



Tax Issues and the Gulf of Mexico Oil Spill: Legal Analysis of Payments and Tax Relief Policy Options

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Summary

The explosion of the Deepwater Horizon oil rig and subsequent oil spill into the Gulf of Mexico has led to substantial damages, particularly in the form of lost wages and income. BP has begun to make interim payments to compensate for lost income resulting from the oil spill. Given the magnitude of the economic disruption resulting from the spill, however, policymakers may consider exploring alternative mechanisms for providing relief to the affected region. One option is to provide relief through the tax code by adopting measures similar to those employed following past major disasters.

BP is currently making interim payments to claimants “who are not receiving their ordinary income or profit” during the cleanup phase. The IRS has released guidance regarding the tax treatment of these payments in an effort to help taxpayers understand the tax implications of receiving claims payments from BP. This report provides a legal analysis of the tax status of payments received from BP by Gulf Coast victims under current law, and discusses potential legal distinctions between payments received for lost income versus those that may be received to compensate for property loss and physical injuries. Further, this report comments on the tax implications in the event a federal disaster declaration is issued with respect to this incident.

In the past, Congress has used the tax code as a tool to provide relief to disaster victims. While the Gulf of Mexico oil spill has not been classified as a federally declared disaster, the tax code could be used as a mechanism for delivering additional relief. Policy options that could be explored include added casualty loss deductions, an extended net operating loss (NOL) period, employment incentives, enhanced access to retirement savings, and incentives for charitable relief. Similar policies were adopted following past disasters.

The oil spill in the Gulf of Mexico presents lawmakers with unique challenges in using the tax code to provide relief. First, the oil spill is not a natural disaster. The oil spill is the result of human action where, unlike a natural disaster, compensation may be recovered from a financially responsible party. Second, the nature of the damages is different from those typically borne by victims of natural disasters. Specifically, damages may primarily be in the form of lost business income and employment, rather than direct property loss. Relief that has been awarded in the past, such as tax filing extensions to assist with the destruction of taxpayer records, is not likely to be an issue. Finally, if the goal is to provide relief or assistance to the poor, the tax code may not be the best policy instrument.

Legislation has been introduced in the House and is being discussed in the Senate that would provide tax relief to the Gulf Coast oil spill victims. The Oil Spill Tax Relief Act of 2010 (H.R. 5598) would require that any compensation provided by BP to an oil spill victim be treated as a qualified disaster payment, and thereby excluded from gross income for tax purposes. The Gulf Coast Access to Savings Act of 2010 (H.R. 5602) would allow for enhanced access to retirement savings. The Gulf Oil Spill Recovery Act of 2010 (H.R. 5699) would make various tax relief measures available to businesses and individuals. Senate discussions include proposals similar to what has been introduced in the House, as well as a tax holiday for tourism-related activities.

Contents

Tax Relief for Natural Disasters Versus Oil Spill Relief	1
Automatic Tax Consequences of Disaster Declarations	2
Payments to Oil Spill Victims: Selected Legal Issues and Analysis	3
Description of Payments Received	3
Tax Treatment of Payments	4
Section 102 Gift Exclusion.....	4
Section 139 Qualified Disaster Relief Payments Exclusion.....	5
General Welfare Exclusion.....	6
Section 104 Personal Physical Injury or Sickness Exclusion	6
Other Selected Tax Issues Related To Payments	6
Information Reporting Requirements	6
FICA and SECA	7
Expense Deduction	7
Ordinary Income v. Capital Gain.....	7
Oil Spill Tax Relief: Policy Options	8
Tax Treatment of Claims Payments	8
Casualty Losses	9
Net Operating Loss Carryback	10
Employment Incentives.....	11
IRA Distributions	12
Charitable Relief.....	12
Tax Policy Options: Economic Analysis	13
Legislative Response.....	14

Contacts

Author Contact Information	15
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The explosion of the Deepwater Horizon oil rig and subsequent oil spill in the Gulf of Mexico have led to substantial damages, particularly in the form of lost wages and income. BP has begun to make interim payments to compensate for losses resulting from the oil spill. Given the magnitude of the economic disruption resulting from the spill, however, policymakers have begun to explore possible alternative mechanisms for providing relief to the affected region.

As of June 21, 2010, BP had paid out \$105 million in claims.¹ Media reports suggest confusion regarding whether BP payments are subject to tax.² On June 25, 2010, the Internal Revenue Service (IRS) released guidance regarding the tax status of the BP payments.³ This guidance was released following a request from Senator Mary Landrieu.⁴ This report provides a legal analysis of the tax status of payments received from BP by Gulf Coast victims under current law, highlighting the difference between payments received for lost income versus those received to compensate for property loss and physical injuries. Further, this report comments on the tax implications of federal disaster declarations.

Relief through tax policy is one option Congress may want to consider while exploring options for providing relief to victims of the oil spill. In the wake of recent natural disasters, Congress has used the tax code to provide relief to individuals and businesses, and promote charitable giving directed towards those in need. This report provides analysis of various policy options for providing tax relief to oil spill victims, highlighting the circumstantial differences between previous natural disasters and the current oil spill. The report concludes with a brief summary of current legislative efforts.

Tax Relief for Natural Disasters Versus Oil Spill Relief

In recent years, Congress has responded to various natural disasters by providing various tax relief measures.⁵ Typically, measures have been designed to assist victims with property losses, job displacement, and lost taxpayer records. The tax code has been used to provide assistance to both individuals and businesses finding themselves victims of a natural disaster. For example, limits associated with casualty losses for individuals have been scaled back, while businesses have been awarded an extended net operating loss (NOL) carryback period.

