Helping Business Cope with COVID-19-Related Closures

It's no surprise the COVID-19 pandemic has dealt a major blow to businesses of all sizes. According to one forecast, one in three U.S. restaurants may close permanently this year. This marks an abrupt halt to steady growth seen by many companies over the past two decades. We at Abo and Company are amazed at the resiliency and ingenuity of so many of our commercial clients, especially restaurants, in artfully adapting to a rapidly changing marketplace. Alas, unfortunately we're also seeing so many friends and clients succumb to the economic effects of the novel coronavirus. We don't want to dwell on negative or even depressing topics but perhaps we can suggest certain tax strategies that could help ease the sting?

Dealing with COVID-19-Related Closures

As a result of the COVID-19 pandemic, many businesses were either closed temporarily due to "shutdown" orders or forced to significantly reduce capacity. Also, many of the enterprises' patrons experienced financial distress, which prevented them from spending at the establishment. Other patrons simply decided to just stay home. Many of these businesses were forced to close as a result. In March 2020, President Trump issued a federal disaster declaration with respect to the entire country due to the pandemic.

When a business closes, several types of losses may be incurred. The business may have perishable, seasonal or just rapidly dated inventory that has become unsalable; supplies and smallwares that have become worthless; and expensive equipment, furniture, and fixtures that have declined in value or even become worthless. (In many instances, the pandemic has destroyed the resale market.)

Businesses can generally deduct uncompensated losses. Operations that close as a result of the pandemic must first identify deductible losses and then determine whether those losses are “*disaster losses”* that can even be deducted in the prior year under a special Internal Revenue Code section (if the proper election is made).

Claiming Losses on Asset Sales

A closed or downsized business may sell what it can to generate cash, but many assets will likely be sold at a loss due to a lack of marketability. Asset sales in this situation are generally treated under the normal tax rules for selling assets, but if losses qualify as disaster losses, the election to claim them in the prior tax year is available.

Abandoning Depreciable Property

To the extent a depreciable asset is abandoned, the taxpayer can claim a loss equal to the asset's adjusted basis. In the context of a closed restaurant, retail or other commercial enterprise, this clearly would apply to leasehold improvements made to space rented by the business if it closes and terminates its lease with the building owner, as well as to any other depreciable assets that are abandoned.

Note: Whether or not property is considered abandoned for tax purposes is based on all facts and circumstances. Abandonment must be evidenced by a completed transaction established by an identifiable event. In most cases, the identifiable event will be the physical act of abandonment. In addition, the business must intend to discard the asset irrevocably, meaning it will neither use the asset again nor retrieve it for sale, exchange, or other disposition.

Losses on Nondepreciable Property

A business that closes may have property that can't be sold after it closes. When a business is discontinued and nondepreciable property used in that business suddenly becomes useless, a loss can be deducted in the year it's sustained, which isn't necessarily the year in which an overt act of abandonment occurs or the owner loses title to the property. It appears that a business can deduct the adjusted tax basis in any nondepreciable property (such as inventory, supplies, and smallwares) that became useless when the business closed (to the extent the property isn't disposed of by sale or overt abandonment). Again, if the loss qualifies as a disaster loss, the election to deduct it in the prior tax year is available.

Claiming Losses from Abnormal Retirements

We believe that, in many cases, depreciable assets (such as machinery and equipment) used in a business that has permanently closed due to the COVID-19 pandemic have been *abnormally retired* because their loss of value is due to extraordinary obsolescence. Then, a loss deduction under is available in the year of retirement, even though the assets haven't been physically abandoned.

Note: A retirement is considered abnormal if the asset is withdrawn earlier than the taxpayer customarily retires such assets, or where the asset has been damaged by casualty or has lost its usefulness as the result of an extraordinary obsolescence. Simple nonuse of a restaurant doesn't meet the requirements of an abnormal retirement.

We read about two cases that we think are relevant. In *Tanforan*, the court found that the taxpayer's racetrack had become obsolete and therefore had been abnormally retired because (1) several unforeseeable factors affected the racing industry, (2) it became necessary to make extensive repairs and improvements to the racetrack, and (3) a portion of the taxpayer's already inadequate parking lot was condemned. The court noted that any efforts by the taxpayer to continue to use its property would have been fruitless.

Likewise, in *Keller St. Development*, we saw the court ruled that a small brewery's equipment became extraordinarily obsolete when several national producers moved into its territory and started selling beer at low prices that caused the taxpayer to lose most of its distributors. As a result, the taxpayer abandoned its plans to build an additional facility where the equipment would be used. We think many a restaurant that have closed due to the COVID-19 pandemic are in a similar situation. Their assets suffered extraordinary obsolescence due to external forces that they couldn't foresee or control. In addition to becoming useless in the taxpayer's business, the restaurant equipment had little or no value to other restaurant businesses at the time of closure because other restaurants also were closing or scaling back due to the pandemic.

Determining the Loss Amount

The amount of loss claimed can't exceed the difference between the asset's adjusted basis and any expected proceeds, such as a sale at scrap value or insurance.

Claiming Losses as Disaster Losses

The COVID-19 pandemic has been declared a federal disaster, with the entire country as the designated disaster area. We believe that, absent evidence to the contrary (such as an existing plan to close or a history of operating losses that made closure likely before the pandemic), it can be argued that many business closures in 2020 and perhaps 2021 are attributable to the pandemic disaster. This means the election to deduct losses in the year before the year of the disaster may be available, which accelerates the tax benefit of loss deductions.

Observation: For losses incurred in 2018-2025, individuals can't deduct personal casualty losses (losses on personal-use property) unless they are due to a federally declared disaster. This restriction doesn't apply to business casualty losses.

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