock becoming worthless at any time after March 1, 2020, and the extent to which the resulting loss is attributable to the COVID-19 pandemic disaster.

IV. Discussion

A. Initial Observations as to the General Application of Section 165(i) to a WSD

As an initial observational matter, there appears to be no technical or policy reason why, in the right set of circumstances, a Section 165(i) election generally cannot apply to a WSD associated with the COVID-19 pandemic.

Section 165(g) provides that, for purposes of Section 165(a), if any security that is a capital asset becomes worthless during the taxable year, the loss resulting therefrom will be treated as a loss from the sale or exchange of a capital asset on the last day of the taxable year.[12] A security for

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[10] Unfortunately, the COVID-19 pandemic continues to cause economic disruption and loss during the beginning of 2022 and, accordingly, the application of Section 165(i) potentially may be relevant for the 2022 taxable year as well.

[11] For instance, in March 2020, the *Coronavirus Aid, Relief, and Economic Security (CARES) Act*, Pub. L. No. 116-136, was enacted in response to the COVID-19 pandemic and provided taxpayers with, among other tax relief, a 5-taxable-year carryback of NOLs generated in taxable years beginning in 2018, 2019, and 2020.

[12] Reg. §1.165-1(b) provides that a loss must be evidenced by a closed and completed transaction to be deductible under Section 165(a). Therefore, the rule in Section 165(g)(1) allows a taxpayer to treat the worthlessness of a security as an identifiable event that closes the transaction for purposes of Section 165(a). There is an exception to the capital loss treatment under Section 165(g) for certain worthless securities of a domestic corporation if the taxpayer is an affiliate of the corporation (*i.e.*, the taxpayer directly owns stock in the corporation that satisfies the requirements of Section 1504(a)(2)), and more than 90 percent of the aggregate of the corporation's gross receipts for all taxable years has been from sources other than certain passive-type income, including royalties, certain rents, dividends, certain interest, annuities and gains from sales of stocks and securities. Section 165(g)(3). On November 19, 2021, the U.S. House of Representatives passed the Build Back Better Act (H.R. 5376), which amends Section 165(g) to provide that the sale or exchange of the worthless security would be deemed to occur on the day that the identifiable event establishing worthlessness, rather than on the last day of the taxable year. *See* Section 138142(a)(1), Build Back Better Act, H.R. 5376, 117th Congress, 1st Sess. (2021). Action has not yet been taken on the Build Back Better Act in the US Senate.

purposes of this rule includes stock of a corporation.[13] To claim a WSD under Section 165(g), a taxpayer must establish that the stock had value at the end of the preceding taxable year and that it became worthless during the current year.[14] Establishing worthlessness requires a showing that there is a loss of both liquidating value and potential value.[15] Stock of a corporation has no liquidating value if the corporation's liabilities exceed its assets and lacks potential value when the occurrence of an identifiable event, such as the bankruptcy, cessation from doing business, or liquidation of the corporation, has foreclosed any reasonable hope or expectation that the stock will become valuable at some future time.[16]

As a technical matter, there is no requirement that the disaster loss be attributable to *physical* damage or destruction of property. As mentioned above, Section 165(i) permits a taxpayer who has sustained a disaster loss in a taxable year to elect to deduct the loss in the preceding taxable year. A disaster loss is a loss occurring in a federally declared disaster area that is attributable to a federally declared disaster and that *is otherwise allowable as a deduction for the disaster year under Section 165(a)*. The Regulations under Section 165(i) do not explicitly address whether a loss for worthless stock can be a disaster loss, but because stock that becomes worthless within the meaning of Section 165(g) is treated as a deductible loss under Section 165(a) and Reg. §1.165-5, a loss for worthless stock (*i.e.*, a WSD) should be eligible for a Section 165(i) election if the requisite conditions are satisfied as a factual matter; WSDs are governed by Reg. §1.165-5, which is one of the Regulations referenced in Reg. §1.165-11. Moreover, as a policy matter, if such conditions are satisfied, application of Section 165(i) is appropriate because the loss of stock value has been caused by the economic effects of the Covid-19 pandemic in the United States.

> *Example 1*. A taxpayer owns stock in a corporation that has a basis of $100 and a value of $200 at the beginning of Year 2. The corporation's main factory is destroyed in a hurricane that is a federally declared disaster. As a result of the destruction of the factory, the corporation files for bankruptcy, and its stock ceases to have liquidating value and potential value (*i.e.*, it becomes worthless) by the end of Year 2. Under these facts, the taxpayer is allowed to claim a WSD under Section 165(g) for Year 2.

The WSD in Example 1 should be a disaster loss for which the taxpayer is entitled to make the Section 165(i) election so long as the $100 loss is "attributable to" the hurricane. Furthermore, there appears to be no principled reason why the taxpayer should not be entitled to claim a loss with respect to the worthless stock even though the corporation itself may also claim a disaster loss under Section 165(i) with respect to the factory. The worthlessness of the stock in Example 1

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[13] The term security also includes a right to subscribe for, or to receive, stock of a corporation or 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.

[14] *See, e.g.*, *Corbett v. Comm'r*, 28 B.T.A. 46 (1933); *DeLoss v. Comm'r*, 28 F.2d 803 (2d Cir. 1928); *G.E. Employees Sec. Corp. v. Manning*, 137 F.2d 637 (3d Cir. 1943); *Livingston v. Comm'r*, 46 B.T.A. 538 (1942), *acq.*, 1944 C.B. 17; *Morton v. Comm'r*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940); *Roosevelt Inv. Corp. v. Comm'r*, 45 B.T.A. 440 (1941).

[15] *Morton*, 38 B.T.A. at 1278-79.

[16] *Morton*, 38 B.T.A. at 1278-79.

is caused by a federally declared disaster because the hurricane destroyed the factory, which diminished the value of the corporation's stock. Lastly, the result should not change if the economic loss is caused by the COVID-19 pandemic (*e.g.*, by causing a loss of business revenue and opportunities that make continued operation of the factory uneconomic so that its value is zero, or at least significantly less than the amount of the corporation's debt), rather than by the hurricane.

We recommend that Treasury and the Service clarify that taxpayers are permitted to make a Section 165(i) election with respect to losses for worthless stock associated with the COVID-19 pandemic if the requisite conditions are satisfied. Implicit in this recommendation is the principle that, although a Section 165(i) is not precluded, a WSD that accrued during the pandemic should not always be eligible for a Section 165(i) election. The discussion below considers the facts and circumstances that should be considered in determining whether and to what extent a Section 165(i) election should be applicable to a WSD.

B. "Occurring in a Disaster Area"

Section 165(i) provides taxpayers an election to claim any loss *occurring in a disaster area* and attributable to a federally declared disaster in the taxable year immediately preceding the taxable year in which the disaster occurred. A federally declared disaster is any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, and a disaster area is an area that is determined to warrant such assistance.[17]

Typically, previous federal disaster declarations have been issued on a county-by-county basis, or sometimes on a state-by-state basis for more substantial disaster events. However, as mentioned above, the COVID-19 pandemic was declared to be a federal disaster across the United States, the District of Columbia, and all US territories, and thus the entirety of the nation and its territories are a disaster area for purposes of Section 165(i) with respect to the pandemic. However, the consequences of the COVID-19 pandemic do not end at the US border, and the effect of the pandemic on operations of multinational companies has impacted both the equity value of enterprises within the United States or its territories, and the equity value of enterprises outside the United States held by persons residing in the United States. As a result, determining whether the worthlessness of the stock of a corporation occurred in a disaster area (and thus is potentially eligible for a Section 165(i) election) presents significant ambiguities.

As applied to WSDs, we believe that the "occurring in a disaster area" requirement implies that the stock must have a reasonable nexus to the disaster area. There are a number of possible connections to the disaster that could be used as the relevant factors to establish the requisite nexus of a WSD to the disaster area. The most appropriate appear to be the following:

(1) the residence of the taxpayer with the WSD (*i.e.*, the shareholder);

(2) the place of incorporation or organization of the worthless corporation; or

[17] Section 165(i)(5); Reg. §1.165-11(b)(1)-(2).

(3) the location of a significant portion of the worthless corporation's activities, determined by reference to its assets, revenues, and employees.

The merits and shortcomings of each of these factors are discussed below.

1. Residence of the Taxpayer (*i.e.*, Shareholder of the Worthless Corporation)

Under this approach, the shareholder may establish requisite nexus to the disaster area with respect to a WSD if the shareholder resides in a disaster area. This approach would offer a straight-forward, bright line rule.

Although sourcing rules rely on the residence of the shareholder to determine where capital gain on stock is sourced,[18] a similar rule to determine whether a WSD occurred in a disaster area seems less appropriate because it fails to establish a significant economic connection between the disaster area and the WSD. A location of the shareholder rule would seem to be both under- and over-inclusive. The rule would be under-inclusive because it would prevent taxpayers from claiming disaster losses where the taxpayer is not resident in a location that is a disaster area, but the corporate activities impacted by the pandemic are in the disaster area. In the case of the COVID-19 pandemic, this problem is magnified by the possibility that this bright-line rule would have the effect of effectively making the election only available for US residents and residents of US territories. The rule would be over-inclusive because it may allow taxpayers to claim a WSD as a disaster loss where the taxpayer is located or resident in a disaster area, but the corporation itself has no business activities in the disaster area. An additional issue is that, if the stock is held by a partnership or other pass-through entity, it is unclear under a location of the shareholder test whether the WSD location determination should be made based on the residence of the partnership[19] or the partnership's beneficial owners.