¹ Liz Robbins, "Faster Claims Payment Needed, Feinberg Says," *New York Times*, June 21, 2010, available at <http://dealbook.blogs.nytimes.com/2010/06/21/feinberg-seeks-faster-payments-of-bp-claims/>.

² Alan Sayre, "Gulf Coast residents unsure if claims are taxed," *Associated Press*, June 22, 2010, available at http://www.google.com/hostednews/ap/article/ALeqM5jScK8nCmjgoAM7J0mtw_6662Wo0gD9GG61NG4.

³ Internal Revenue Service, "IRS Provides Tax Help, Guidance to Gulf Oil Spill Victims; Special Assistance Day Planned for July 17," press release, June 25, 2010, <http://www.irs.gov/newsroom/article/0,,id=224757,00.html>.

⁴ On June 23, 2010, Senator Mary Landrieu, in a letter addressed to the Treasury and Internal Revenue Service, requested guidance on the tax treatment of BP payments. Specifically, the letter requests guidance on the tax treatment of income replacement payments, property damage payments, and personal injury claims.

⁵ For an overview of tax relief provided following Hurricane Katrina in 2005, see CRS Report RL33088, *Tax Policy Options After Hurricane Katrina*, by Jane G. Gravelle.

In addition to the aid provided through Congressional action for specific disasters, permanent features of the tax code also provide relief.⁶ For example, taxpayers are allowed a deduction for casualty losses.⁷ Limits associated with this deduction have been removed following natural disasters in the past. Another example is that qualified welfare or disaster relief payments are not required to be reported as income. As discussed below, additional tax benefits become available should a disaster be declared a major disaster or emergency under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act).

The oil spill in the Gulf of Mexico presents lawmakers with unique challenges in using the tax code to provide relief. First, unlike other recent disasters, such as the 2005 hurricanes in the Gulf, the oil spill is not a natural disaster. The oil spill is the result of human action, where unlike a natural disaster, there may be a liable party. Second, the nature of the damages is different from those typically borne by victims of natural disasters. Specifically, damages are more likely to be in the form of lost business income and employment, rather than direct property loss. Certain relief that has been awarded in the past, such as tax filing extensions to assist with the destruction of taxpayer records, is not likely to be an issue.

Automatic Tax Consequences of Disaster Declarations

The Gulf of Mexico oil spill has been deemed a Spill of National Significance (SONS) under the National Contingency Plan,⁸ but has not been declared a major disaster or emergency under the Stafford Act. The following paragraphs distinguish the tax consequences of a Presidential disaster designation, a disaster as designated by the Secretary of the Treasury, and a SONS.

Some Internal Revenue Code (IRC) provisions may be affected or triggered by a Presidential disaster declaration under the Stafford Act.⁹ For example, § 139 of the IRC excludes qualified disaster relief payments from recipients' gross income.¹⁰ Exclusion of these payments requires the existence of a qualified disaster, further defined to include any declared disaster or emergency under the Stafford Act.¹¹ As of this date, no Presidential declaration has been made under that authority with respect to the Gulf oil spill.

Other tax provisions that are also triggered by a Presidentially declared disaster include §§ 56 (adjustments in computing alternative minimum taxable income), 165 (disaster losses), 172 (net operating loss), 198A (expensing of qualified disaster expenses), 1033 (involuntary conversions), and 7508A (postponement of deadlines). It appears these provisions require a Presidentially declared disaster and would not be triggered by the other types of declarations discussed below.

Section 139 also defines a qualified disaster to include any event "which is determined by the Secretary [of the Treasury] to be of a catastrophic nature."¹² For example, in 2010, the Secretary

⁶ See CRS Report RL33642, *Permanent Tax Relief Provisions for Disaster Victims as Presented in the Internal Revenue Code*, by Jennifer Teefy.

⁷ This deduction is allowed for losses incurred in instances other than natural disasters as well.

⁸ 40 C.F.R. part 300.

⁹ 42 U.S.C. § 5121 *et seq.*

¹⁰ I.R.C. § 139.

¹¹ I.R.C. § 139(c)(2) (borrowing definition of "federally declared disaster" from I.R.C. § 165(h)(3)(C)).

¹² I.R.C. § 139(c)(3).

has used this authority to designate the earthquakes in Haiti and Chile to be qualified disasters for purposes of § 139.¹³

On April 29, 2010, Homeland Security Secretary Janet Napolitano declared the Gulf oil spill a Spill of National Significance (SONS). This is a term used under the National Oil and Hazardous Substances Pollution Contingency Plan (NCP), and is defined as

a spill that due to its severity, size, location, actual or potential impact on the public health and welfare or the environment, or the necessary response effort, is so complex that it requires extraordinary coordination of federal, state, local, and responsible party resources to contain and clean up the discharge.¹⁴

While such a designation is relevant to the operation of the NCP, it does not automatically result in differential tax treatment for payments or losses arising from the underlying event.

Payments to Oil Spill Victims: Selected Legal Issues and Analysis¹⁵

Currently, BP is making payments to compensate for lost income due to the oil spill. As is discussed below, the payments being made to replace lost income are includible in recipients' gross income because they do not appear to qualify for exclusion. However, it should be noted that if payments are made in the future to compensate for property damages or personal injury, they may qualify for exclusion or other favorable tax treatment. Furthermore, while the oil spill is currently a Spill of National Significance, such a declaration does not have direct tax implications. The tax consequences of payments might change if the oil spill is declared a disaster by the President or Secretary of the Treasury.

