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

name redacted
Analyst in Economics

name redacted
Legislative Attorney

name redacted
Legislative Attorney

October 14, 2010

Congressional Research Service
7-....
www.crs.gov
R41323

CRS Report for Congress
Prepared for Members and Committees of Congress

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. Individuals and businesses impacted by the oil spill may file a claim with the Gulf Coast Claims Facility, an independent entity established to administer the claims, with payments coming from an escrow account funded by BP. The tax consequences of these payments to the recipients will depend on the nature of the underlying claim. Payments received for lost wages or income will generally be taxable, while payments for other types of claims, such as physical injury or damage of property, may qualify for exclusion or deferral.

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. 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. Tax 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. However, 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 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. Similar to H.R. 5699, the Gulf Coast Oil Recovery Zone Tax Relief and Economic Recovery Act (S. 3934) would provide various forms of tax relief for businesses and individuals in the affected region.

Contents

Contacts

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 made payments for claims to compensate for losses resulting from the oil spill and established an escrow fund to pay future claims. One issue that has arisen is the tax treatment of these payments to the recipients, and whether that treatment should be modified.

Furthermore, given the magnitude of the economic disruption resulting from the spill, policymakers have begun to explore possible alternative mechanisms for providing relief to the affected region. Relief through changes in 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 will briefly discuss existing disaster-related tax provisions and their application to the recent oil spill. We will then provide an analysis of the tax treatment of the BP payments to the individuals and businesses impacted by the oil spill as well as 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.[1] 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.

In addition to the aid provided through congressional action for specific disasters, permanent features of the tax code also provide relief.[2] For example, taxpayers are allowed a deduction for casualty losses.[3] 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

---

[1] For an overview of tax relief provided following Hurricane Katrina in 2005, see CRS Report RL33088, *Tax Policy Options After Hurricane Katrina*, by (name redacted).

[2] See CRS Report RL33642, *Permanent Tax Relief Provisions for Disaster Victims as Presented in the Internal Revenue Code*, by (name redacted).

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

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,[4] 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.[5] For example, § 139 of the IRC excludes qualified disaster relief payments from recipients' gross income.[6] Exclusion of these payments requires the existence of a qualified disaster, further defined to include any declared disaster or emergency under the Stafford Act.[7] 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."[8] For example, in 2010, the Secretary has used this authority to designate the earthquakes in Haiti and Chile to be qualified disasters for purposes of § 139.[9]

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.[10]

---

[4] 40 C.F.R. part 300.

[5] 42 U.S.C. § 5121 *et seq.*

[6] I.R.C. § 139.

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

[8] I.R.C. § 139(c)(3).

[9] Notice 2010-16 (I.R.S. 2010); Notice 2010-26 (I.R.S. 2010).

[10] 40 C.F.R. § 300.5.

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.

BP Payments to Oil Spill Victims: Tax Treatment and Other Selected Legal Issues

BP initially established a claims process in which individuals and businesses affected by the oil spill could file claims directly with the company. As of August 23, 2010, all claims are to be filed with the Gulf Coast Claims Facility (GCCF), an independent entity that is administering the claims, with payments coming from an escrow account funded by BP. Claims may be filed for lost income or wages, damage to real or personal property, physical injury or death, loss of subsistence use of natural resources, and removal and clean-up costs.[11] One issue that has been raised is the proper tax treatment of the payments made for these claims.

Payments received for oil-spill-related claims are includible in the recipient's income (i.e., subject to tax) unless specifically excluded by law.[12] 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).

Most of the payments have been for claims of lost income or wages.[13] These payments are generally includible in recipients' gross income because they do not appear to qualify for any exclusion. For example, they do not appear to be excludible under the provisions that apply to certain disaster-related payments. While IRC § 139 provides an exclusion for "personal, family, living, or funeral expenses incurred as a result of a qualified disaster,"[14] the oil spill's designation as a spill of national significance does not meet the criteria to be a "qualified disaster"[15] even if a payment could meet the other requirements. Similarly, while certain disaster-related payments made by a government for the general welfare are eligible for exclusion,[16] those circumstances do not appear applicable here. The payments also generally do not appear to qualify for any other exclusion. For example, they do not appear to be non-taxable gifts[17] since BP does not have the requisite donative intent in making them as it appears the company has a legal obligation to do

[11] Information on the claims filing process is available at http://www.gulfcoastclaimsfacility.com.

[12] *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.