On the other hand, perhaps especially in the context of a global pandemic, it seems unlikely (or, at best, coincidental) that where the shareholder resides for tax purposes bears any meaningful, economic relationship to the events that actually give rise to the WSD; accordingly, it does not appear that the potential benefits of ease of administration of a residence-based rule outweighs the potential policy concerns of divorcing the events resulting in the WSD from the availability of a deduction resulting therefrom.

2. Place of Incorporation or Organization of the Worthless Corporation

Another possibility for establishing minimal nexus of the WSD to the disaster area is the place where the corporation whose stock is worthless is incorporated or otherwise organized. This alternative also would create a bright-line rule for determining whether a WSD with respect to a corporation has occurred in a disaster area. Like the residence of the shareholder rule, this place

[18] *See* Section 865.

[19] *See* Reg. § 1.701-2(f), Example 3, where the tax residence of a partnership that is treated as a US person is treated as dispositive in requiring that the partnership's ownership interest in a foreign corporation determine whether the ownership interest results in the foreign corporation having a United States shareholder for purposes of the controlled foreign corporation rules. *See also* Reg. § 1.884-1(d)(3), which requires a foreign corporation to determine the value of its interest in a US partnership, not the value of the US partnership's assets, for purposes of determining US assets.

of incorporation rule may be both too narrow and too broad. The rule would effectively mean that a shareholder of a corporation organized in one state but having all or even a very substantial portion of its activities in a disaster area outside that state of organization would not be able to establish that the WSD occurred in the place where the corporation does business. Additionally, this bright-line approach would effectively mean that no WSD taken on the stock of a non-US corporation could qualify for a Section 165(i) election, even though that non-US corporation had substantial activities in the disaster area. At the same time, this rule could permit a Section 165(i) election to be made where the corporation has no significant activities in the disaster area. Thus, the policy justification for a place of incorporation or organization rule seems at best uncertain.

3. Location of a Significant Portion of the Worthless Corporation's Assets, Revenue, Management, or Employees

Under this approach, the shareholder may establish requisite nexus to a disaster area for a Section 165(i) election for a WSD if a significant portion of the corporation's activities are located in the disaster area. For this purpose, the location of the corporate activities would be determined by looking to where the corporation's assets, revenue, management, or employees are located or derived from.

Unlike the options above, this would require the shareholder to make the nexus determination based on all the facts and circumstances, which would be more difficult to apply than a bright-line rule. However, Treasury and the Service could enumerate certain factors to consider, which could include where the management of the company is located, where the corporation provides its goods and/or services, where a significant portion of the corporation's assets, management, or employees are located, where its customers are located, etc. Additionally, this approach would seem to be most consistent with more typical federally declared disasters (*e.g.*, federally declared disasters resulting from localized natural disasters) – *i.e.*, if a corporation is incorporated in Delaware but in fact conducts all of its business in an agricultural county in California, and the corporation's business is entirely destroyed (and thus its stock become worthless) as a result of a federal disaster declared in that county in California, the availability of the Section 165(i) election for that corporation's worthless stock seems eminently reasonable tax policy.

Having the entire United States and its territories declared to be a disaster area does not on its face seem to suggest a different policy conclusion. Indeed, the declaration of the broadest possible disaster area would seem to suggest that the COVID-19 pandemic's effect is presumed to reach everywhere within the limits of the President's authority to declare a disaster. However, the application of a significant portion of assets, revenue, management, or employees test would also mean that taxpayers would be able to establish requisite nexus on WSDs with respect to non-US corporations that conduct significant business activities in the United States.

We recommend that Treasury and the Service issue guidance providing that a shareholder electing to apply Section 165(i) to a WSD must establish that a significant portion of the worthless corporation's business activities are located in the disaster area, generally to be determined by reference to where its assets, revenue, management, or employees are located or derived from. However, we note that there is an interaction between the nexus question and the "attributable to"

question (discussed below) and that a higher standard for the nexus question (*e.g.*, a requirement that a plurality of the corporation's business activity be located in the disaster area) could be considered if the Realization Model is adopted.

C. "Attributable to a Federally Declared Disaster"

In addition to requiring that a WSD occur in a disaster area, Section 165(i) requires that the WSD be "attributable to a federally declared disaster" for a taxpayer to claim the WSD as a deduction in the taxable year immediately preceding the taxable year in which the disaster occurred. We recommend that Treasury and the Service issue guidance for determining the amount of a WSD that is "attributable to" a federally declared disaster for purposes of Section 165(i).

The following section discusses various issues that we recommend Treasury and the Service consider in clarifying the meaning of "attributable to" for purposes of determining whether a WSD is eligible for a Section 165(i) election.

1. Definition of "attributable to"

No definition is given to the phrase "attributable to" as used in Section 165(i) and the Regulations thereunder. Furthermore, the meaning of the phrase has not been specifically addressed in case law or administrative guidance. Courts, however, have consistently construed the phrase to imply causation for purposes of federal income tax law more generally. In *Lawinger v. Commissioner*,[20] the Tax Court summarized how other courts have interpreted "attributable to" and concluded that the plain meaning of the phrase is "due to, caused by, or generated by."[21] Subsequent cases have followed this reading of the phrase where it appears in other areas of the Code or Regulations.[22]

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[20] 103 T.C. 428 (1994).

[21] *Id.* at 435 ("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 non-tax contexts. Under the definition of collapsible corporation under 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. Comm'r*, 374 U.S. 65, 70 (1963). In interpreting the statutory language of section 165(i) of the 1954 Code that governed 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). These interpretations are based on the conclusion that "attribute" or "attributable" connotes causation. *See National Ass'n of Greeting Card Publishers v. United States Postal Serv., et al.*, 462 U.S. 810, 823 (1983); *Watson v. Employment Sec. Comm'n 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.").

[22] *See*, *e.g.*, *Russian Recovery Fund Ltd. v. United States*, 851 F.3d 1253, 1261 (Fed. Cir. 2017); *Keener v. United States*, 551 F.3d 1358, 1365 (Fed. Cir. 2009), *cert. denied*, 558 U.S. 825 (2009); *Electrolux Holdings, Inc. v. United States*, 491 F.3d 1327, 1331 (Fed. Cir. 2007); *Stanford v. Comm'r*, 152 F.3d 450, 459 (5th Cir. 1998).

We recommend that Treasury and the Service consider issuing guidance under Section 165(i) consistent with the case law that the phrase "attributable to" implies a requirement of causation and means "due to, caused by, or generated by."

2. Models for Taxpayers to Satisfy "Attributable to" Requirement

Taxpayers claiming a WSD with respect to a corporation with the requisite nexus to the COVID-19 pandemic disaster area may have difficulty determining to what extent their WSD is attributable to the federally declared disaster. This issue is especially important, considering that the WSD may be caused by more than one factor (*i.e.*, the pandemic and one or more events unrelated to the disaster, such as a pre-existing economic decline in the relevant industry). One reason taxpayers and the government may have difficulty making this determination is that the COVID-19 pandemic presents an essentially unique challenge in that it is not a traditional "casualty" event and that nearly every other federally declared disaster has been a casualty event—*e.g.*, hurricanes, tornadoes, severe storms, earthquakes, or wildfires. For these more traditional federally declared disasters, Reg. §1.165-7 provide clear rules for taxpayers to determine their casualty losses—(1) if the property becomes wholly worthless, a taxpayer takes a casualty loss under Section 165(a) equal to its entire adjusted basis in the property (this is the case even if the property is in a built-in loss position before the casualty, meaning that a portion of the loss did not arise economically from the casualty), and (2) if the property becomes partially worthless, the casualty is treated effectively as creating a realization of a loss deductible under Section 165(a) equal to the lesser of the decline in the property's value due to the casualty or the taxpayer's adjusted basis.[23] It is unclear to what extent similar rules should be adopted for a non-casualty disaster loss resulting from the economic repercussions of the COVID-19 pandemic, and there appears to be no real precedent that resolves this issue because the vast bulk of prior federally declared disasters have resulted in casualty losses.

Accordingly, taxpayers and the government alike will benefit from guidance on how to determine whether, and the amount to which, a WSD is considered "attributable to" a federally declared disaster and thus eligible for the Section 165(i) election.

There are at least two potential models that can be applied to determine the amount of a WSD that is attributable to a federally declared disaster—the "Realization Model" and the "Apportionment Model", both of which are discussed below.

Realization Model—The Realization Model is essentially an "all-or-nothing" test for determining whether a WSD is "attributable to" a federally declared disaster. That is, if the requirements under the Realization Model are met, the taxpayer's entire WSD is treated as attributable to the disaster and eligible for the Section 165(i) election, including any portion of the WSD attributable to a pre-COVID-19 pandemic decline in economic value. To satisfy the test under the Realization Model, the taxpayer needs to show that the federally declared disaster was the "last-in-time" proximate

[23] Reg. §1.165-7(b)(1).

cause of the stock becoming worthless (*i.e.*, it is the proximate cause of the economic loss which is evidenced by one or more identifiable events of worthlessness).[24]

> *Example 2*. A taxpayer owns stock in a corporation that has a basis of $100. In Year 2, the value of the stock falls to $50 as a result of economic decline in the relevant industry. Later that year, the corporation's main factory is required to shut down as a result of a statewide government order related to the COVID-19 pandemic. As a result of the shutdown, the corporation files for bankruptcy, and its stock ceases to have liquidating value and potential value (*i.e.*, it becomes worthless) by the end of Year 2. The COVID-19 pandemic is the proximate cause of the economic loss resulting from the shutdown of the corporation's factory and evidenced by its bankruptcy filing. Under the Realization Model, the taxpayer is allowed to make a Section 165(i) election in Year 2 with respect to the WSD in amount equal to $100, *i.e.*, both the $50 loss attributable to the economic decline in the relevant industry and the $50 loss attributable to the COVID-19 pandemic.

