As COVID-19 continued to spread across the United States, President Trump declared the outbreak to be a national emergency on March 13, 2020. That declaration triggered several tax changes that may be of interest to the asset management industry and related portfolio companies. There are very powerful tax code provisions that ordinarily lie dormant but activate for certain periods of time, in certain geographical areas when an event or area is officially designated as a disaster or disaster area. The presidential declaration on March 13 caused the entire United States to become a qualified disaster area due to the COVID-19 pandemic. Below we describe two of the more useful tax provisions to the asset management industry that have now become activated.

**Section 165(i) Disaster Losses**

Section 165(i) provides that any loss attributable to a disaster occurring in a designated disaster area may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred. If the election is made, the event resulting in the loss is treated for tax purposes as having occurred in the year the deduction is claimed (i.e., the preceding tax year). The amount of the loss that can be taken into account in the prior year under this Code provision is unlimited. The only limitations are (i) the loss must be attributable to the disaster (i.e., some direct causation), (ii) the loss must have occurred within the disaster area, (iii) the loss must be of a type deductible under section 165(a) (trade or business activity or a transaction entered into for profit), and (iv) the loss must be uncompensated for by insurance or otherwise.

For asset managers this provision may be useful to bring certain losses in the 2020 year back to 2019 and claim a tax refund. Funds of all types, as well as portfolio companies, may have realized losses post COVID-19 that could benefit from being taken in the 2019 tax year.

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1. Unless otherwise noted, all section references herein refer to the Internal Revenue Code of 1986 (the Code) as amended, and the Treasury regulations promulgated pursuant thereto.
2. Section 165(i)(1). Technically, the statute requires that the area in question be 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. The March 13, 2020 Presidential designation should satisfy this requirement.
3. Section 165(i)(2).
4. Section 165(i)(1) (loss attributable to disaster); Section 165(i)(3) (the amount of the loss taken into account in the preceding taxable year may not exceed the uncompensated amount).
5. Note, corporate taxpayers have a three year carryback period for capital losses but individuals have no carryback period. Section 1212. In the limited circumstances where a Section 165 loss can be ordinary in character, the Section 165(i) procedure may allow a more immediate access to a cash flow benefit than an NOL carry back which would normally have to wait until after the end of the tax year. See Section 172(b)(1)(D) (as amended by the CARES Act in 2020). Utilization of Section 165(i) can, in certain cases, permit the loss to be claimed on the original previous year tax return (assuming not already filed at the time of the disaster loss), thereby allowing an immediate reduction in tax or an expedited refund.
March 13, 2020, that are attributable to the disaster. Such losses may be better utilized in tax year 2019 which may have been more profitable.  

Within a fund context, while no provision within the section 165(i) statute or regulations specifically addresses the issue, it seems the Section 165(i) election is a partnership level election.  

The intent of the Section 165(i) election is to accelerate the 2020 eligible disaster loss to 2019 in order to produce a tax reduction or refund and alleviate cash flow issues for the impacted parties. Thus, depending on where the partnership is within its 2019 tax compliance process at the time the disaster loss is confirmed, the path to generating a tax benefit and/or refund will be different.  

As a practical matter, in the fund context, Section 165(i) may be best utilized within C corporation portfolio companies, joint ventures, co-investment vehicles and other private partnerships.  

Section 165(i) has generally been associated with casualty losses, such as those resulting from hurricanes, earthquakes, or fires, but losses attributable to COVID-19 will not result in the physical damage to property that is generally required for a casualty loss. In fact, the types of losses that may be carried back to the prior year are not limited to “casualty” losses, but include any loss otherwise deductible that falls within the scope of section 165. This was made explicit in amendments to the regulations in 1977 (i.e., T.D. 7522). Indeed, Section 165 is applicable to any loss incurred in a trade or business and losses incurred in a transaction entered into for profit.  

Examples of such losses include, but are not limited to:

- Closure of store and facility locations
- Abandonment of leasehold improvements
- Permanent retirement of fixed assets
- Abandonment of pending business deals for which costs have been capitalized

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4 The subject loss may arise from any of a sale or exchange of property, a worthless security or a mark-to-market loss. See Section 165(a); Treas. Reg. Section 1.165-4

7 Section 703(b). Any election affecting the computation of partnership taxable income is made at the partnership level, except for certain enumerated elections not relevant here. Neither section 165(i) nor the regulations thereunder provide for a partner-level election. It appears, also, that the IRS believes the election to be made at the partnership level. See instructions to Form 4684.

8 As a partnership election this raises several issues. First, as a non-tax issue, the general partner would be moving the tax effects of the loss to the prior year when the partners may have been different or sharing in different ratios. This separates the tax effect from the economic impact which is unusual and could raise contractual and/or fiduciary issues. Second, there are a host of tax issues that arise including the effect of the loss in the previous tax year on Sections 704(b) and 704(c), the possible impact to limits under Sections 704(d), 465 and 469, as well as withholding obligations with respect to partners’ distributive shares in the previous year. Moreover, one would want to consider the previous year’s tax distributions, if any, and the possible claw back implications. In short, one would need to add the 2020 tax year disaster loss into the partnership’s 2019 year and rerun the tax returns to determine the full spectrum of tax implications.

