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# Worse Than Spilled Milk: A Cry for Casualty Loss Reform in the Wake of the Deepwater Horizon Disaster

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— Note —

WORSE THAN SPILLED MILK:  
A CRY FOR CASUALTY LOSS  
REFORM IN THE WAKE OF THE  
*DEEPWATER HORIZON* DISASTER

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INTRODUCTION

The explosion on the *Deepwater Horizon* drilling rig on April 20, 2010, resulted in the spill of more than four million barrels of oil into the Gulf of Mexico.<sup>1</sup> The disaster was a result of human agency<sup>2</sup> and caused extensive damage to the economy of the Gulf states, the ecosystem, and the property of businesses and individuals in the areas

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1. NAT’L COMM’N ON THE BP DEEPWATER HORIZON OIL SPILL & OFFSHORE DRILLING, *DEEP WATER: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING*, at vi (Jan. 2011).
  2. *Id.* at vii (“The explosive loss of the Macondo well could have been prevented. The immediate causes of the Macondo well blowout can be traced to a series of identifiable mistakes made by BP, Halliburton, and Transocean that reveal such systematic failures in risk management that they place in doubt the safety culture of the entire industry.”). Both the federal and state governments were also partially responsible for “fail[ing] to anticipate and prevent [the] catastrophe, and fail[ing] again to be prepared to respond to it.” *Id.* at ix.

affected.<sup>3</sup> President Obama called the spill “the worst environmental disaster America has ever faced,”<sup>4</sup> and the oil affected approximately 650 miles of the Gulf Coast, with Louisiana being hit the hardest.<sup>5</sup>

This Note focuses on the tax treatment of casualty losses<sup>6</sup> to individuals affected by the *Deepwater Horizon* oil spill, as well as future oil spills and contamination disasters, under section 165(c)(3) of the Internal Revenue Code. Code section 165(c)(3) covers “casualty losses”—losses not connected with a trade or business or a project entered into for a profit and that arise from “fire, storm, shipwreck, or other casualty.”<sup>7</sup> It is unclear whether section 165(c)(3) applies in the oil spill context, but this Note advocates that such spills should be treated as an “other casualty.”<sup>8</sup> Utilizing the Code in a modified way to compensate victims of such disasters is a superior approach to the current framework for compensating victims of casualty losses stemming from oil spills. The current approach applies a combination of strict applications of section 165(c)(3), claims under the Oil Pollution Act of 1990 (OPA),<sup>9</sup> private claims processes set up by tortfeasor oil companies, and private causes of action by individuals and businesses against those oil companies. This Note argues that this current framework is disjointed, inefficient, and ought to be streamlined, and it suggests an alternative to the current approach: IRS subrogation with a removal of section 165(h) floors and an adoption of the Code section 165(i) election, through a modified understanding and application of Code section 165(c)(3), particularly as it pertains to the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act)<sup>10</sup> and the OPA.

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3. *Id.* at vi (“The costs from this one industrial accident are not yet fully counted, but it is already clear that the impacts on the region’s natural systems and people were enormous, and that economic losses total tens of billions of dollars.”).
  4. *Id.* at 173. Interestingly, however, the President did not invoke the Robert T. Stafford Disaster Relief and Emergency Assistance Act.
  5. *Id.*
  6. See I.R.C. § 165(a) (2006) (“General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.”).
  7. I.R.C. § 165(c) (“In the case of an individual, the deduction . . . shall be limited to . . . losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.”).
  8. I.R.C. § 165(c)(3).
  9. Oil Pollution Act of 1990, Pub. L. No. 101-380, 104 Stat. 484 (codified as amended at 33 U.S.C. §§ 2701–2762 and in scattered sections of other titles).
  10. Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§ 5121–5207 (2006).

Part I discusses the mechanics of Code section 165(c)(3). It explains the judicial history of this section of the Code, including the standard statutory interpretation approach that courts have used in light of the limited legislative history surrounding this provision. It also explains how casualty loss deductions are calculated, covering the burden of proof, the floors involved in calculating a casualty loss, and the social and political reasons for these limitations. It goes on to examine the meaning of this section of the Code itself, applying the rule of *ejusdem generis* (“of the same kind”) to explore whether property damage caused by the *Deepwater Horizon* oil spill can or should be treated as a casualty loss, ultimately arguing that it should be treated as such. It also discusses the Tax Benefit Rule, a doctrine limiting casualty loss deductions to those “not compensated by insurance or otherwise.”<sup>11</sup> The Rule requires individuals who take a casualty loss deduction and subsequently make a recovery for that loss to count that recovery in their income for the year in which they receive the recovery, potentially causing major financial hardship to individuals.