The Realization Model is rooted in the view that "attributable to" in the Section 165(i) context as applied to WSDs should be read to mean simply that the closed and completed event which caused the sustained loss to be deductible must be the federally declared disaster itself and not some other, prior cause. This is not an apportionment rule, but a binary bright-line test. The fact that the stock had decreased in value before the disaster is not relevant to the occurrence of the WSD realization event, and a mere decline in value, without more (and with the exception of a casualty loss), is generally not a realized loss for tax purposes. There must be a closed and completed transaction proximately caused by the disaster in the disaster area—an identifiable event of worthlessness—that evidences the loss, but once that is established, the entire amount becomes deductible. [25]

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[24] This "last-in-time" model is neither inherently advantageous nor disadvantageous to taxpayers. For example, a corporation's stock may have lost most of its value due to non-pandemic related events, but the COVID-19 pandemic may be the event that causes the stock to be worthless. Conversely, a corporation's stock may have lost most of its value due to the COVID-19 pandemic, but the last-in-time event that caused the worthlessness may be a non-pandemic related event (*e.g.*, the introduction into the marketplace of a superior product by a competitor).

[25] Under Reg. §1.1502-80(c), the stock of a member subsidiary is not treated as worthless under Section 165 until immediately before the earlier of the time (i) the stock is worthless within the meaning of Reg. §1.1502-19(c)(1)(iii), or (ii) the subsidiary for any reason ceases to be a member of the group. This rule generally has the effect of deferring the time in which a WSD may be taken into account with respect to stock of a member subsidiary (*e.g.*, until all of the subsidiary's assets are sold and the proceeds thereof are used to partially repay debt or until the subsidiary's creditors convert their debt into stock of the subsidiary). Reg. §1.1502-80(c) is intended to (i) further the application of single entity principles by generally coordinating the timing of worthlessness of subsidiary stock with the timing of investment adjustments attributable to items generated by the subsidiary in winding up its operations and the associated disposition of its assets and (ii) lessen the tension that would otherwise exist between tax and bankruptcy law (which may preclude a parent company from taking a worthless stock deduction). *See* IRS Notice of Proposed Rule Making, 57 Fed. Reg. 53634 (November 12, 1992); T.D. 8560 (August 15, 1994); T.D. 9118 (March 17, 2004). We believe that there is no indication that Reg. §1.1502-80(c) was intended to preclude application of Section 165(i) to member stock once the timing rule of Reg. §1.1502-80(c) is satisfied and, consistent with this, in the case of member stock, we think that the Realization Model should be applied by reference to whether the COVID-19 pandemic is the proximate cause of the economic loss even though the application of Section 165(i) is otherwise deferred until the requirements of Reg. §1.1502-80(c) are satisfied.

This approach makes the election consistent with the rest of the statute and the Regulations, which do not explicitly provide any sort of apportionment rule or mechanics for bifurcating a loss between its disaster and non-disaster components and deducting the former in a prior year and the latter in the current year. Moreover, the Realization Model avoids the main issue with an apportionment rule—that it is difficult to administer, as it requires complex determinations regarding degrees of causation (discussed in more detail below).

As mentioned above, support for applying the Realization Model to a WSD caused by the COVID-19 pandemic in the United States can be found, by analogy, in Reg. §1.165-7, which provides that the amount of a casualty loss taken into account under Section 165(a) is the *lesser of*: (i) the amount which is equal to the fair market of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or (ii) the amount of the adjusted basis prescribed in Reg. §1.1011-1 for determining the loss from the sale or other disposition of the property involved.[26] Thus, the amount of casualty loss generally is the lesser of the value decline or the basis. However, if property used in a trade or business or held for the production of income is *totally destroyed* by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property (*i.e.*, the property is in a built-in loss position pre-casualty and thus one or more components of the loss did not arise from the casualty), the amount of the adjusted basis of such property is treated as the amount of the loss for purposes of Section 165(a).[27] Thus, in such a case, the amount of casualty loss equals the property's basis even though a portion of the value decrement arises from one or more causes separate from the casualty itself.

On the other hand, as with other "all-or-nothing" tests, a potential shortcoming of the Realization Model is that it may be both under- and over-inclusive. The model may be under-inclusive because it would preclude the availability of the Section 165(i) election for a WSD in a situation where another event or circumstance is the identifiable event of worthlessness, but most of the loss of value was caused by the COVID-19 pandemic. The model may be over-inclusive because it would permit a Section 165(i) election for a WSD where the disaster is the identifiable event of worthlessness, but the stock had lost most of its value prior to the disaster due to an unrelated cause.

Another potential shortcoming of the Realization Model is that, while it applies easily when identifiable events happen sequentially, it becomes more difficult to apply when events or circumstances happen or co-exist simultaneously, which is more likely to be the case with respect to WSDs arising from the COVID-19 pandemic given the extended duration of the COVID-19 pandemic. In some sectors, such as "bricks and mortar" retail, economic decline may have begun before the COVID-19 pandemic and may or may not have continued even in the absence of a pandemic: is the worthlessness of stock of a corporation in such a sector attributable to the decline in the industry or to the COVID-19 pandemic? Thus, the factual inquiry required by the

[26] Reg. §1.165-7(b)(1).

[27] *Id.*

Realization Model is not always necessarily simple—*i.e.*, it can be difficult to determine the "last-in-time" event that caused worthlessness.

To mitigate this aspect of the Realization Model, one of the following conventions can be adopted and applied in circumstances when a taxpayer is unable to determine the "last-in-time" event that caused the worthlessness because there were multiple events that simultaneously caused the corporation to become worthless.

- *Sole Cause Test*—this test is met if the taxpayer is able to show that the worthlessness was solely caused by the federally declared disaster.

- *Principal Cause Test*—this test weighs the various causes that contributed to the worthlessness of the corporation and is met if the federally declared disaster is the principal cause of the worthlessness (*i.e.*, greater than 50%).

- *But For Cause Test*—this test is met if the taxpayer can demonstrate that the worthlessness would not have occurred "but for" the federally declared disaster, even though the disaster is neither the sole nor principal cause. In making this determination, it is not relevant that the worthlessness would have occurred at a later date had the disaster not occurred – the inquiry focuses on whether the stock became worthless *at the time of the disaster*.

The Sole Cause Test seems overly strict because it excludes from the purview of Section 165(i) a WSD with respect to which the pandemic played a critical, but not exclusive role. Reasonable arguments can be made in favor of the Principal Cause Test as balancing the potential permissiveness of the Realization Model in not requiring any apportionment. On balance, however, we recommend applying the But For Test, which appropriately limits the application of Section 165(i) to a WSD to circumstances where the WSD would not have occurred without the COVID-19 pandemic.

Apportionment Model—The Apportionment Model generally is not an "all-or-nothing" test like the Realization Model. Instead, the taxpayer is required to assess all the facts and circumstances to determine the relative causes of the worthlessness. Based on the facts and circumstances, the taxpayer determines what percentage of the decline in value of the stock is "attributable to" the federally declared disaster (*i.e.*, the COVID-19 pandemic disaster in the United States) and only that portion is eligible for the Section 165(i) election. The Apportionment Model attempts to more accurately reflect the extent to which a loss claimed through a WSD is caused by the COVID-19 pandemic. Applying the Apportionment Model to the facts in Example 2 above, the taxpayer would only be permitted to make a Section 165(i) election with respect to the $50 of stock loss that is attributable to the COVID-19 pandemic. Arguably, this avoids the Realization Model's potential over-inclusiveness in a situation where the disaster is the identifiable event of worthlessness, but the stock had lost most of its value prior to the disaster due to unrelated causes, and the Realization Model's under-inclusiveness in a situation where another event or circumstance is the identifiable event of worthlessness, but most of the loss of value was caused by the COVID-19 pandemic.

The following factors are representative of those that might be considered for purposes of the Apportionment Model:

- Whether the operations of the corporation were entirely or only partially disrupted by the disaster;
- Whether the corporation was making economic profits or losses prior to the disaster;
- Whether the value of the stock that became worthless was dependent on specific macroeconomic conditions (*e.g.*, interest rates) or asset prices (*e.g.*, oil prices), and whether the disaster directly affected those conditions or prices;
- How close the fair market value of the stock that became worthless was to zero prior to the disaster;
- Whether the corporation had commenced a Title 11 (or similar) proceeding prior to the declaration of the disaster; and
- Whether there were additional objective factors not related to the disaster that would reasonably suggest that the corporation's stock was very likely to have become worthless regardless of whether the disaster occurred.