Description of Payments Received

Under the Oil Pollution Act of 1990, injured persons may recover damages against a party who is responsible for an oil spill. Damages include "the loss of profits or impairment of earning capacity due to the injury, destruction, or loss of real property, personal property, or natural resources."¹⁶ As part of its claims process, BP is currently making interim payments to claimants "who are not receiving their ordinary income or profit" during the cleanup phase.¹⁷ These payments do not represent final resolution of each claim and may be supplemented by subsequent payments in order to address the entire amount claimed. The maximum interim payment received so far appears to be \$5,000, and the average amount has been estimated to be approximately \$3,000 and may increase in the future.¹⁸ According to BP's claims website, the interim payment is

¹³ Notice 2010-16 (I.R.S. 2010); Notice 2010-26 (I.R.S. 2010).

¹⁴ 40 C.F.R. § 300.5.

¹⁵ This section was written by Erika K. Lunder, Edward C. Liu, and Heather S. Klein.

¹⁶ 33 U.S.C. § 2702.

¹⁷ BP, *Claims Submission Form*, available at <https://www.bp.com/secure/iframe.do?categoryId=9033722&contentId=7062138>.

¹⁸ Sharyn Alfonsi, David Muir and Bradley Blackburn, *BP Oil Spill: As Pay Czar Promises Money, Workers Turned Away From BP Claims Center*, ABC NEWS, June 18, 2010, available at [http://abcnews.go.com/WN/bp-oil-spill-ken-\(continued...\)](http://abcnews.go.com/WN/bp-oil-spill-ken-(continued...))

intended to be the equivalent of one month's lost income, based on documentation provided by the claimant.¹⁹

On June 16, 2010, the Obama Administration announced that the claims of individuals and businesses will be administered by an Independent Claims Facility (ICF).²⁰ Payments will come from a \$20 billion escrow account funded by BP. Although specifics regarding the ICF are not available at this time, it is possible that certain characteristics of the ICF, such as the fact that appeals are heard by a three-judge panel, might lend support for its consideration as a governmental entity for purposes of certain tax provisions.²¹

Tax Treatment of Payments

Payments are includible in the recipient's income (i.e., subject to tax) unless specifically excluded by law.²² There are several exclusions that might apply, and an overview of some is provided below. Factors that impact the applicability of an exclusion to a particular payment include (1) whether the recipient is an individual or business; (2) whether the payment's source is BP or a governmental entity; and (3) the nature of the payment (e.g., replacement income for lost wages or damages for property destruction).

As mentioned above, BP is currently making interim payments that are intended to replace lost income. As analyzed below, these payments are taxable to the recipient because they do not appear to qualify for an exclusion. The discussion below primarily focuses on exclusions that might apply to payments received by individuals or small businesses for reasons other than property damage. Future payments might receive different treatment, depending on the specific circumstances and purposes for which they are made.

Section 102 Gift Exclusion

Payments to Gulf Coast residents would likely not fall under the gift exclusion. Internal Revenue Code (IRC) § 102(a) states that the value of property acquired by gift is excluded from gross income.²³ The determination of whether a transfer is a gift is made by looking at the transferor's intent in making it.²⁴ Gifts proceed "from a 'detached and disinterested generosity,' ... 'out of affection, respect, admiration, charity or like impulses.'"²⁵ On the other hand, payments are not gifts when they proceed primarily from a moral or legal duty, from an anticipated economic

(...continued)

feinberg-promises-money-abc/story?id=10956385.

¹⁹ *Claims Submission Form*, *supra* note 2.

²⁰ WHITE HOUSE, *FACT SHEET: Claims and Escrow*, June 16, 2010, available at <http://www.whitehouse.gov/the-press-office/fact-sheet-claims-and-escrow>.

²¹ *See, e.g.*, I.R.C. § 139 and *infra* at "Section 139 Qualified Disaster Relief Payments Exclusion."

²² *See* IRC § 61 ("gross income means all income from whatever source derived ..."); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) ("gross income" includes all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion"); Internal Revenue Service, Press Release, June 25, 2010, available at <http://www.irs.gov/newsroom/article/0,,id=224886,00.html>.

²³ I.R.C. § 102(a).

²⁴ *Comm'r v. Duberstein*, 363 U.S. 278, 285-86 (1960).

²⁵ Notice 2003-18 (I.R.S. 2003) (citing *Duberstein* at 285 (1960), 1960-2 C.B. 428).

benefit, or in return for services rendered.²⁶ BP's intent in making payments is not, on the whole, charitable. BP has a legal obligation under the Oil Pollution Act, and it will likely have a legal obligation under the terms of the ICF. Arguably, BP has a moral duty stemming from its responsibility for the spill. BP may receive an economic benefit from compensating claimants outside of litigation. Lastly, some of the payments are to parties providing services such as cleanup and remediation.

Section 139 Qualified Disaster Relief Payments Exclusion

Payments by BP currently are not excludable as “qualified disaster relief payments” under IRC § 139 (the tax implications of disaster declarations are discussed below).²⁷ Qualified disaster relief payments include payments “to or for the benefit of an individual” for, among other things, “personal, family, living, or funeral expenses incurred as a result of a qualified disaster.”²⁸ These payments are qualified disaster relief payments “only to the extent that any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.”²⁹ It is unclear whether BP's payments would be defined as payments for a personal or other allowed expense. Regardless, for the payments to fall under the § 139 exclusion, designation of the oil spill as a “qualified disaster” would also be required.

Several types of disasters are “qualified disasters.” One, a “federally declared disaster,” is a disaster that the President (pursuant to a request from the governor of the affected state) determines exceeds the response capabilities of the affected state or local governments.³⁰ Examples of federally declared disasters are flooding, severe storms, earthquakes, and tornadoes.³¹ President Obama has not designated the Deepwater Horizon oil spill as a federally declared disaster. Another type of “qualified disaster” is an “event ... determined by the Secretary [of the Treasury] to be of a catastrophic nature,”³² such as the 2010 earthquakes in Haiti and Chile.³³ “Qualified disaster relief payments” are also defined as payments “by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare.”³⁴ For this purpose, “qualified disaster” refers to “a disaster which is determined by an applicable Federal, State, or local authority (as determined by the Secretary [of the Treasury]) to warrant assistance from the Federal, State, or local government or agency or instrumentality thereof.”³⁵

²⁶ *Duberstein* at 285.