Part II identifies and analyzes the circuit split between the Courts of Appeal for the Eleventh and Ninth Circuits regarding whether application of section 165(c)(3) requires physical damage to the property, or whether general decline in property value suffices. Oil spills occupy a unique niche within the broader category of casualty losses because publicity surrounding oil spills contributes to a broad decline in property values, regardless of whether a property was directly damaged or contaminated by the spill. To allow for casualty loss recovery due to a general decline in value of surrounding properties, provisions must be put in place to allow for widespread recovery and to prevent inequitable outcomes due to the jurisdiction in which the taxpayer resides. By streamlining the framework for recovering from oil spills, the federal government could bypass the circuit split on general property value decline and adopt the Eleventh Circuit’s position as announced in *Finkbohner v. United States*,<sup>12</sup> at least in the oil spill context.

Part III identifies three current approaches to compensating oil spill victims: the OPA, the Gulf Coast Claims Facility (GCCF), and private causes of action in tort and insurance. It identifies shortcomings in each of these avenues of recovery, focusing on the burdens and tradeoffs taxpayers face in the wake of casualty losses. It suggests that the current infrastructure for dealing with casualty losses is inefficient and results in unnecessary hardships for taxpayers and argues

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11. I.R.C. § 165(a) (“There shall be allowed as a deduction any loss sustained during the taxable year *and not compensated for by insurance or otherwise.*” (emphasis added)).

12. *Finkbohner v. United States*, 788 F.2d 723 (11th Cir. 1986).

that there ought to be a more streamlined, uniform system of recovery for oil spill victims with casualty losses.

Part IV discusses the Stafford Act and Code section 165(i)(1),<sup>13</sup> which makes special provisions for individuals claiming casualty loss deductions when the President of the United States invokes the Stafford Act. This Part also discusses legislation Congress enacted to bolster the benefits of the Stafford Act in response to Hurricane Katrina, allowing for elimination of the floors and ceilings associated with casualty loss deductions. It explains when and how the Stafford Act is implemented in response to natural disasters and examines the political and social justifications for the allowances the Stafford Act provides for victims of natural disasters. Further, it analyzes legislative approaches that the federal government has taken in the past, in conjunction with an invocation of the Stafford Act, to adjust the floors of Code section 165(h)<sup>14</sup> to allow more widespread taxpayer recovery. It explains why President Obama did not invoke the Stafford Act in response to this disaster by offering a comparative analysis of the Presidential response to the *Exxon Valdez* oil spill off the coast of Alaska in 1989. An invocation of the Stafford Act would have been an inappropriate presidential response to the *Deepwater Horizon* incident, given the restrictions, mechanics, and justifications of the Stafford Act, particularly because this and other oil spills are almost always the result of human agency. But the direct and indirect damages suffered by victims in oil spills are so analogous to those suffered by the victims of natural disasters that, at the very least, the tax allowances extended by an invocation of the Stafford Act ought to be extended to the victims of oil spills.

Finally, Part V identifies a solution for the shortcomings of the current methods of recovery for individual taxpayers suffering prop-

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13. I.R.C. § 165(i)(1) (“[A]ny loss occurring in a disaster area . . . may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred.”); I.R.C. § 165(k) (describing the procedure for treatment as a disaster a loss where a taxpayer is ordered to relocate or demolish his or her residence because of a Stafford Act disaster declaration).
  14. I.R.C. § 165(h)(1)–(2) (“Treatment of casualty gains and losses.—(1) \$100 limitation per casualty.—Any loss of an individual described in subsection (c)(3) shall be allowed only to the extent that the amount of the loss to such individual arising from each casualty, or from each theft, exceeds \$500 (\$100 for taxable years beginning after December 31, 2009). (2) Net casualty loss allowed only to the extent it exceeds 10 percent of adjusted gross income.—(A) In general.—If the personal casualty losses for any taxable year exceed the personal casualty gains for such taxable year, such losses shall be allowed for the taxable year only to the extent of the sum of—(i) the amount of the personal casualty gains for the taxable year, plus (ii) so much of such excess as exceeds 10 percent of the adjusted gross income of the individual.”).