The Apportionment Model apportions the WSD between a disaster loss (which gets relocated under Section 165(i) to the preceding year) and a non-disaster loss (which presumably is taken in the disaster year). This may raise technical questions as to whether there is any authority supporting the proposition that a loss from a single asset and a single realization event can be taken into account in two separate taxable years. On the one hand, one may argue that under the Code and Regulations, in a realization-based system, such a loss can only be taken in its entirety in one taxable year. On the other hand, one may argue that the "attributable to" language of the Regulations under Reg. §1.165-11 bifurcates the WSD into two different realized losses, only one of which is "attributable to" the COVID-19 pandemic. Thus, that loss is relocated to the preceding year, but the other loss stays in the disaster year (this would effectively mean that there are two different realization dates resulting from the same event).[28]

Another important consideration of the Apportionment Model is that determining the portion of the WSD caused by the COVID-19 pandemic may be complex and the extent of causation may be subject to different interpretations. For example, it may be difficult to distinguish with any precision between the loss of value attributable to a general economic decline in an industry and the loss of value attributable to the COVID-19 pandemic. As another example, in an economically interconnected world, the extent to which the COVID-19 pandemic as a U.S. disaster rather than a global disaster is responsible for loss of value is likely to be a difficult determination that needs to be assessed based on a corporation's particular facts and circumstances. For example, a corporation and its subsidiaries may have business activities both within and outside of the United States that are highly dependent on each other and that were both impacted by the COVID-19

[28] *Cf.* CCA 200642001 (Oct. 20, 2006) ("Making a section 165(i) election causes the loss to be treated as incurred in the prior taxable year for federal income tax purposes, which prevents it from being taken into account in determining the amount of . . . loss for the current taxable year.) The issue does not appear to arise with respect to a casualty loss that results in partial worthlessness of an asset in circumstances in which the asset is later sold, and the remaining loss is recognized; under Reg. §1.165-7, the casualty itself entitles the owner to a deduction with or without the later realization event.

pandemic. Distinguishing the portion of the economic damage caused by the COVID-19 pandemic within the United States from the portion caused by the global aspects of the COVID-19 pandemic is likely to be challenging at best because the two are in reality interconnected (*e.g.*, governmental action in one jurisdiction may have been undertaken, at least in part in reaction to governmental action or health-related conditions in another jurisdiction). Moreover, one's ability to weigh the relative importance of causal effects may change over time and an Apportionment Model may require a reassessment over time. For these reasons, the Apportionment Model seems to present significant administrative challenges for taxpayers and the governmental alike, both of whom are likely to have difficulties in distinguishing the magnitude of the effects of the COVID-19 pandemic within the United States from its global effects or other factors contributing to the loss of stock value.

To ease the administrative burden somewhat, the Apportionment Model can adopt a simplifying 80/20 convention. Under this convention, (i) if more than 80% of the WSD was caused by the disaster, then the taxpayer may treat 100% of the WSD as attributable to the disaster; (ii) if between 20% and 80% of the WSD was caused by the disaster, then the taxpayer may treat the applicable percentage of the WSD as attributable to the disaster; and (iii) if less than 20% of the WSD was caused by the disaster, then none of the WSD is treated as being attributable to the disaster. Although this convention could reduce complexity around the edges, valuation challenges would remain substantial as a general matter.

Although we did not reach a unanimous consensus regarding whether the Realization Model or the Apportionment Model should be applied in determining whether a WSD is attributable to a federally declared disaster, a clear majority of the Executive Committee of the NYSBATS supports use of the Realization Model. Thus, we recommend that Treasury and the Service consider issuing guidance under Section 165(i) adopting the Realization Model.

D. Determining Whether the WSD is Otherwise Allowable: "Time Traveling" Considerations in General

1. Background

Section 165(i)(2) elaborates on the mechanics of the special timing rule of Section 165(i) by stating that the casualty[29] resulting in the loss is treated, for all purposes of the Code,[30] as occurring in the preceding year.[31] Unlike other rules in the Code (*e.g.*, Sections 172 and 1212), Section 165(i) arguably transports the actual event underlying the loss rather than merely "carrying" the loss from

[29] Section 165(i) uses both the terms "disaster" and "casualty" in describing the loss incurred by the taxpayer. *See* Section 165(i)(1) and (2). The IRS addressed this discrepancy in a preamble to the final regulations by concluding that the term "casualty" as used in Section 165(i) is merely a synonym for "disaster." T.D. 7522 (December 16, 1977). Furthermore, the IRS determined that the Section 165(i) election is properly available whenever a taxpayer incurs a deductible "disaster" loss whether or not that loss is technically a "casualty" loss. *Id*.

[30] *See, e.g., Godwin v. Comm'r*, T.C. Memo 2003-289 (Section 6404 interest abatement rules as in effect in the taxable year preceding the disaster year, rather than as in effect in the disaster year itself, applied to the Section 165(i) loss deduction).

[31] *See* CCA 200642001, *supra* note 28; former Section 165(h) (provided the same approach from 1962 through 1982).

the disaster year to the preceding year. Stated differently, the Section 165(i) election seems to require "time travel" with respect to the "disaster loss."[32]

Regulations under Section 165(i)[33] expand on the Section 165(i) time travel paradigm by providing that, if a taxpayer makes a Section 165(i) election with respect to a particular disaster occurring during the disaster year, the disaster to which the election relates is deemed to have occurred, and the disaster loss to which the election applies is deemed to have been sustained,[34] in the preceding year.[35] Thus, there are two aspects of time travel under the Regulations: first, the disaster is deemed to have occurred in the preceding year; and second, the disaster loss is treated as having been sustained in the preceding year. Having relocated the disaster and the disaster loss to the preceding tax year, Section 165(i)(1) and Reg. §1.165-11(a) then direct the taxpayer to "deduct" (or "take into account") such sustained loss in the preceding year.[36]

The exact parameters around the implementation of the time traveling deduction for a disaster loss are not entirely clear. There is very little by way of published guidance on how taxpayers are to apply Section 165(i) time traveling, especially with respect to a WSD that is a disaster loss.

There may be many different approaches as to how the Section 165(i) time traveling paradigm is to apply to a WSD. As described above, Reg. §1.165-11(b)(3) provides that a disaster loss must be "otherwise allowable as a deduction for the disaster year under [S]ection 165(a) and [Reg.] §§1.165-1 through 1.165-10." Depending on how far taxpayers take the time traveling paradigm,

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[32] A "**disaster loss**" is a "a loss occurring in a federally declared disaster area that is attributable to a federally declared disaster and that is otherwise allowable as a deduction for the disaster year under Section 165(a) and [Reg.] §§1.165-1 through 1.165-10." Reg. §1.165-11(b)(3). For this purpose, "**disaster year**" is the taxable year in which the taxpayer sustains the disaster loss. Reg. §1.165-11(b)(4).

[33] *See, e.g.,* Reg. §1.165-11 (providing rules and procedures for making and revoking an election to claim a disaster loss in the preceding year).

[34] To be allowable as a deduction under Section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. *See* Reg. §1.165-1(b); Reg. §1.1001-1(c)(1). Thus, a loss "sustained" has been realized and recognized, and also has been preliminarily quantified. *See, e.g.*, Reg. §1.1001-1(a) ("a loss is sustained to the extent of the difference between [the] adjusted basis and the amount realized"); Rev. Rul. 74-293, 1974-1 C.B. 54 ("the excess of the taxpayer's basis in the shares over the amount realized from their sale is a loss sustained from the sale of a capital asset").

[35] Section 165(i)(2); Reg. §1.165-11(c). The relocation of the disaster occurs for purposes of the Code. Section 165(i)(2). *See also* CCA 200642001, *supra* note 28; *Godwin*, *supra* note 30.

[36] Section 165(i)(3), however, seems to provide a limitation on the conceptual time travel otherwise created by Section 165(i) and Reg. §1.165-11. In particular, under Section 165(i)(3), the amount of the loss taken into account in the preceding year shall not exceed the uncompensated amount determined on the basis of the facts existing at the date the taxpayer claims the loss. That is, when applying the general Section 165(a) proscription on claiming loss deduction to the extent they may be compensated for by insurance or otherwise, Section 165(i)(3) imputes the taxpayer's disaster year knowledge of compensation back to the preceding year; in this way, taxpayers are unable to assert a preceding year deduction through ignoring the potential compensation. *See also* S. Rept. 92-1082 (1972) (1972-2 C.B. 713, 714-715) ("The amount of any reimbursement to which the taxpayer is entitled or has a reasonable prospect of receipt with respect to the disaster will be determined as of the date on which he files an amended return or claim for refund deducting the disaster loss in the preceding year. Any subsequent additional reimbursement would be includable in the taxpayer's gross income under the 'tax-benefit rule,' in the year in which it was received or accrued.").

the approach may impact the determination of whether, and to what extent, the WSD is otherwise allowable for several reasons, including:

(1) it may impact how the taxpayer calculates its WSD, that is, which facts are used in determining the amount of the WSD;

(2) it may impact the application of various limitations that determine whether, and to what extent, the WSD would be allowed, including by impacting in which year such limitations may apply; and

(3) it may impact the character of the WSD.

Determining the correct approach in applying this Section 165(i) time traveling paradigm may depend upon the underlying policy considerations for the election. When examining the statutory and regulatory text and the legislative history, there appear to be two animating policies which may be thought of as competing, or perhaps complimentary, namely that the Section 165(i) election provides:

(1) a timing benefit for taxpayers to quickly recover any tax benefits of a disaster loss, and

(2) a mechanism permitting taxpayers to apply disaster losses in a "normalized" year (*i.e.*, the preceding year).

The legislative history, along with a close reading of the statute and Regulations, may shed light on which of these two policies should guide a taxpayer and the government in determining the circumstances in which a taxpayer may properly claim the benefits of a Section 165(i) election for a WSD.[37]

a. Congress Provides Tax Relief for Taxpayers with Casualty and Disaster Losses

Former Section 165(h)[38] was signed into law on March 31, 1962. The legislation was enacted in response to the Ash Wednesday Storm of 1962 that hit the eastern seaboard of the United States just three weeks prior on March 5 through 9, 1962. Congress acted quickly out of concern that taxpayers affected by the storm would not have the resources to pay their 1961 tax liability, which were due on April 15, approximately a month after the storm. On the Senate floor, Senator Williams of Delaware (a state hit hard by the storm) stated: "Next month many persons will be filing their 1961 tax returns, and they do not have the money with which to pay the tax. Many of these citizens will have to become tax delinquents when, in reality, they are entitled to this deduction next year anyway. All we are asking is that they be allowed to estimate their losses and

[37] Numerous provisions in the Code and Regulations implement versions of "time travel" in the sense that items may be carried back or forward to a taxable year different from the taxable year, or deferred until a later taxable year, in which the tax item originated. *See, e.g.*, Section 172; Section 267(f); Section 469; Section 1212; Reg. §1.1502-13. Section 165(i) generally differs from these provisions in that Section 165(i) transports not only the tax item but the underlying event giving rise to the tax item. As a result, the principles underlying these other provisions shed limited light on the principles of the Section 165(i) time travel.