²⁷ Disaster payments were originally excluded from income under the Victims of Terrorism Tax Relief Act of 2001 (P.L. P.L. 107-134), which added §139 to the IRC.

²⁸ I.R.C. § 139(b). Another type of “qualified disaster relief payment” is payment “by a person engaged in the furnishing or sale of transportation as a common carrier.” *Id.*

²⁹ *Id.*

³⁰ I.R.C. §§ 139(c), 165(h)(3)(C)(i); 42 U.S.C. § 5170.

³¹ Federal Emergency Management Agency, “2010 Federal Disaster Declarations,” available at <http://www.fema.gov/news/disasters.fema>.

³² I.R.C. § 139(c)(3). A “qualified disaster” may also be “a disaster which results from a terroristic or military action.” I.R.C. § 139(c)(1).

³³ Notice 2010-16 (I.R.S. 2010); Notice 2010-26 (I.R.S. 2010).

³⁴ I.R.C. § 139(b)(4).

³⁵ I.R.C. § 139(c)(4). One question that might arise in the future is whether payments administered by the ICF could fall under this category if the ICF is structured in such a way to permit the conclusion that the funds are being paid by a government instrumentality and there is a “qualified disaster” determination. *See, e.g.*, I.R.C. § 468B(g)(2) (settlement (continued...))

General Welfare Exclusion

Through a series of rulings, the IRS has developed a non-statutory exclusion known as the “general welfare exclusion.” It excludes qualifying payments made by governmental units “under legislatively provided social benefit programs.”³⁶ In order to qualify for exclusion, a payment must (1) be made from a governmental fund; (2) be for the general welfare, which essentially means it must be based on individual or family needs; and (3) not represent compensation for services.³⁷ It appears the interim payments made by BP would not qualify for the exclusion because they represent replacement income and are not made from a governmental fund or based on need.

Section 104 Personal Physical Injury or Sickness Exclusion

For individuals, damages (other than punitive damages) received “on account of personal physical injuries or physical sickness” are excluded from the recipient’s gross income.³⁸ The damages must be received from a legal judgment or a settlement agreement entered into in lieu of prosecution of a lawsuit.³⁹ Excludible damages may include economic ones (e.g., lost wages) that are received because of the personal physical injury or sickness. Physical injury or sickness does not include emotional distress, apparently even if such distress manifests itself with physical symptoms.⁴⁰ Thus, awards for emotional distress are generally taxable unless the emotional distress had its origin in physical injury or sickness.⁴¹ Here, the interim payments currently made by BP to replace lost income would not qualify for the § 104 exclusion since they are not made on account of physical injury or sickness.

Other Selected Tax Issues Related To Payments

In addition to the issues addressed above, the BP claims payments may raise a number of other tax issues. Specifically, there are reporting requirements concerns, questions over payroll tax contributions, questions related to expense deductions incurred while filing claims, and questions regarding categorization of income. The following paragraphs analyze these issues.

Information Reporting Requirements

In order to further voluntary tax compliance, the IRC requires all persons who, in the course of a trade or business, pay another person amounts totaling \$600 or more in a single tax year to file an information return with the IRS regarding such payments. The definition of person in this context includes a corporation and includes payments for compensatory damages for which the payer is

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funds used to pay for cleanup of CERCLA (Superfund) sites are treated as beneficially owned by the United States if four conditions are met, one of which is that a government entity controls the expenditure of funds).

³⁶ See, e.g., Rev. Rul. 2003-12, 2003-1 C.B. 283.

³⁷ See *id.*

³⁸ I.R.C. § 104(a)(2).

³⁹ Treas. Reg. § 1.104-1(c).

⁴⁰ See H.Rept. 104-737 at 301 (footnote 56).

⁴¹ See H.Rept. 104-737 at 301.

liable. Therefore, BP is required by federal law to file an information return, also known as a Form 1099, for each claimant who receives more than \$600. The instructions for Form 1099 require the payer to identify the recipient by name and taxpayer identification number (TIN), which is generally the recipient's Social Security Number (SSN) or employer identification number (EIN). Failure to accurately report identifying information without reasonable cause may result in penalties for the payer.⁴² Additionally, if the recipient does not provide his or her TIN, payments may be subject to backup withholding of 28%.⁴³

FICA and SECA

According to IRS guidance, payments to individuals to compensate for lost wages will not be considered wages for the purposes of Social Security tax and Medicare tax.⁴⁴ The IRS guidance reasons that because such payments were not given for employment, these payroll taxes do not apply.⁴⁵ However, self-employed individuals receiving payments as compensation for lost income have been instructed to include the payment in net earnings from self-employment for the purposes of self-employment tax.⁴⁶ This suggests that BP payments received by the self-employed may be considered "self-employment income" for purposes of the Self-Employment Contributions Act (SECA),⁴⁷ and subject to SECA taxes.

Expense Deduction

Taxpayers for whom these payments are taxable might be able to deduct any costs (e.g., legal expenses) incurred in obtaining the payment. Business taxpayers may generally deduct these costs as "ordinary and necessary" business expenses.⁴⁸ Individuals who are subject to tax on the payments may be able to deduct the costs as a miscellaneous itemized deduction, which are subject to limitations that will prevent the entire amount from being deductible.⁴⁹

Ordinary Income v. Capital Gain

If a payment is included in the recipient's gross income, it must be characterized as ordinary income or capital gain. This is important because it determines such things as the appropriate tax

⁴² I.R.C. § 6721.

⁴³ I.R.C. § 3406.

