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KPMG report: COVID-19-related inventory impairments; cash flow opportunity for resellers

Wholesalers, retailers, and similar businesses (referred to collectively in this report as “resellers”) may have an opportunity to enhance current cash flow by treating COVID-19-related* inventory impairments as disaster losses eligible to be recovered on the 2019 federal tax return, rather than accounting for those losses through their inventory accounts in 2020. Central to this potential benefit is section 165(i) of the Code.

*COVID-19 refers to the coronavirus (COVID-19) pandemic.

Optional treatment for inventory impairments

Section 165(i) permits taxpayers to elect to treat losses arising from a presidentially declared disaster as having occurred in the prior tax year. Doing so results in all disaster losses arising from that event being deductible on the prior year’s return. This results in a number of potential cash flow benefits, including:

- Immediately reducing the taxpayer’s final extension payment of tax for 2019—eligible companies able to do so by July 15, 2020, may file a request for a “quickie refund” of overpaid estimated taxes; and
- Reflecting the disaster loss deduction on the 2019 rather than 2020 return—potentially creating or increasing a 2019 net operating loss (NOL) eligible to be carried back to profitable, pre-TCJA* years and generating a faster refund.

*TJCA refers to the 2017 tax law that is often referred to as the “Tax Cuts and Jobs Act” (Pub. L. No. 115-97).

Resellers’ option to treat COVID-19-related inventory impairments either as disaster losses or as inventory adjustments arises from Rev. Rul. 77-94. The IRS takes the position that the taxpayer has this option so long as it does not attempt to derive a “double benefit,” and removes from inventory and cost of goods sold any items with respect to which it claims a disaster loss. Although the casualty loss regulations specifically provide that section 165 “does not apply to a casualty loss reflected in the inventories of the taxpayer,” the IRS clarified in GCM 36904 that the provision only prohibits recouping

the loss through both the disaster loss and inventory accounting provisions, and that taxpayers may choose either.

This choice allows resellers to accelerate the recoupment of COVID-19-related inventory losses by making an election under section 165(i) to claim all section 165 losses arising from the pandemic on the 2019 return and including inventory losses for which there has been a “closed and completed transaction” among those claims.

Important considerations

Resellers seeking to benefit from this election should focus on two key aspects.

First, the inventory losses must have resulted from the COVID-19 pandemic. This is a factual showing, focusing on documenting and quantifying the extent of the inventory losses arising from COVID-19-driven business interruptions. For most resellers, establishing the required linkage with the pandemic will not be a high hurdle, but careful documentation and quantification will be crucial.

Second, as with any disaster losses claimed under section 165, the inventory losses must arise from a “closed and completed transaction.” In the context of impaired inventory, this could be inventory that is:

- Sold at a loss (e.g., seasonal inventory unable to be sold due to store closures)
- Donated to a non-charitable organization (otherwise, section 170 rather than section 165 governs, and the deduction is not includible in a section 165(i) election)
- Disposed of or destroyed (whether by the disaster or by the taxpayer because it is no longer saleable)
- Expired, tainted, obsolete or otherwise unsalable (e.g., food inventory)
- Abandoned
- Evidenced by shrinkage (through theft, loss or otherwise)

Cash flow benefits

Upon establishing factually that the inventory loss is attributable to the pandemic and represents a closed and completed transaction, those losses may be included on the 2019 return via a section 165(i) election. Making that election requires following the procedures provided in Rev. Proc. 2016-53. Generally the election is made on either an original or amended 2019 return, and requires attaching a statement with some basic information.

An even faster infusion of cash may be available by requesting a “quickie refund” on Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax*. Under extended filing deadlines, calendar year taxpayers must file the request no later than July 15, 2020, and before filing the 2019 tax return. If available, the quickie refund will result in a refund of overpaid estimated taxes, generally within 45 days (but current realities may slow that time frame).

As with any disaster loss, however, it is important to consider any insurance reimbursements the reseller expects to receive for the inventory impairment.

Other inventory losses

While inventory losses from causes other than the COVID-19 pandemic will be ineligible for the favorable treatment afforded disaster losses, relief may still be available outside of section 165 through the inventory accounting rules. Taxpayers using the lower of cost or market (LCM) method may claim a write-down for items in ending inventory under Reg. section 1.471-4 if the inventory is held for sale at an amount below cost, or if the replacement cost is below original cost, or based on a realizable value for abnormal market conditions.

Taxpayers also may be eligible to claim a write-down under Reg. section 1.471-2(c) for items in ending inventory that are “subnormal,” meaning unsaleable at normal prices or unusable in the normal way because of damage, imperfections, or other similar causes. A decline in the value of inventory due to such factors as style changes, shop wear, change in local demand, and similar operational conditions may be deductible through cost of goods sold in the year when the decline occurs, provided certain evidentiary requirements are met. None of these options depends upon having a factual nexus with the pandemic.

Additionally, food inventory that is consumable and donated in 2020 to charitable organizations may qualify for the enhanced charitable contribution deduction under section 170(e)(3). The *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act) (Pub. L. No. 116-136) has temporarily increased the relevant percentage limitation applicable to eligible donations of food inventory in 2020 from 15% to 25%.

Industry considerations

In addition to traditional wholesale and retail outlets, other enterprises with physical inventories affected by the interruption of their business operations need to consider the potential benefits of either a section 165(i) election or an adjustment to their inventory accounts, as appropriate. These may include, for example:

- Restaurants experiencing food spoilage due to the government-imposed cessation or significant reduction in business;
- Consumer goods, apparel, and other companies donating essential and non-essential goods to non-charitable organizations or individuals such as healthcare workers, first responders, teachers, and sick patients;
- Grocers experiencing abnormal increases in spoilage of perishable or other time-sensitive commodities resulting from government restrictions;
- Theme parks, resorts, or similar enterprises with large volumes of seasonal souvenir or apparel merchandise affected by the protracted closure of parks; and
- Retailers with seasonal merchandise that will remain unsold.

Apart from inventory, resellers may also face a permanent closure of certain locations which could give rise to eligible business losses for leasehold improvements, capitalized lease origination costs, or abandonment of pending expansion plans.

Including inventory losses or other related losses within the company’s identification and calculation of disaster losses eligible for the section 165(i) election will require thorough documentation to support causation (i.e., sufficient evidence that establishes the loss as resulting from the COVID-19 pandemic disaster) as well as accurate computations of the resulting losses, including giving consideration to potential insurance or other financial indemnity. The identification of the eligible cost basis will also require coordination with the taxpayer’s overall inventory method, such as FIFO, LIFO, or LCM, and will

need to take into account the impact on the application of the uniform capitalization rules under section 263A to the remaining inventory.

KPMG observation

Resellers need to consider identifying, quantifying, documenting, and meeting the procedural requirements for claiming such losses in the prior year using the section 165(i) election and recouping any resulting tax refund. Eligible resellers may choose, instead, to account for inventory losses through their current or changing to a more advantageous inventory accounting method.

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