[13] *See* Gulf Coast Claims Facility, *GCCF Program Statistics - Overall Summary (as of October 07, 2010, 5:05 PM ET),* available at http://www.gulfcoastclaimsfacility.com/GCCF_Overall_Status_Report_10-07-2010.pdf.

[14] I.R.C. § 139(b)(1).

[15] I.R.C. § 139(c) defines "qualified disaster" to include federally declared disasters, among others. *See supra* at "Automatic Tax Consequences of Disaster Declarations."

[16] I.R.C. § 139(b)(4), (c)(4). Additionally, through a series of rulings, the IRS has developed a non-statutory exclusion known as the "general welfare exclusion," which excludes qualifying payments made by governmental units "under legislatively provided social benefit programs." *See, e.g.,* Rev. Rul. 2003-12, 2003-1 C.B. 283. 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. *See id.*

[17] I.R.C. § 102.

so,[18] arguably has a moral duty stemming from its responsibility for the spill, and may receive an economic benefit from compensating claimants outside of litigation.[19]

Other claims payments may qualify for different tax treatment. For example, payments received by individuals due to physical injury or sickness arising from the oil spill may qualify for exclusion under IRC § 104. Under that section, damages (other than punitive damages) received "on account of personal physical injuries or physical sickness" are excluded from the recipient's gross income.[20] The damages must be received from a legal judgment or a settlement agreement entered into in lieu of prosecution of a lawsuit.[21]

The tax treatment of payments for the damage or destruction of real or personal property will depend on each situation. For example, if the payment is less than the taxpayer's adjusted basis[22] in the property, then it is not taxable. If the payment exceeds the adjusted basis, then the taxpayer has realized a gain, which may not be immediately taxable if the taxpayer purchases similar property within a certain time period and is able to take advantage of the special treatment that applies to involuntary conversions.[23] If so, the taxpayer may elect to immediately recognize gain only to the extent that the payment exceeds the cost of the new property and will defer any other gain until the replacement property is sold or otherwise disposed of.

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

---

[18] 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." 33 U.S.C. § 2702.

[19] *See* Comm'r v. Duberstein, 363 U.S. 278, 285-86 (1960) (explaining that the determination of whether a transfer is a gift is made by looking at the transferor's intent in making it, with gifts proceeding "from a detached and disinterested generosity, ... out of affection, respect, admiration, charity or like impulses")(internal quotations and citations omitted).

[20] I.R.C. § 104(a)(2). Physical injury or sickness does not include emotional distress, apparently even if such distress manifests itself with physical symptoms. *See* H.Rept. 104-737 at 301. Thus, awards for emotional distress are generally taxable unless the emotional distress had its origin in physical injury or sickness. *See id.*

[21] Treas. Reg. § 1.104-1(c).

[22] Adjusted basis is typically the cost of the property with adjustments made depending on the taxpayer's use of the property and subsequent events (e.g., basis is decreased if the taxpayer uses the property for business and is allowed to take a deduction for tax purposes, while basis is increased if the owner incurs expenses in improving the property). For more information on basis, *see* CRS Report RL34662, *Tax Basis: What Is It? Why Is It Important?*, by (name redacted).

[23] IRC § 1033. An involuntary conversion occurs when property is converted to money or other property because of its complete or partial destruction, theft, seizure or condemnation, or if it is disposed of under threat of condemnation.

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.[24] Additionally, if the recipient does not provide his or her TIN, payments may be subject to backup withholding of 28%.[25]

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.[26] The IRS guidance reasons that because such payments were not given for employment, these payroll taxes do not apply.[27] 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.[28] 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),[29] 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.[30] 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.[31]

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

[24] I.R.C. § 6721.

[25] I.R.C. § 3406.

[26] IRS, Gulf Oil Spill: Questions and Answers, 2010.

[27] 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 F2d 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.

[28] *Id.*

[29] I.R.C. § 1402.

[30] 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.

[31] 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 Options[32]

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 the claims 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 result 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.[33] Many of the policy options below represent tools that have been used to assist victims of natural disasters.

Tax Treatment of Claims Payments

As discussed above, unless Congress enacts legislation, the payments for lost income will generally be included in recipients' gross income. Therefore, these payments may be subject to taxation to the extent that the recipients' aggregate income exceeds the federal income tax threshold.

[32] This section was written by (name redacted).

[33] 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.

Congress could choose to enact legislation explicitly exempting the 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 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.[34] This leaves the following policy questions: (1) should 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 claims payments be treated as welfare payments, as such payments are helping victims put in need by the emergency?