⁴⁴ IRS, *Gulf Oil Spill: Questions and Answers*, 2010.

⁴⁵ In other situations, courts have held that payments to compensate for lost work can constitute wages for purposes of the Social Security and Medicare payroll taxes. *See, e.g.,* STA of Baltimore-ILA Container Royalty Fund v. United States, 621 F. Supp. 1567 (D. Md. 1985) *aff'd*, 804 F.2d 296 (4th Cir. 1986) (payments from trust fund established as part of settlement between labor union and trade association to compensate longshoremen for lost work constitutes wages for purposes of FICA). However, in this case, the payments for lost wages came from a fund that was controlled by the employer for whom the longshoremen continued to work. It is not clear that the same could be said for the payments for lost wages being made by BP, perhaps justifying the different treatment of the two payments.

⁴⁶ *Id.*

⁴⁷ I.R.C. § 1402.

⁴⁸ I.R.C. § 162. However, if the payment is treated as capital gain, then the expenses should be capitalized so that the cost of the asset can be depreciated over time, rather than currently deducted. I.R.C. § 263.

⁴⁹ I.R.C. § 212.

rate. The characterization is made by looking at the nature of the payment. Payments meant to replace lost income or profits are treated as ordinary income.

Oil Spill Tax Relief: Policy Options⁵⁰

From an economic perspective, tax relief may be justified as achieving distributional objectives or addressing market failures. Market failures occur when resources are not efficiently allocated due to unpriced costs or benefits. Markets may fail to efficiently distribute resources following disasters for a number of reasons. First, imperfect insurance markets may not allow individuals to adequately insure against the risk of a disaster such as a major oil spill. Specifically, the loss to business and individuals may exceed insurance or BP compensation. For example, loss of property may be measured, but it is difficult to quantify and compensate for the loss of a consumer base for businesses. From this perspective, the nation broadly shares the risk of large-scale disasters by providing federal relief where insurance markets are incomplete. Second, labor market frictions may create a mismatch between labor supply and labor demand and resulting in an inefficient distribution of labor resources. A number of workers have been displaced as a result of the oil spill. If these workers are immobile, the excess supply of labor will drive down wages in the affected region relative to wages outside the Gulf region. Given the inefficiency associated with the excess supply of labor resulting from labor immobility, policies that subsidize wages may enhance economic efficiency.

Given that oil spill losses are primarily income rather than property related, Congress may want to consider policies that address the lost ability to earn income. Unlike most natural disasters, the oil spill has not resulted in widespread property loss to individuals and businesses at this time. Compensating individuals will require making up for lost business income, opportunity, and wages.

It is also important to recognize the limitations associated with using the tax code to provide income relief, particularly for low-income individuals with limited tax liability. For individuals without a tax liability, refundable tax incentives are an option. Given the administrative problems oftentimes associated with using the tax code to provide aid, direct spending might be a more efficient mechanism for distributing aid.

Many of the options presented below were used in the wake of Hurricane Katrina. Prior to 2005, the use of tax policy as a tool for disaster relief was relatively limited.⁵¹ Many of the policy options below represent tools that have been used to assist victims of natural disasters.

Tax Treatment of Claims Payments

Unless Congress enacts legislation, BP's payments for lost income will be included in recipients' gross income.⁵² As was discussed above, as a baseline, all forms of income are includible unless

⁵⁰ This section was written by Molly F. Sherlock.

⁵¹ Patrick E. Tolan, Jr., "The Flurry of Tax Law Changes Following the 2005 Hurricanes," *Brooklyn Law Review*, vol. 72, no. 3 (2007), pp. 799-870.

⁵² See IRC § 61 ("gross income means all income from whatever source derived ..."); see also IRS, *Gulf Oil Spill: Questions and Answers*, 2010.

explicitly excluded. While some types of payments received by individuals due to a disaster may qualify for exclusion,⁵³ it does not appear any exclusion would apply to these income replacement payments. Therefore, these payments may be subject to taxation to the extent that the recipients' aggregate income exceeds the federal income tax threshold.

Congress could choose to enact legislation explicitly exempting the BP claims payments for lost income from the federal income tax. Doing so, however, would result in federal revenue losses. If the oil spill had not caused income losses, income earned would have been taxable.

Exempting these BP claims payments from taxation may be appealing despite expected federal revenue losses. Qualified disaster and welfare payments, such as those made to individuals in presidentially declared disaster areas, are excluded from income under the theory they help families put in need by an emergency.⁵⁴ This leaves the following policy questions: (1) should BP claims payments received by oil spill victims be subject to tax, as the income the payments are designed to replace would have been, or (2) should the BP claims payments be treated as welfare payments, as such payments are helping victims put in need by the emergency?

Subjecting BP claims payments to the income tax has the benefit of maintaining federal revenue collections. Requiring claims recipients to pay income taxes on their claims, however, may impose planning burdens on claims recipients. Most wage earners have withholdings taken from each paycheck in anticipation of a future income tax liability. If the BP claims payments do not withhold expected federal income taxes on behalf of recipients, recipients will be responsible for any federal income tax obligations arising out of any claims received. One option could be to require BP to withhold income taxes prior to making payments.

Exempting the BP claims payments from federal income tax provides an additional benefit to the Gulf Coast oil spill victims, but also results in federal revenue losses. Exempting the payments from federal income taxation effectively could be interpreted as making victims more than whole, as income that would have been earned in the absence of the oil spill would have been subject to tax. If BP is to be held fully liable, one may question why the government should forgo revenues by exempting claims payments from taxation.