[38] Pub. L. No. 87-426, Sec. 2. Section 165(i) was originally enacted as Section 165(h) and later renumbered and revised as section 165(i) in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Sec. 203.

to take the deduction when computing their 1961 liabilities."[39] Senator Beall of Maryland stated that "this is a proposal to allow these people cash refunds now so that they can rehabilitate themselves, rather than wait until 1963, when they would ordinarily get the money."[40]

This legislative history emphasizes that the timing of the storm hit taxpayers particularly hard because the storm occurred after the close of the 1961 tax year and shortly before 1961 taxes were due.[41] Congress acted to provide taxpayers with an additional cash infusion by relocating their casualty loss deduction to the preceding year to reduce their 1961 tax liability, which provided increased tax refunds or reduced out-of-pocket expenses for their taxes due.[42]

b. Congress's 1972 Amendments to Section 165(i) Election

In 1972, Congress amended former Section 165(h) in two significant ways.[43] First, Congress expanded the taxpayer election to apply to losses attributable to disasters that occur at any time during the year.[44] Thus, taxpayers were no longer required to wait until the year after the disaster to obtain the tax relief from their disaster losses that were incurred later in the taxable year.

Second, Congress amended former Section 165(h) to read, in relevant part, as follows:

> . . . Such deduction shall not be in excess of so much of the loss as would have been deductible in the taxable year in which the casualty occurred, ***based on facts existing at the date the taxpayer claims the loss*** [(the "**Former Section 165(h) Reimbursement Limitation**")]. If an election is made under this subsection, the casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed. [Emphasis added.]

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[39] 108 Cong. Rec. 4146 (March 14, 1962).

[40] 108 Cong. Rec. 4147 (March 14, 1962).

[41] "The reason that such action is necessary is that the storm struck at such an early date in the year; the damage occurred after the tax liability for the last year had been established but before it has been paid. If the damage had occurred in October or November, the taxes for the previous year would have been paid. . . . [T]hey could claim these losses within a couple of months." 108 Cong. Rec. 4149 (March 14, 1962).

[42] As originally enacted, former Section 165(h) provided an exception to the general timing rule of Section 165(a) by allowing a disaster loss to be deducted in the immediately preceding year. Former Section 165(h), as originally enacted, read:

> Notwithstanding the provision of [Section 165(a)], any loss
>
> (1) attributable to a disaster . . ., and
>
> (2) occurring in [a federally declared disaster area],
>
> at the election of the taxpayer, may be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred. Such deduction shall not be in excess of so much of the loss as would have been deductible in the taxable year in which the casualty occurred [(the "**Former Section 165(h) General Limitation**")]. If an election is made under this subsection, the casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed.

[43] Publ. L. No. 92-418, Sec. 2(a); Publ. L. No. 92-336, Sec. 2.

[44] Prior to 1972, the former Section 165(h) election applied only to losses attributable to disasters occurring before the due date (without regard to any extensions) for the taxpayer's return for the preceding year.

Congress made this amendment because Congress had become concerned that, when engaging in time travel, taxpayers could avoid the "not compensated for by insurance or otherwise" limitation in Section 165(a)[45] by claiming that, in the preceding year, it had no knowledge of reimbursement.[46]

c. Congress Provides Additional Insights in TEFRA

In the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, former Section 165(h) was struck from the Code and Congress added Section 165(i). Although Section 165(i) closely resembles former Section 165(h), some differences warrant mention:

- First, former Section 165(h) provides that the loss may be "deducted" in the preceding year whereas Section 165(i)(1) provides that the loss may be "taken into account." The TEFRA Conference Report is silent as to the reason that the language changed from "may be deducted" to "may be taken into account" and to whether such change was meant to be significant.[47] However, given that current Reg. §1.165-11(a) states that Section 165(i) allows a taxpayer to "deduct" the loss in the preceding year, and that Reg. §1.165-11 was finalized in 2019, it appears that "deduct" and "take into account" have the same meaning for purposes of Section 165(i).
- Second, the Former Section 165(i) Reimbursement Limitation is now reflected in Section 165(i)(3), which limits its scope to the "not compensated for by insurance or otherwise" qualifier in Section 165(a) in agreement with the legislative history underlying the Former Section 165(h) Reimbursement Limitation.
- Third, the Former Section 165(h) General Limitation was struck from the Code and was neither reenacted nor rearticulated in the newly added Section 165(i).

TEFRA also added a new subsection to Section 165, specifically current Section 165(h)(2), which limits the deduction of an individual's casualty and theft losses only to the extent that the individual's loss exceeds 10 percent of the individual's adjusted gross income ("**AGI**"). Importantly, the TEFRA Conference Report provides some guidance as to how this AGI limit should be applied in conjunction with a Section 165(i) election (the "**1982 Legislative History**"):

> Individuals who elect to take into account a nonbusiness disaster loss for the taxable year prior to the taxable year in which the disaster occurred must use the adjusted gross income of the prior taxable year in determining the extent to which the loss is *deductible*. . . . For example, if a calendar year taxpayer experiences a disaster

[45] Section 165(a) provides that "there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise" [emphasis added].

[46] *See* S. Rept. 92-1082 (1972) (1972-2 C.B. 713, 714-715) ("The amount of any reimbursement to which the taxpayer is entitled or has a reasonable prospect of receipt with respect to the disaster will be determined as of the date on which he files an amended return or claim for refund deducting the disaster loss in the preceding year. Any subsequent additional reimbursement would be includable in the taxpayer's gross income under the 'tax-benefit rule,' in the year in which it was received or accrued.").

[47] Furthermore, there does not appear to be any analysis (legislative history, IRS, or judicial) with respect to the distinction in the language, if any.

loss in 1983 and elects to claim the loss for the calendar year 1982, the loss will be deductible only to the extent it exceeds 10 percent of the taxpayer's 1982 adjusted gross income.[48] [Emphasis added.]

d. Joint Committee on Taxation Explanation of Section 165(i) in Connection with Disaster Tax Relief Legislation

The Joint Committee on Taxation, in its "Technical Explanation" of the Disaster Tax Relief Act of 2008[49] (the "**2008 JCT Technical Explanation**"), which, among other things, eased the Section 165(h) AGI limits, stated that:

> The provision generally applies to taxable years beginning after December 31, 2007. The provision applies to the taxpayer's last taxable year beginning before January 1, 2008, solely for purposes of determining the amount *allowable* as a deduction with respect to any net disaster loss for such year by reason of an election under section 165(i).[50] [Emphasis added.]

2. Policy Considerations and Potential Time Traveling Models under Section 165(i)

Although some guidance may be gleaned from a close reading of the statute, Regulations, and legislative history of Section 165(i), given the ambiguity as to how the "otherwise allowable" for the disaster year rule of Reg. §1.165-11(b)(3) is to applied,[51] the practical application of a time traveling model should be informed by the underlying tax policy considerations for the Section 165(i) election. To that end, as previously stated, there seems to be two competing (or perhaps complimentary) tax policies at play here, namely that the Section 165(i) election provides a (i) timing benefit for taxpayers to quickly recover any tax benefits of the disaster loss (the "**Timing Benefit Policy**") and (ii) mechanism permitting taxpayers to use disaster losses to the same extent that they would be able to do so in a "normalized" taxable year (*i.e.*, the preceding year) (the "**Normalization Policy**").

In providing the election, Congress acknowledged this Timing Benefit Policy – that the taxpayer may benefit from using the disaster loss deduction as soon as possible.[52] The original legislation

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[48] S. Rep. 97-760, 182 Cong. Rec. (Part 12) 21585 (August 17, 1982).

[49] H.R. 7006 (110th Congress). The Disaster Tax Relief Act of 2008 was passed in the US House of Representatives on September 24, 2008, but no action was taken on the legislation in the US Senate.

[50] Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 7006, the "Disaster Tax Relief Act of 2008"* (JCX-73-08), September 24, 2008.

[51] It should be noted that ambiguity concerning the interpretation of "otherwise allowable" may exist with respect to disaster losses other than WSDs. However, the issue seems more acute with respect to WSDs, which are more likely to be capital losses subject to the capital gain limitation and which are more likely to be widespread in light of the depth and breadth of the economic disruption from the Covid-19 pandemic. Accordingly, the Report addresses the issue only in the WSD context.

[52] *See also Matheson v. Comm'r*, 74 T.C. 836 (July 24, 1980). In the majority opinion, Judge Tietjens stated that "[a]ccording to S. Rept. 92-1082 (1972), . . . the purpose of section 165(h) is to allow taxpayers suffering these losses

was enacted just a few weeks before the preceding year's tax liability was due. Thus, the ability to use the disaster loss in the preceding year provided taxpayers a welcomed cash infusion to help recovery efforts from the destructive nature of the disaster.