Subjecting the 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 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 the claims fund to withhold income taxes prior to making payments.

Exempting the 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 the claims, are not taxed, as the asset being replaced would not be subject to an income tax.[35]

If property is destroyed, damaged, or stolen due to a casualty, taxpayers may be entitled to a deduction for uninsured losses.[36] Casualty losses are available for losses generally, with 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).[37]

[34] Tolan, 2007, p. 810.

[35] See, e.g., IRS, Gulf Oil Spill: Questions and Answers, 2010.

[36] Casualty losses can be categorized as business losses, employee related losses, or personal losses. Business losses may be treated as net operation losses, and are discussed in the next section.

[37] IRC §165(h).

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, most of the 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, the 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.[38] 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.[39]

Net Operating Loss Carryback

A net operating loss (NOL) occurs when business taxpayers have negative taxable income.[40] With negative taxable income, a taxpayer has zero tax liability. NOL, however, can be carried 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.

---

[38] For additional details regarding this proposal, see Tolan, 2007, pp. 848-854.

[39] 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.

[40] For additional background information, see CRS Report RL34535, *Tax Treatment of Net Operating Losses*, by (name redacted).

In an amendment to the tax extenders bill (H.R. 4213), 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.[41] 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.[42]

Employment Incentives

Following Hurricane Katrina, two tax credits designed for employment relief were enacted.[43] 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.[44] 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 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.

---

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

[42] CRS Report RL34535, *Tax Treatment of Net Operating Losses*, by (name redacted).

[43] The Katrina Emergency Tax Relief Act (KETRA; 109-73).

[44] For background information, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by (name redacted).

IRA Distributions

Following Hurricane Katrina, victims located in the disaster area were allowed enhanced access to retirement funds.[45] 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.[46] 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.[47]

Generally, charitable giving is not particularly responsive to tax incentives.[48] As such, tax provisions designed to promote charitable giving often benefit those that would have given in the 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.

---

[45] KETRA Sec. 101.

[46] 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.

[47] See CRS Report R40434, *Charitable Standard Mileage Rate: Considerations for the 111th Congress*, by (name red acted).

[48] See CRS Report R40518, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, by (name redacted) and (name redacted).

Tax Policy Options: Economic Analysis

Tax policy can be evaluated using the concepts of economic equity and economic efficiency. The concept 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.[49] 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.[50] 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.[51] 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 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.

[49] 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.

[50] 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.

[51] CRS Report R40518, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, by (name redacted) and (name redacted).

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.[52]

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.[53] 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

A number of bills have been introduced in both the House and the Senate that would provide tax relief to victims of the oil spill. Some of this legislation targets the tax treatment of disaster payments, while other proposals seek to enact a broader package of tax-related relief measures.

A number of 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 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

[52] 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 (name redacted).

[53] *Ibid.*

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 a 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.

In the Senate, the Gulf Coast Oil Recovery Zone Tax Relief and Economic Recovery Act (S. 3934), would provide various forms of tax relief for Gulf oil spill victims. Like H.R. 5699, S. 3934 would create a Recovery Zone and provide similar tax relief measures. S. 3934 would adopt a number of measures discussed in detail above. Specifically, (1) oil-spill-related losses would be allowed a five-year NOL carryback, (2) individuals would be awarded enhanced access to retirement accounts, and (3) a work opportunity tax credit (WOTC) would be available for firms hiring individuals living in the affected region.

S. 3934 would also provide additional tax relief for certain businesses making qualifying investments in the region. Specifically, businesses would not be required to recognize as income insurance or other claims payments reinvested in the affected region. Eligible investments include those made in commercial or charter fishing businesses, hotels, recreation, entertainment, or restaurants located in the Recovery Zone. Additional tax relief provisions included in S. 3934 include favorable depreciation and expensing allowances for Recovery Zone property and tax-exempt bond financing.

A number of provisions in S. 3934 appeared in a Gulf Coast recovery plan released by Gulf Coast Senators in July 2009. One feature of this earlier plan, not included in S. 3934, is the proposed 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.[54]

[54] 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.

Author Contact Information

(name redacted)
Analyst in Economics
[redacted]@crs.loc.gov, 7-....

(name redacted)
Legislative Attorney
[redacted]@crs.loc.gov, 7-....

(name redacted)
Legislative Attorney
[redacted]@crs.loc.gov, 7-....