Casualty Losses

Casualty losses can result from the destruction of, or damage to, property from any sudden, unexpected, or unusual event such as a flood, hurricane, tornado, or fire. Casualty loss payments, such as from insurance or from BP, are not taxed, as the asset being replaced would not be subject to an income tax.⁵⁵

If property is destroyed, damaged, or stolen due to a casualty, taxpayers may be entitled to a deduction for uninsured losses.⁵⁶ Casualty losses are available for losses generally, with

⁵³ See discussion *supra* at “Section 139 Qualified Disaster Relief Payments Exclusion” and “General Welfare Exclusion.”

⁵⁴ Tolan, 2007, p. 810. See also *supra* at “Section 139 Qualified Disaster Relief Payments Exclusion” and “General Welfare Exclusion.”

⁵⁵ See, e.g., IRS, Gulf Oil Spill: Questions and Answers, 2010.

⁵⁶ Casualty losses can be categorized as business losses, employee related losses, or personal losses. Business losses (continued...)

additional loss claims often allowed following a presidentially declared disaster. Personal property, or individual, losses include damages to homes, furnishings, and automobiles. Personal losses are itemized deductions, generally only available to itemizing taxpayers. There are also limitations associated with the personal-use property casualty loss deduction. Specifically, the loss must be reduced by \$100 for each casualty event. Further, a casualty loss deduction is only allowed to the extent such losses exceed 10% of the taxpayer's adjusted gross income (AGI).⁵⁷

The Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343) temporarily changes some of the rules associated with claiming casualty losses for taxpayers in federally declared disaster areas. For the 2008 and 2009 tax years, (1) all taxpayers, including non-itemizers, could claim a disaster loss deduction; (2) the 10% AGI limitation on disaster losses was suspended; (3) a five-year NOL carryback was available for disaster losses (see below); and (4) the amount by which individual taxpayers were required to reduce their personal casualty losses per event was increased from \$100 to \$500 for deductions claimed in 2009.

As an additional benefit for losses in federally declared disaster areas, taxpayers may elect to take losses in the previous tax year. This allows taxpayers to accelerate the benefit associated with the loss deduction during a time of need.

As has been noted above, the majority of damages caused by the BP oil spill are expected to be in the form of lost income. Nonetheless, both individuals and business have suffered property casualty losses as a result of the oil spill. Individuals are currently able to claim casualty losses subject to the limitations discussed above. One option for providing additional relief to those suffering casualty losses due to the oil spill would be to enact provisions similar to those provided under EESA, allowing all taxpayers to deduct losses and suspending AGI limits. Given that BP is expected to compensate individuals for losses, taxpayers should not need reduced tax liability to compensate for losses. If, however, BP payments do not fully compensate for oil spill property losses, favorable loss deductions could be used to help compensate those in need.

Another option would be to provide a casualty loss credit, rather than a deduction.⁵⁸ Under a progressive tax system, deductions are more valuable for higher-income taxpayers. A refundable tax credit would provide a more equitable benefit across income levels. Further, the credit could be limited to a fixed amount, which would limit compensation for taxpayers with higher uninsured losses. It should be noted that providing generous benefits to the underinsured may create moral hazard problems.⁵⁹

Net Operating Loss Carryback

A net operating loss (NOL) occurs when business taxpayers have negative taxable income.⁶⁰ With negative taxable income, a taxpayer has zero tax liability. NOL, however, can be carried

(...continued)

may be treated as net operation losses, and are discussed in the next section.

⁵⁷ IRC §165(h).

⁵⁸ For additional details regarding this proposal, see Tolan, 2007, pp. 848-854.

⁵⁹ Moral hazard describes the situation where a party may take on excessive risk in cases where the party is not responsible for bearing the full burden of outcomes associated with risks.

⁶⁰ For additional background information, see CRS Report RL34535, *Net Operating Losses: Proposed Extension of Carryback Period*, by Mark P. Keightley.

backward or forward to reduce past or future tax liability. Generally, an NOL can be carried back for two years or carried forward for up to 20 years. Taxpayers that carry back an NOL recalculate the earlier years' tax liability and claim a refund for taxes already paid.

Congress has responded to disasters in the past by modifying the NOL carryback rules. The Gulf Opportunity Act of 2005 (P.L. 109-135) extended the carryback period for taxpayers in the Hurricane Katrina, Rita, and Wilma disaster area from two to five years. In 2008, EESA extended the NOL carryback period to five years for certain Midwestern flood-disaster-related losses.

In an amendment to the tax extenders bill (H.R. 4312), Senator Bill Nelson proposed a five-year NOL carryback allowance for oil-spill-related losses (S.Amdt. 4335). Marine-business industry representatives have noted that an expanded NOL carryback period could help businesses in the short term while businesses wait on the claims process.⁶¹ The amendment has not yet been considered by the Senate.

Given the recent economic slowdown, the default two-year NOL carryback may have limited benefit for some businesses negatively affected by the oil spill. For businesses with no taxable income in 2008 or 2009, net operating losses resulting from the oil spill will not result in an immediate refund. Instead, the NOL can be carried forward to reduce future tax liability. The ability to carry back an oil-spill-related NOL for five years, as opposed to two years, increases the likelihood that a taxpayer would have had positive taxable income that can be offset to generate a rebate.

While extending the NOL carryback period may provide cash to businesses negatively affected by the oil spill, such an extension will also result in short-term federal revenue losses. Further, extending the NOL carryback tends to benefit established (as opposed to relatively new) businesses. Established businesses are likely to have past taxable income a current NOL can offset, while new businesses may not have yet been in a positive taxable income position.⁶²

Employment Incentives

Following Hurricane Katrina, two tax credits designed for employment relief were enacted.⁶³ A special application of the Work Opportunity Tax Credit (WOTC) allowed businesses located in the core disaster area a tax credit for hiring, while businesses outside the disaster area were also eligible for a credit for hiring displaced employees.⁶⁴ Similar incentives were available to employers hiring in the New York Liberty Zone following the terrorist attacks of September 11, 2001. A second tax credit, the Employee Retention Credit, was available for small businesses in the disaster area that retained employees after being forced to close following the hurricane.