Likewise, Congress acknowledged that, in a disaster year, taxpayers are likely to have lost income, incurred additional costs, and suffered casualty losses—a combination of factors that, together, likely result in a taxpayer having an overall loss, which reduces the benefits of a casualty or disaster loss in the disaster year. While debating the original enactment of the Section 165(i) election, Senator Williams of Delaware explained that "many of [the people that suffered losses in the Ash Wednesday Storm of 1962] will not earn any money [in 1962] because they have lost their means of livelihood. It will take a full year for them to get their property reconstructed and back into operation. Therefore, there may be no 1962 tax liability."[53] Allowing a taxpayer to relocate a disaster loss to the preceding year allows the taxpayer to deduct such losses in a more normalized year (*i.e.*, a year in which the disaster loss is more likely to provide the taxpayer a benefit). This is similar to other policies that allow taxpayers (particularly C corporations) to "average" their taxable years by providing for the carryover of operating and capital losses.[54] This policy is also present in other disaster tax relief legislation[55] where Congress routinely permits individual taxpayers to use their "earned income" from the preceding year (a normalized year) to determine their eligibility for the earned income tax credit and the refundable portion of the child tax credit (both of which have "earned income" limits) in the disaster year.[56]

The following discussion examines two time traveling models designed to achieve the stated tax policy goals of the Timing Benefit Policy and the Normalization Policy. The merits and shortcomings of each of these models are also discussed.[57]

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to receive an immediate tax benefit to help restore their lost homes or businesses. By so doing, section 165(h) aims to prevent any hardship for the taxpayer who otherwise would have been required to wait for relief until he filed his return for the year in which the disaster actually occurred." *Id*. at 839. In his concurring opinion, Judge Chabot stated that "[a]lthough section 165(h) clearly was intended to permit taxpayers to secure the tax benefits of disaster loss deductions sooner than they normally would, the language that was enacted is not so limited. The statutory language imposes no requirement that the rules of this subsection are to apply only if they would result in an earlier tax benefit. The statutory language merely provides that the taxpayer has a choice, without stating or necessarily implying when or why the choice is to be made." *Id*. at 841-42.

[53] 108 Cong. Rec. 4147 (March 14, 1962).

[54] *See* Sections 172 and 1221.

[55] *See, e.g.*, former Section 1400S(d) (Hurricanes Katrina, Rita, and Wilma); Pub. L. No. 110-343, Section 702(a)(1)(F) and (d)(14) (the 2008 Midwestern floods); Pub. L. No. 115-63, Section 504(c) (Hurricanes Harvey, Irma, and Maria); Pub. L. No. 115-123, Section 20104(c) (certain California wildfires).

[56] Joint Committee on Taxation, *Background Related to Certain Temporary and Disaster Relief Tax Provisions* (JCX-22R-19), May 16, 2019.

[57] Another possible time traveling model—rooted in the language of the Regulations providing that the disaster itself is treated as occurring in the prior year—would be require that there be a full recomputation of the amount of the WSD allowable in the prior year. We believe that such a rule is inappropriate as a technical and practical matter, especially as applied to WSDs. As an initial matter, this model seems contrary to the regulatory mandate that a disaster loss to which Section 165(i) may apply must be otherwise allowable in the disaster year; determining the amount and

a. The Timing Benefit Policy and its Implications for the Time Traveling Model

Under a time traveling model that is solely designed to achieve the goals of the Timing Benefit Policy (the "**Lift and Shift Model**"), taxpayers:

> (i) determine the amount of their WSD in the disaster year, using the facts (*e.g.*, basis, fair market value, any compensated amounts) existing at the time the claim is taken,[58] and also taking into account any limitations on the amount of such loss that would be allowed in the disaster year resulting from the interaction of the WSD and other items taken into account in the disaster year (*e.g.*, capital loss limitations under Sections 165(f) and 1211);
>
> (ii) determine whether all, or a portion, of the allowed WSD is a disaster loss (as defined in Reg. §1.165-11(b)(3)) (the "**WSD disaster loss**"); and
>
> (iii) relocate the allowed WSD disaster loss to the preceding year.[59]

When relocating the WSD disaster loss to the preceding year, the loss is added to the taxpayer's other ordinary or capital loss deductions (as the case may be) for the preceding year without any other limitations, adjustments, or modifications.[60] Thus, the policy objectives are met by providing a quicker tax benefit for the taxpayers' disaster losses.

The advantage of this model is that it is aligned with the policy consideration of providing taxpayers with a timing benefit of a quick recovery of their disaster loss. Taxpayers may freely use the WSD disaster loss that was calculated and allowed in the disaster year in the preceding tax year without further limitation—which should achieve the policy goal of providing the taxpayers with a quicker tax benefit for the WSD disaster loss by decreasing the taxpayer's taxable income

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allowability of the WSD (as with a disaster loss with respect to any other asset) as if the disaster actually occurred in the preceding year ignores the requirement that it be otherwise allowable in the disaster year. Interpreting the relocation of the disaster in a literal sense to the prior year and recalculating the amount and allowability of the disaster loss based on the facts that existed then (*e.g.*, stock basis, fair market value, corporate attributes) would undoubtedly be distortive and produce incorrect results. For example, using a snapshot of the facts at the end of the preceding year would seemingly ignore any and all activities that occurred in the disaster year (*e.g.*, dividends and other distributions, contributions, stock sales and other stock transfers) with respect to the worthless stock and the underlying corporation. Are all such events then to be disregarded in determining the taxpayer's income in the disaster year? Additionally, this construct seems unduly burdensome to both the taxpayer and the government and creates unintended consequences that do not seem to improve tax administration but rather frustrate it. As one example, consider a WSD with respect to stock of a consolidated subsidiary. As of the end of the preceding year, the subsidiary may not actually meet the conditions for worthlessness required by Reg. §1.1502-80(c) (*e.g.*, the worthlessness of the subsidiary may have been triggered by a deconsolidation event in the disaster year). Is it possible that relocating the disaster in a strict sense to the preceding year still does not entitle the shareholder to a deduction in that year because of the conditions of the Regulation are not satisfied?

[58] *See* Section 165(i)(3).

[59] The portion of the WSD, if any, that is not a "disaster loss" would be deductible in the disaster year. For a discussion of determining the amount of a WSD that is a "disaster loss" for purposes of Section 165(i) see Part IV.C, *supra*.

[60] This approach finds support in Section 165(i) and Reg. §1.165-11(a), which directs taxpayers to take the loss into account in the prior taxable year. Thus, this arguably directs taxpayers to merely shift the taxable year of the WSD disaster loss after having determined the allowed amount in the disaster year.

(and its corresponding tax liability) for the preceding tax year or by increasing its operating or capital loss (and its corresponding carryovers).

Furthermore, this model seems to be the most straightforward to apply once taxpayers have determined the portion of their WSD that qualifies as a disaster loss. The taxpayer simply adds the WSD disaster loss to its preceding year deductions without having to apply any other adjustments for limitations that might apply in the preceding year and that may serve to further limit the deduction (*i.e.*, simply "lift and shift" the deduction to the preceding year).[61]

This model, however, may be inconsistent with the statutory text and the 1982 Legislative History. First, Section 165(i)(2) relocates not only the disaster loss but also the disaster event—"[i]f an election is made . . ., the casualty resulting in the loss shall be treated for purposes of this title as having occurred in the taxable year for which the deduction is claimed."[62] Similarly, Reg. §1.165-11(c) provides that if an election is made, then the disaster is "deemed to have occurred, and the disaster loss . . . is deemed to have been sustained, in the preceding year."[63] Thus, Section 165(i)(2) and Reg. §1.165-11(c) each specify that it is not merely the deduction that is relocated to the prior taxable year but rather the *disaster itself*. If Congress' intention was simply to relocate the deduction with no potential adjustment or modification, there seems to be no need to create an additional fiction under which the disaster itself is relocated.[64]

Additionally, the 1982 Legislative History specifies that the disaster loss that is deductible in the preceding year is subject to the casualty loss limitation as applicable in the preceding year under current Section 165(h)(2) (*i.e.*, the AGI limitation applicable to disaster losses that are personal casualty losses), and the 2008 JCT Technical Explanation affirms this approach. As a result, it seems clear that Congress contemplated that at least some limitations applicable to the year preceding the disaster year apply with respect to a Section 165(i) limitation and the Lift and Shift Model seems to run afoul of this Congressional intent.

At the same time, by determining limitations on use of the disaster loss by reference to income, gain, and other attributes in the disaster year, the Lift and Shift Model constricts the scope of the relief provided by Section 165(i) to an extent contravening the apparent Congressional intention

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[61] However, it is arguable that under this Lift and Shift Model the capital loss limitation of Sections 165(f) and 1211 may apply twice, both in the disaster year and then again in the preceding year (as capital losses are used to offset capital gains). This may be an additional reason to reject this approach, as there is no indication in the Code, Regulations, or legislative history that this is intended.

[62] Section 165(i)(2). As originally enacted, former Section 165(h) contained similar language—"If an election is made . . . , the casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed." Pub. L. No. 87-426.

[63] Reg. §1.165-11(c).

[64] This can be contrasted with a similar movement of deductions from one year to another with respect to carryovers of NOLs) under Section 172. An NOL carryover is its own type of deduction; that is, in the carryback year, there is no disaggregation of the NOL into its constituent pieces. For example, if a taxpayer has an NOL arising from a disaster loss and the taxpayer does not make a Section 165(i) election, the NOL carryback is a Section 172 deduction (along with other Sections 162 and 163 deductions) in the carryback year rather than a disaster loss deduction in the carryback year. The disaster loss that is carried back as an NOL is also subject to Section 172 limitations, but not subject to other limitations that may apply to disaster losses in the carry back year(s).

to assist taxpayers who, as a result of the disaster, do not generate sufficient income or gain in the disaster year to utilize the disaster loss in that year. For example, a corporate taxpayer with a WSD disaster loss may be subject to limitation in the disaster year under Section 1211 because it lacks sufficient capital gains in the disaster year due to the disaster. In such a case, the Lift and Shift Model limits the ability for that corporate taxpayer to take the WSD disaster loss in the prior taxable year. This result seems inconsistent with the Normalization Policy and the statement of Senator Williams quoted above.