9 If the partnership has extended its 2019 income tax return, and it substantiates the 2020 loss prior to filing the return, it may be eligible to claim the eligible loss on its originally filed 2019 return. Furthermore, if the partnership already filed its original return, but filed a valid extension request, the partnership may be able to file a superseding original return on or before the extended due date and claim the loss on its 2019 return. If neither of these options is available the partnership would need to file an Administrative Adjustment Request (AAR), assuming the partnership is operating under the new centralized partnership audit regime (CPAR) which will be true for most funds. Note that the rules of the CPAR are complex, and the provisions regarding when a partner takes into account the loss under the CPAR regime with respect to an AAR filed for 2019 versus when the partner would take into account the loss if reported on a 2020 Schedule K-1 should be compared. Additionally, to claim a Section 165(i) disaster loss for the 2019 tax year, the taxpayer also must attach a statement to its return providing specific information set out in section 3.02 of Revenue Procedure 2016-53. This information is required to be attached via statement to IRS Form 4684, which is filed with the taxpayer’s return. The revenue procedure provides detailed instructions for submitting the required information.

10 In larger partnerships, especially open-end vehicles, moving a loss from 2020 to 2019 could impact the fiduciary obligation on the general partner to act in the best interest of the partners during each year of the partnership. See Footnote 8, above.

11 Section 165(c).
— Disposal of inventory, supplies and other property that has become unsaleable
— In certain circumstances, termination payments for executory supply or customer contracts, leases, or licenses
— Worthless securities (but not business bad debt debts)
— Depreciated securities if the taxpayer uses a mark-to-market methodology (or the financial instrument is otherwise subject to mark-to-market taxation)
— Losses from the sale or exchange of property.

Many of the relevant losses may be more applicable to portfolio companies than the fund itself but some may occur at the fund and/or management company. In any case, it will be critical for the taxpayer to document causation (i.e., objective evidence that directly associates the loss with the COVID-19 disaster). For many fund level losses this causation requirement will be a gating factor. However, in some instances, e.g., a portfolio company running retail stores that were ordered closed by state/local laws, the causation factor will be more direct.

**Tax-Free Payments To Employees and Partners**

Congress is sometimes criticized when it utilizes the tax code to advance certain public policy or partisan economic goals. But once in a while, the tax code is used for the good of all. This is one of those times. Section 139 of the Code provides much needed tax relief when disaster strikes. Added to the Code in the wake of the 9/11 terrorist attacks, Section 139 permits taxpayers to exclude “qualified disaster relief payments” from gross income. Like Section 165(i) discussed above, Section 139 is only activated upon a qualified disaster.\(^{12}\)

“Qualified disaster relief payments” include, among other things, amounts paid to or for the benefit of an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster.\(^{13}\) If such payments are made by an employer, the payments remain deductible despite the noninclusion by the employee.\(^{14}\)

The payments excludible by an individual under Section 139 do not include any amount that is reimbursable to the individual by insurance or otherwise.\(^{15}\) Moreover, payments representing wage replacement, including paid sick leave, severance, lost wages, unemployment compensation, or business income replacement are not excludable from income.\(^{16}\) Otherwise, there is no limit on the amount that an individual can exclude under Section 139, other than the requirement that the payment be “reasonable and necessary” for personal, family, or living expenses. One previous ruling involving Section 139, in a flood disaster situation, stated as a fact of the ruling that the payments would not reimburse for nonessential, luxury, or decorative items or services.\(^{17}\)

Qualified disaster relief payments, when excluded from gross income under Section 139, would also be excluded from employment withholding taxes, including self-employment taxes. No IRS Form W-2 or Form 1099 reporting would be required. Moreover, there is little to no administration required to qualify for the Section 139 benefit. There is no requirement that employees must account to the employer for

\(^{12}\) A qualified disaster is, among other things, a disaster subsequently determined by the President of the United States to warrant assistance by the federal government. Section 165(i)(1). This cross-reference has been deemed applicable for purposes of Section 139. Rev. Rul. 2003-29, 2003-1 C.B. 587 (Feb. 26, 2003).

\(^{13}\) Section 139(b)(1).

\(^{14}\) Section 162.

\(^{15}\) Section 139(b) (flush language).


their expenses provided the amounts paid by the employer are reasonable in relation to the type of expenses incurred. Likewise, there is no requirement that the employer establish a written plan for administering Section 139 payments. Nevertheless, having a written plan with defined parameters is advisable. Indeed, in a ruling involving employer-provided Section 139 payments, the ruling provided that the employer did have a written program.  

While a virus pandemic is unique in the application of Section 139, as opposed to floods and hurricanes, the additional expenses incurred by individuals as a result of COVID-19 are nonetheless wide ranging and without bounds or an identifiable end. The following is a nonexclusive list of expenses that may qualify for both deduction by the employer and exclusion by the employee where reasonable and necessary as a result of COVID-19.

1. Uninsured medical
2. Child care (including in-person and/or online tutoring due to school closings)
3. In-home technology and materials to work remotely
4. Increased cost of supplies, food, meals, etc.
5. Utility expenses (including internet)
6. Cell phones
7. Transportation
8. Temporary housing and storage in certain circumstances.

Different expenses will be justifiable in different circumstances. Additionally, management companies/portfolio companies may consider making loans available to employees to bridge expected cash flow shortages. Normally, employers can loan up to $10,000 to employees on an interest-free basis without taxable compensation issues. However, in the case of a loan from an employer to an employee eligible for Section 139 qualified disaster relief payments, it may be possible to provide a higher-dollar-value interest-free loan.

The global COVID-19 pandemic is truly unprecedented. But as economic markets continue to operate, asset managers must not only continue to serve their clients but also strive to earn outsized returns. The tax provisions described above can be a silver lining to the dark cloud that is COVID-19. KPMG has asset management tax professionals that can assist you in implementing Section 165(i) and Section 139, as well as other provisions that may be useful to your particular fund or situation.

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18 Id.
19 For purposes of Section 139, guaranteed payments to partners should be equivalent to payments to employees and subject to the same deduction/non-inclusion benefit.
20 Section 7872(c)(3).
21 Note, with respect to all employer/employee payments under Section 139, certain state and local payroll laws may be implicated. This issue is beyond the scope of this article but may be important.
Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.