erty damage in this or future oil spills, drawing on an approach recommended by another scholar:<sup>15</sup> IRS subrogation and a removal of the Code section 165(h) floors.<sup>16</sup> Instead of taxpayers individually filling claims with the BP Oil Spill Fund, this Note proposes that the Code section 165(h)<sup>17</sup> floors be eliminated in the case of an oil spill, allowing everyone to deduct casualty losses to property. Then, the IRS can subrogate those claims and recover from the BP Oil Fund or other funds created by section 2715 of the OPA,<sup>18</sup> thereby avoiding lost tax revenue. This approach creates an equitable remedy for taxpayers, lowers transaction costs for all parties involved, and would be easy to implement, especially given the federal government's use of subrogation in other contexts.

I. CASUALTY LOSS DEDUCTIONS FOR INDIVIDUALS: THE ADMINISTRATIVE LIMITATIONS OF APPLYING I.R.C. § 165(c) TO THE VICTIMS OF OIL SPILLS.

Code section 165 provides as a general rule that “any loss sustained during the taxable year and not compensated for by insurance or otherwise” may be deducted as a loss, with limitations set by its subsections.<sup>19</sup> Section 165 has been called a “free partial insurance scheme.”<sup>20</sup> Justifications for allowing a casualty loss deduction include ensuring that the income tax reflects a taxpayer's ability to pay and ensuring that the income tax equals consumption plus savings, since “amounts lost to casualties are neither consumed by the taxpayer . . . nor saved.”<sup>21</sup>

There is little legislative history about the meaning of “casualty” as contemplated in section 165(c), and its parameters “have evolved

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15. Andrew Blair-Stanek, *Using Insurance Law and Policy to Interpret the Tax Code's Loss and Medical Expense Provisions*, 26 YALE L. & POL'Y REV. 309, 343–44 (2007).
  16. I.R.C. § 165(h)(1)–(2).
  17. *Id.*
  18. 33 U.S.C. § 2715(a) (2006) (“Any person, including the Fund, who pays compensation pursuant to this Act to any claimant for removal costs or damages shall be subrogated to all rights, claims, and causes of action that the claimant has under any other law.”).
  19. I.R.C. § 165(a).
  20. Blair-Stanek, *supra* note 15, at 310–11 (“The taxpayer's co-pay amounts to 100% minus the marginal tax rate, with deductibles (in the insurance sense of the word) applying to individual taxpayers in some situations.”).
  21. MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 24.01 (3d ed. 2013 cum. supp. no. 1).

judicially.”<sup>22</sup> Courts have interpreted casualty losses to individuals under section 165(c)(3) to require an element of suddenness, unusualness, unexpectedness, or some combination of the three.<sup>23</sup> Additionally, casualty losses are subject to two major statutory monetary limitations. First, under section 165(h)(1), each loss must exceed \$100.<sup>24</sup> Second, under section 165(h)(2), a net casualty loss is allowed “only to the extent it exceeds 10 percent of adjusted gross income (‘AGI’).”<sup>25</sup> In some disaster situations, these floors and other statutory barriers to recovery from casualty losses are lifted, either under a specific provision of the Code<sup>26</sup> or by legislative mandate.<sup>27</sup>

This provision of the Code has been called “free insurance,”<sup>28</sup> and has been criticized for discouraging people from purchasing property insurance because of the benefits associated with claiming a deduction.<sup>29</sup> But the 10 percent AGI “floor” helps mitigate this moral hazard effect by preventing claims for minimal losses.