Thus, although the Lift and Shift Model's time traveling model is potentially the most straight forward model for taxpayers to apply as it is most akin to a loss carryback, it seems both over- and under-inclusive and does not reflect statutory and regulatory text or Congressional intent as to how the disaster loss should time travel.

b. The Normalization Policy and its Implications for the Time Traveling Model

The Normalization Policy allows the disaster loss to be taken into account in a more normal taxable year (*i.e.*, the year preceding the disaster year). Thus, taxpayers' use of their disaster losses is not limited by other disaster year adverse effects that taxpayers may endure, including, for example, the absence of income or gain against which to offset the disaster loss. Thus, a model that achieves the goals of the Normalization Policy, while being true to the regulatory requirement that Section 165(i) only operate with respect to a loss that is "other allowable as a deduction for the disaster year", requires a bifurcated analysis: first, determining the amount of the WSD "allowable" as a deduction in the disaster year on a stand-alone basis (*i.e.*, without regard to limitations based on the interaction of the WSD with other items taken into account in the disaster year), and then applying such limitations in the preceding year by reference to other items taken into account in such preceding year (the "**Bifurcated Model**").

Specifically, under the Bifurcated Model, taxpayers:

> (i) tentatively determine the amount of their WSD in the disaster year and whether all, or a portion, of the WSD is a disaster loss (as defined in Reg. §1.165-11(b)(3)) (*i.e.*, the WSD disaster loss), using the facts existing in the disaster year (*e.g.*, basis, fair market value, any compensated amounts), but without regard to loss limitations that restrict the amount actually allowed in the disaster year based on the interaction of the WSD and other items taken into account in the disaster year (*e.g.*, capital loss limitations under Sections 165(f) and 1211); and
>
> (ii) relocate the WSD disaster loss to the preceding year[65] and apply such loss limitations based on items taken into account in such preceding year.

The main difference between the Bifurcated Model and the Lift and Shift Model is that the capital loss limitations and AGI limitations apply to limit the WSD disaster loss in the preceding year and not the disaster year.

[65] The portion of the WSD, if any, that is not a "disaster loss" would be deductible in the disaster year. For a discussion of determining the amount of a WSD that is a "disaster loss" for purposes of Section 165(i) see Part IV.C, *supra*.

The Bifurcated Model gives full effect to a qualitative and quantitative assessment of the WSD in the disaster year on a stand-alone basis, as seems inherent in the requirement that the WSD be "otherwise allowable" for the disaster year; for example, a WSD for which the taxpayer is compensated by insurance in the disaster year is not otherwise allowable because the loss would not have been sustained. At the same time, the Bifurcated Model furthers the Normalization Policy by assuring that abnormal results for the disaster year with respect to other items taken into account in the disaster year do not preclude the recovery that Congress intended (while limiting that recovery to the amount that would have been deductible if an allowable loss of that magnitude had actually occurred in the preceding year).

As previously discussed, taxpayers experiencing disaster losses may have significant reductions to income and significant cost increases. As a result, these taxpayers are likely to have no, or significantly reduced, income and capital gains for the disaster year. Accordingly, requiring that disaster losses be subject to loss limitations as applicable in the disaster year may frustrate the relief provided to taxpayers under Section 165(i). But under the Normalization Policy, taxpayers are permitted to apply any loss limitations based on the interaction of the disaster loss with other items on the return in the preceding year, which allows taxpayers to take such disaster losses in a normalized year for the taxpayer.

With respect to the AGI limitation in Section 165(h)(2), the Bifurcated Model clearly gives effect to Congressional intent as expressed or described in the 1982 Legislative History and the 2008 JCT Technical Explanation. As previously discussed, the 1982 Legislative History supports applying any loss limitations in the preceding year instead of the disaster year. It states that "individuals who elect to take into account a nonbusiness disaster loss . . . must use the adjusted gross income of the prior taxable year in determining the extent to which the loss is deductible."[66] As a policy matter, the same framework should be applied with respect to the capital loss limitations of Sections 165(f) and 1211.

Accordingly, on balance, we recommend that Treasury and the Service issue guidance adopting the Bifurcated Model for Section 165(i) elections to respect to WSD disaster losses.

E. Determining Whether the WSD Is Otherwise Allowable: Application of the ULRs of Reg. §1.1502-36

The following discussion examines the application of the ULRs of Reg. §1.1502-36 to consolidated groups that make Section 165(i) elections with respect to a WSD disaster loss on the stock of a member subsidiary. Treasury and the Service should provide guidance for consolidate group taxpayers with respect to the proper application of the ULRs to this scenario.[67] Without this

[66] S. Rep. 97-760, 182 Cong. Rec. (Part 12) 21585 (August 17, 1982).

[67] Other interesting interactions between the Section 165(i) time traveling and the consolidated return rules include, without limitation, the interaction with deferred intercompany transactions, and separate return limitation years.

Additionally, moving corporate deductions, including a WSD, to a prior taxable year may create circular basis adjustment issues when a consolidated group disposes of the stock of a member, including with respect to a WSD. *See* Reg. §§1.1502-32 & -11. Treasury and the Service may, in connection with any guidance on Section 165(i),

guidance, taxpayers may forgo the Section 165(i) relief provided by Congress decades ago simply to avoid needless complexity or the possibility of being challenged by the IRS on audit.

1. Application of the ULRs under Reg. §1.1502-36

When a member of a consolidated group becomes worthless within the meaning of Reg. §1.1502-80(c), the ULRs under Reg. §1.1502-36 apply to potentially adjust the basis of the worthless stock. The ULRs have two principal purposes—(i) to prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation and recognition of noneconomic loss on member stock, and (ii) to prevent the recognition of two tax losses from a single economic loss that is duplicated, one with respect to the stock of the subsidiary and one with respect to the subsidiary's assets.[68]

A consolidated group that makes a Section 165(i) election with respect to a WSD on a member subsidiary stock deducts the WSD disaster loss in the preceding year, and Section 165(i) treats both the WSD disaster loss and disaster as occurring in the preceding taxable year. Any time traveling model that is used to relocate the WSD disaster loss should not violate the two ULR principal purposes. The following discussion examines the previously described potential time traveling models under the Timing Benefit Policy and the Normalization Policy to determine whether these models satisfy this goal.

a. The ULRs Generally

Reg. §1.1502-36 provides rules for adjusting members' bases in stock of a subsidiary (S) and for reducing S's attributes when a member (M) transfers (including worthlessness) a loss share of S stock.[69] For this purpose, a "**loss share**" is a share of stock with a basis that exceeds its value.[70]

The Regulations apply when M transfers a share of S stock and, after taking into account the effects of all applicable rules of law, the share is a loss share.[71] To address the underlying purposes of the ULRs described above, the Regulations provide two principal rules: (1) a basis reduction rule;[72]

consider addressing any stock basis circularity issues presented when moving such losses and deduction to a preceding taxable year.

[68] Reg. §1.1502-36(a)(2).

[69] Reg. §1.1502-36(a).

[70] Reg. §1.1502-36(f)(7).

[71] Reg. §1.1502-36(a)(3).

[72] Reg. §1.1502-36(c).

and (2) an attribute reduction rule.[73] The consolidated group applies both rules in the given order so long as the share of S stock remains a loss share after each rule is applied.[74]

b. Basis Reduction Rule

The basis reduction rule under Reg. §1.1502-36(c) applies to reduce M's basis in the S shares, but not below value, by the lesser of (i) the share's net positive adjustment and (ii) the share's disconformity amount. Generally, the share's net positive adjustment is the sum of all investment adjustments (generally adjustments under Reg. §1.1502-32(c)) reflected in the basis of the share, but in no event can the net positive adjustment be less than zero.[75] The share's disconformity amount is the excess, if any, of M's basis in the share over the share's allocable portion of S's net inside attribute amount.[76]

c. Attribute Reduction Rule

If, after the application of the basis reduction rule, S's stock continues to be loss stock and such loss is duplicated in S's attributes, the attribute reduction rule generally reduces S's attributes to eliminate the duplication.[77] Specifically, S's attributes are reduced by S's attribute reduction amount immediately before the transfer. S's attribution reduction amount is the lesser of (i) the net stock loss and (ii) S's aggregate inside loss.[78] A special rule applies to provide additional attribute reduction in the case of certain stock transfers due to worthlessness. This rule applies if M transfers a share of S stock solely by reason of worthlessness, M recognizes a net deduction or loss on the share, and S is a member of the group on the day following the last day of the group's taxable year during which the share becomes worthless under Section 165.[79] In such a case, S's attributes are fully eliminated immediately before the transfer.[80]

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[73] Reg. §1.1502-36(d). Additionally, the Regulations provide a basis reallocation rule in Reg. §1.1502-36(b) that generally reduces the disparity in the basis in different blocks of a subsidiary's stock prior to applying the basis reduction and attribute reduction rules. Further, the Regulations include a general anti-abuse rule aimed at transaction undertaken with a view to avoid the purposes of the Regulations or use of the Regulations to avoid the purposes of any other rule of law. Reg. §1.1502-36(g).

[74] Reg. §1.1502-36(a)(3).

[75] Reg. §1.1502-36(c)(3).