As jobs losses resulting from the oil spill continue to mount, Congress could consider adopting provisions encouraging the hire of those unemployed due to the oil spill. For example, as was done following the September 11, 2001, terrorist attacks or Hurricane Katrina, the WOTC could

⁶¹ Meg Shreve, "Groups Hit by Oil Spill Support Extended NOL Carryback Period," *Tax Notes*, June 21, 2010, p. 1325.

⁶² CRS Report RL34535, *Net Operating Losses: Proposed Extension of Carryback Period*, by Mark P. Keightley.

⁶³ The Katrina Emergency Tax Relief Act (KETRA; 109-73).

⁶⁴ For background information, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by Linda Levine.

be modified to include oil-spill-displaced Gulf employees as a targeted group for hiring. Expanding the WOTC to encourage hiring those who lost jobs due to the oil spill will increase the costs associated with the credit, resulting in federal revenue losses. Given the high unemployment rates in the region and nation, increasing the demand for a certain subset of workers, by making such workers a targeted group under the WOTC, may enhance employment prospects for such displaced workers relative to employment prospects for the general population.

IRA Distributions

Following Hurricane Katrina, victims located in the disaster area were allowed enhanced access to retirement funds.⁶⁵ Penalties for early withdrawals from individual retirement accounts (IRAs) and 401(k)s were eliminated, and the income tax on these distributions could be spread over three years rather than being due in the first year. Any replacement contributions made in the three years following the distribution could be treated as a rollover. The limits on borrowing from qualified employer plans were also increased.

Allowing Gulf Coast oil spill victims greater access to retirement savings could help affected individuals smooth their income and consumption during this crisis. This benefit, however, is unlikely to provide much assistance to low-income taxpayers who are unlikely to have substantial retirement reserves. Further, high-income taxpayers may not need the additional relief.

Allowing individuals access to retirement savings is unlikely to have substantial negative revenue consequences for the federal government within the budget window. In fact, relaxing the rules surrounding retirement distributions may increase federal revenues in the near term. Essentially, providing enhanced access to retirement funds allows individuals to borrow from themselves in a time of need. So long as these funds are repaid, there should be minimal effect on federal revenues. For individuals who do not repay, and instead take a distribution without penalty, federal revenues increase as these individuals pay taxes in the three years following the distribution rather than at retirement.

Charitable Relief

As a response to past disasters, Congress has adopted legislation to promote charitable assistance to disaster victims. Some of these measures have been designed to make it easier for charities to mobilize and operate in the affected region.⁶⁶ Other provisions have been designed to encourage giving to disaster victims. For example, following Hurricane Katrina, limits on charitable contributions were increased and the mileage rate for charitable use of a vehicle was increased.⁶⁷

Generally, charitable giving is not particularly responsive to tax incentives.⁶⁸ As such, tax provisions designed to promote charitable giving often benefit those that would have given in the

⁶⁵ KETRA Sec. 101.

⁶⁶ For example, the IRS expedited review of applications for tax exempt status following the Northridge (Los Angeles) Earthquake in 1994. See Tolan, 2007, p. 817.

⁶⁷ See CRS Report R40434, *Charitable Standard Mileage Rate: Considerations for the 111th Congress*, by Nonna A. Noto.

⁶⁸ See CRS Report R40518, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, by Jane G. Gravelle and Donald J. Marples.

absence of additional tax incentives, without causing additional giving to take place. Charitable organizations are likely to play an important role in oil spill clean-up efforts. Direct aid, rather than tax incentives, may be a more efficient mechanism for government support of these activities.

Tax Policy Options: Economic Analysis

Tax policy can be evaluated using the concepts of economic equity and economic efficiency. The concepts of equity in economics can be further assessed by utilizing the concepts of vertical equity and horizontal equity. Vertical equity refers to the notion that those with a greater ability to pay should pay more.⁶⁹ Horizontal equity suggests that those in a similar position should be treated the same by the tax code. Economic efficiency refers to the distribution of output, where the economically efficient level is the one that maximizes possible output given a set of inputs. The following paragraphs provide an economic analysis, using the concepts of economic equity and efficiency, of the tax relief options addressed above.

Evaluating tax relief policy options from a vertical equity perspective underscores the difficulty inherent in using the tax code to help the poor. The current structure of the casualty loss deduction, as an itemized deduction, tends to benefit the higher income as higher income taxpayers are more likely to itemize. Further, deductions are more valuable to taxpayers in higher tax brackets.⁷⁰ Low income individuals are also less likely to have savings. Thus, tax policy options that allow individuals to access retirement savings in times of disaster favor those that have savings, who tend to have higher income, and may be less likely to require additional assistance. Finally, incentives designed to promote charitable giving also tend to favor those with higher incomes. Reducing the tax burden for those that give tends to reduce taxes paid by the wealthy. This is particularly concerning if the tax breaks lead to little additional giving, a conclusion that tends to be supported empirically.⁷¹ Given the difficulty in using the tax code to provide relief to those least well off, direct aid may be a more effective relief mechanism, especially if vertical equity is a primary concern.

From a horizontal equity perspective, one question to ask is to what extent victims of the Gulf of Mexico oil spill deserve distinct tax treatment. Victims of the oil spill are likely to suffer losses, and if those losses are less than fully compensated, special tax treatment may be warranted. There are concerns, however, that providing victims of the oil spill with special tax benefits, different from what is awarded to victims of other similar events, may violate notions of horizontal equity. Specifically, if victims of the BP oil spill are provided an enhanced casualty loss deduction, extended NOL carrybacks, or allowed greater access to retirement savings, horizontal equity would suggest that all victims of similar disasters be treated the same. The size and scope of the BP disaster has resulted in substantial national attention. It is conceivable that victims of

⁶⁹ Vertical equity is not a universally embraced concept. For example, proponents of a flat tax, where all taxpayers pay the same proportion of their income, do not subscribe to the notion that vertical equity should be considered in designing tax policy.

⁷⁰ A deduction reduces taxable income. Given a fixed deduction, a taxpayer in a higher tax bracket will receive a larger benefit than a taxpayer in a lower tax bracket. For example, take a taxpayer in the 25% bracket and a taxpayer in the 33% tax bracket. A \$1,000 deduction for the first taxpayer reduces tax liability by \$250. For the second taxpayer, a \$1,000 deduction reduces tax liability by \$333.

⁷¹ CRS Report R40518, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, by Jane G. Gravelle and Donald J. Marples.

relatively small, localized disasters may suffer similar losses in income and property, but not be awarded federal benefits due to limited awareness of the disaster. Thus, horizontal equity would suggest that should special tax treatment be provided to victims of the BP oil spill, measures should be taken to ensure that victims suffering similar consequences from other disasters be awarded the same special tax preferences.

The efficiency of tax incentives can be evaluated according to how much of the intended behavior the tax break causes, or the marginal impact of the incentive. The marginal impact of a tax break should be evaluated relative to the inframarginal impact. The inframarginal impact of a tax subsidy is the benefits given to individuals whose behavior is unchanged by the policy. In the case of charitable giving, the inframarginal impact is the tax savings given to those who would have donated if the charitable tax incentives had not been adopted. Efficient tax incentives are ones where the marginal impact is large relative to the inframarginal impact.⁷²

Extended NOL carryback periods and enhanced access to retirement funds are both policies that potentially benefit those that might not necessarily need the benefit, resulting in inframarginal effects. This may be more of a concern for the extended NOL carryback period, where refunds paid result in federal revenue losses. To address this concern, the allowance of NOL carrybacks should be targeted at groups in need of the income smoothing option. Since allowing enhanced retirement savings to those that may not necessarily need the funds has a small effect on federal revenues, there are fewer efficiency concerns associated with this policy option.

Tax incentives for charitable giving following natural disasters have been criticized for being economically inefficient.⁷³ Since tax incentives generally are relatively ineffective at inducing additional giving, the federal revenue losses associated with the incentive serve to benefit those who would have given in absence of the incentive.

The BP oil spill challenges policymakers to evaluate (1) to what extent the oil spill is a disaster that merits federal aid, through tax relief beyond existing tax provisions or otherwise; versus (2) to what extent BP should be expected and required to fully compensate those individuals for losses. An oil Spill of National Significance necessarily demands substantial federal, state, and local resources to contain and clean up the disaster. Given the breadth and complexity of the damages, is it reasonable to expect that BP will be able to effectively compensate individuals and businesses for the damages caused? If not, relief through the tax code may be one of many policy tools the federal government chooses as a vehicle for providing assistance to oil spill victims.

Legislative Response

In the House, three bills have been introduced that would provide tax relief to victims of the oil spill. Reports also indicate that the Senate is in the process of putting together a tax relief package for victims in the Gulf region.

Three bills have been introduced in the House that would provide some form of tax relief to oil spill victims. The Oil Spill Tax Relief Act of 2010 (H.R. 5598) would require that any

⁷² For a discussion of the efficiency of charitable giving incentives in the context of accelerated charitable contribution deductions, see CRS Report R41036, *Charitable Contributions for Haiti's Earthquake Victims*, by Molly F. Sherlock.

⁷³ *Ibid.*

compensation provided by BP to an oil spill victim be treated as a qualified disaster payment, and thereby excluded from gross income for tax purposes. The Gulf Coast Access to Savings Act of 2010 (H.R. 5602) would allow for up to \$50,000 in tax-free distributions from retirement plans for those sustaining economic losses resulting from the oil spill, provide tax incentives for the use of distributions by affected individuals making home purchases, and increase the amount that may be borrowed from an employer plan without penalty to \$100,000. Both H.R. 5598 and H.R. 5602 have been referred to the House Committee on Ways and Means.

The Gulf Oil Spill Recovery Act of 2010 (H.R. 5699) would make various tax relief measures available for oil spill victims. This legislation would create an Recovery Zone, in which businesses are allowed increased depreciation and expensing allowances, allowed to issue tax-exempt and tax credit bonds, claim a tax credit for wages paid to employees, and a five-year NOL carryback period. Additional low-income housing tax credits and new markets tax credits would also be made available. Individuals in the Recovery Zone would be allowed tax-free withdrawals of up to \$100,000 from retirement plans. In an effort to promote charitable giving, limitations on the deduction for charitable contributions would be suspended for donations to organizations involved in oil spill relief efforts. H.R. 5699 has been referred to the House Committee on Ways and Means.

While Senate tax relief legislation has not yet been introduced, Gulf Coast Senators have released an outline of recovery plan. Similar to H.R. 5699, the Senators' outline includes a five-year NOL carryback period for business losses, enhanced small business expensing allowances, a new markets tax credit for investments in the affected region, and enhanced access to retirement savings. Additionally, the Senators' proposal would provide a Gulf Coast hotel tax holiday. Under this proposal, affected states could reduce tourism related taxes in an effort to attract visitors. The federal government would reimburse state and local governments for forgone revenue.⁷⁴

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⁷⁴ Additional details on the Senate proposal can be found in a Letter from Bill Nelson, Senator, Roger Wicker, Senator, and Mary Landrieu, Senator, et al. to Max Baucus and Charles Grassley, Chairman and Ranking Member, July 2, 2010.