[76] Reg. §1.1502-36(c)(4). S's net inside attribute amount is the sum of S's net operating and capital loss carryovers, deferred deductions, money, and basis in assets other than money, reduced by the amount of S's liabilities and is determined after taking into account all applicable adjustments to such amounts even if deemed effective after the transfer of a loss share. Reg. §1.1502-36(c)(5).

[77] S's attributes that are available for reduction under this rule are capital loss carryovers, NOL carryovers, deferred deductions, and basis of certain assets. Reg. §1.1502-36(d)(4).

[78] Reg. §1.1502-36(d)(3)(i). The net stock loss is the excess, if any, of the aggregate basis of all shares of S stock transferred by members in the transaction, over the aggregate value of those shares. S's aggregate inside loss is the excess, if any, of S's net inside attribute amount (as generally determined under Reg. §1.1502-36(c)) over the value of all outstanding shares of S stock.

[79] Reg. §1.1502-36(d)(7)(ii).

[80] Reg. §1.1502-36(d)(7)(i).

2. Application of ULRs to WSD Relocated by the Section 165(i) Election

Consider the following example:

> *Example 3*. Parent (P) of a consolidated group (the "P group") has two subsidiaries, S1 and S2. S1 engages in a line of business that was hit hard by the COVID-19 pandemic. As a result, S1 becomes worthless under Section 165, taking into account the timing rule of Reg. §1.1502-80(c), at the end of the 2020 taxable year. The entire WSD is a disaster loss and is eligible for the Section 165(i) election.
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> At the beginning of the 2020 taxable year, P had a basis of $2,000x in its shares of S1 stock, and S1's net inside attribute amount was $1,000x (consisting of aggregate asset basis in assets of $2,000x and debt of $1,000x). Additionally, the net positive adjustment amount of the shares of S1 stock was $300x.
>
> For its 2020 taxable year, the P group had a consolidated NOL of $200x, which was comprised of S1's NOL of $300x,[81] S2's taxable income of $100x, and P's taxable income of $0. As a result, on the last day of 2020, P had a basis of $1,900x in its shares of S1 stock ($2,000x minus $100x of absorbed S1 NOL), and S1's net inside attribute amount was reduced to $900x (consisting of $1,700x of asset basis, $200x of unabsorbed NOL, and $1,000x of debt). Additionally, the net positive adjustment amount of the shares of S1 stock was reduced to $200x. At the end of 2020, the value of S1's assets is $500x, the creditors of S1 exchange their S1 debt for shares of S1 stock, and the existing shares of S1 stock held by P are cancelled for no consideration. Further assume that (i) all of S1's business activities are located in the US and (ii) prior to the COVID-19 pandemic S1's assets were worth $3,000x (so that the decline in S1's assets is solely attributable to the economic effects of the pandemic).

Let us first assess the application of the ULRs to the WSD without the Section 165(i) election. Under Reg. §1.165-5, P's stock of S1 is worthless and any worthless stock deduction is not deferred under Reg. §1.1502-80(c) because S1 will no longer be consolidated with P. Because the shares of S1 stock are transferred "loss shares", the ULRs apply. Under the basis reduction rules of Reg. §1.1502-36(c), P must reduce its basis in the shares of S1 stock by the lesser of (i) the shares net positive adjustment amount ($200x) and (ii) the shares' disconformity amount ($1,000x, which is $1,900x minus $900x). Thus, P's basis in its shares of S1 stock is reduced by $200x to $1,700x under the basis reduction rule.

Next, P applies the attribute reduction rules of Reg. §1.1502-36(d) because the S1 shares are still loss shares. Under the attribute reduction rules, S1 must reduce its inside attributes by the lesser of (i) the net stock loss ($1,700x) and (ii) the aggregate inside loss ($900x). Thus, S1's unabsorbed

[81] For 2020, S1 had no gross income and $300 of operating expenses that were paid using $300 of cash.

NOL ($200x) is eliminated first and then its basis in its assets is reduced by $700x, from $1,700x to $1,000x.[82]

Accordingly, after the application of the ULRs, P's worthless stock deduction with respect to the S1 shares is $1,700x and the ULRs have operated to eliminate any non-economic loss (by reducing the basis of the S1 stock from $1,900x to $1,700x, thereby reducing P's WSD by $200x) and any duplicated loss (by reducing S1's inside attributes by $900x).

As discussed above, assuming that the P group makes a Section 165(i) election for its $1,700x WSD on its disaster year (2020) return, this disaster loss is relocated to the preceding year (2019). Under both of the time travel models discussed above (the Lift and Shift Model and the Bifurcated Model), the basis reduction rule applies in the disaster year *before* the relocation of the WSD occurs. That is to say, the basis reduction rule determines the amount of the disaster loss that otherwise would be "allowable" in the disaster year (2020). Under the Lift and Shift Model, this occurs because all loss limitations are determined in the disaster year. Under the Bifurcated Model, the ULR limitation is applied in the disaster year because the ULRs are designed to determine the true economic loss on the worthless stock, in contrast to those limitations (the AGI limitation in Section 165(h)(2) or the capital loss limitation under Sections 165(f) and 1211) that are recomputed in the preceding year because they are not a measure of the taxpayer's economic loss and are determined by the interaction with other items on the preceding year return. As a result, the ULRs deny any noneconomic stock loss notwithstanding the relocation of the WSD to the prior taxable year under Section 165(i).[83]

With regard to loss duplication, S1's attributes in the hands of its new owners (*i.e.*, the former creditors of S1) are reduced under the attribute reduction rule notwithstanding the relocation of P's WSD to 2019 under Section 165(i). Accordingly, the ULRs operate to eliminate duplicated loss in the system even though the timing of P's WSD has been altered under Section 165(i) (*i.e.*, the P group gets a single deduction for its stock loss and that loss is not duplicated in attributes used by the P group or available for use by the former creditors after the restructuring transaction).

Thus, relocating the WSD from the disaster year to the preceding year should not change the outcomes achieved under the ULRs.[84] Accordingly, we recommend that Treasury and the Service

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[82] Reg. § 1.1502-36(d)(3), (4).

[83] In determining the consolidated group's WSD in the disaster year, the consolidated group should look to normal tax and accounting conventions (*e.g.*, income, gains, losses, investment adjustments under Reg. §1.1502-32, application of ULRs under Reg. §1.1502-36) in the disaster year to determine its basis in the worthless member's stock at the time of the worthlessness event. When applying the Section 165(i) election, the mechanics of relocating the WSD to the preceding year should not lend itself to a "feedback loop" that then interferes with the determination of the WSD in the disaster year.

[84] One may argue that relocating the loss to the preceding year allows the consolidated group to benefit from the WSD in an earlier year and, at the same time, allows the group to benefit from the member's inside attributes in the disaster year. However, as demonstrated above, because P's stock basis is adjusted in respect of utilization of the inside attributes in the disaster year (S1's $100x NOL absorbed in 2020) before the determination of P's WSD, such utilization neither results in the recognition of noneconomic loss nor results in duplication of loss. Additionally, P's basis in S1 that is reduced by the ULRs ($200x of basis in S1 stock) is not relocated to the preceding year as a WSD,

provide guidance confirming that the ULRs under Reg. §1.1502-36 are applied in the disaster year (and not also in the preceding year) in the manner described above *before* the timing of a deduction for a disaster loss is relocated under Section 165(i).

F. Determining Whether the WSD is Otherwise Allowable: Gross Receipts Test under Section 165(g)(3)

Generally, if any stock or security that is a capital asset becomes worthless during the taxable year, the loss from such worthlessness is treated as a loss from the sale or exchange of a capital asset.[85] However, Section 165(g)(3)(B) provides that that a taxpayer may treat a WSD as an ordinary loss if, in part,[86] more than 90 percent of the aggregate of the underlying corporation's gross receipts for all taxable years have been sourced from generally active income sources (the "**gross receipts test**").[87]

As discussed above,[88] a Section 165(i) election relocates both the disaster loss and the disaster occurrence to the preceding year. Depending upon how far one takes the Section 165(i) time traveling paradigm, taxpayers that make a Section 165(i) election for a WSD (or portion thereof) that is a disaster loss will need to determine whether the underlying corporation's disaster year gross receipts should be taken into account when applying the gross receipts test. For example, an argument could be made that a corporation's disaster year gross receipts should not be taken into account for purposes of the gross receipts test because the WSD disaster loss and the underlying disaster is deemed to have occurred in the preceding year.[89] We think that this argument is inconsistent with the approach to time traveling generally recommended above. As a result, for reasons similar to those discussed above, although Section 165(i) relocates the WSD disaster loss to the year immediately preceding the disaster year, the corporation is likely to be still operational during the disaster year and its gross receipts should not be ignored, notwithstanding the time travel nature of Section 165(i).

Accordingly, we recommend that Treasury and the Service issue guidance confirming that taxpayers are required to take into account the worthless corporation's disaster year gross receipts (in addition to the gross receipts from all prior years) in determining whether the gross receipts test under Section 165(g)(3)(B) is met.

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but that basis is nonetheless not available to be used by the P group to obtain any other tax benefit in the disaster year. Thus, no ULR-based concern is raised by the relocation.

[85] Section 165(g)(1).

[86] Another requirement is that the taxpayer and the corporation are affiliated, that is, that the taxpayer directly owns stock in such corporation meeting the requirements of Section 1504(a)(2). Section 165(g)(3)(A).

[87] For this purpose, "active income sources" means sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. *See* Section 165(g)(3)(B).

[88] *See* Part IV.D, *supra*.

[89] Section 165(i)(2); Reg. §1.165-11(c).