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22. *Maheer v. Comm’r*, 76 T.C. 593, 596 (1981).
  23. *See, e.g., id.* at 598 (requiring that an event be “sudden, unusual, or unexpected” (quoting *Burns v. United States*, 174 F. Supp. 203, 210 (N.D. Ohio 1959), *aff’d per curiam*, 284 F.2d 436 (6th Cir. 1960))); *Appleman v. United States*, 338 F.2d 729, 730–31 (1964) (“Among characteristics of the specific casualties enumerated in the section are suddenness and unforeseeability of the occurrence. Fire and shipwreck are undesigned, sudden, and unexpected events. While storms are to a degree predictable the factors of their violence and the particular site of loss or damage are uncertain.”).
  24. I.R.C. § 165(h)(1).
  25. I.R.C. § 165(h)(2). For example, if a taxpayer has an adjusted gross income (AGI) of \$50,000 and sustains a loss valued at \$6,000, that taxpayer is entitled to report the casualty loss on his income tax return: \$6,000 less \$100 is \$5,900; 10 percent of \$50,000 is \$5,000; \$5,900 exceeds \$5,000 by \$900, so \$900 is the amount of the deduction.
  26. *E.g.*, I.R.C. § 165(k) (offering special casualty loss deduction treatment when a taxpayer is “ordered to demolish or relocate residence in disaster area because of disaster”).
  27. Rev. Proc. 2006-32, 2006-28 I.R.B. 61 (providing safe harbor methods for taxpayers to use in determining the amount of casualty losses due to Hurricanes Katrina, Rita, and Wilma, and eliminating the \$100 and 10 percent of AGI floors for casualty losses as a result of those hurricanes).
  28. WILLIAM A. KLEIN ET AL., *FEDERAL INCOME TAXATION* 355–56 (15th ed. 2009) (“If [a lawyer deducting a \$10,000 loss] is in the 35 percent tax bracket, the deduction would save him \$3,500 in taxes, thus reducing his after-tax loss to \$6,500. It therefore has the same economic effect on him as . . . insurance with no deductible and a 65 percent ‘co-payment’ . . . . In cases where the deduction is available, therefore, it discourages people from purchasing insurance . . . .”).
  29. *Id.* at 356 (explaining that a taxpayer receiving a casualty loss deduction for a personal loss would receive this so-called free insurance

In assessing whether a loss is deductible under section 165(c)(3), the burden is on the taxpayer to prove that the loss is, in fact, a casualty loss.<sup>30</sup> Evaluation of whether the complete or partial destruction of property constitutes a casualty loss requires an application of the *ejusdem generis* rule:

Under the doctrine of *ejusdem generis* it is necessary to define the word ‘casualty’ in connection with the words ‘fires, storms, shipwreck’ immediately preceding it. By the rule of *ejusdem generis*, where general words follow the enumeration of particular classes of things, the general words should be construed as applicable only to those of the same general nature or class as those enumerated. The rule is based on the reason that, if the Legislature had intended the general words to be used in their unrestricted sense, there would have been no mention of the particular classes.<sup>31</sup>

A casualty loss may be the result of human agency. For example, in *Shearer v. Anderson*,<sup>32</sup> the Second Circuit held that a car accident that was “not caused by the willful act or neglect of the owner” was “analogous to a shipwreck,” and allowed a casualty loss deduction, admitting that it was unclear whether the act was caused by faulty driving on an icy road or the freezing of the car’s motor.<sup>33</sup>

It is common knowledge that oil companies are integral to the Gulf states’ economies, and that drilling and refining are widespread practices in and around the Gulf of Mexico. Property owners in the Gulf states are aware of oil drilling and refining activity on, near, or in the vicinity of their property: being “on notice” in this way might weigh against a finding that the *Deepwater Horizon* oil spill was “unexpected.” But even if property owners are on notice of man-made, abnormally dangerous activities near their property, they are entitled to report casualty losses in the event of an unexpected

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“without paying an arm’s-length premium”—a true economic benefit, since personal insurance premiums are themselves not deductible).

30. See, e.g., *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (“[The Commissioner of Internal Revenue’s] ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong.”).
31. *Keenan v. Bowers*, 91 F. Supp. 771, 774 (E.D.S.C. 1950) (internal citation omitted); see also *Lyman v. Comm’r*, 83 F.2d 811, 813 (1st Cir. 1936) (“[W]here words of a particular or specific meaning are followed by general words, the general words are construed to apply only to persons or conditions of the same general kind as those specifically mentioned, unless there are other provisions clearly indicating that the rule is not applicable.”).
32. *Shearer v. Anderson*, 16 F.2d 995 (2d Cir. 1927).
33. *Id.* at 996–97.

accident or disaster connected to that abnormally dangerous activity.<sup>34</sup>

In *Durden v. Commissioner*, taxpayers' residences were located within a mile of a quarry that engaged in heavy blasting.<sup>35</sup> A "very unusual blast, heavier than a normal charge"<sup>36</sup> cracked the foundations, walls, dormer windows, plastering, and basements of several homes. The court noted that the "damage was caused by the blast . . . [and] not . . . any other form or process of gradual deterioration."<sup>37</sup> Furthermore, the court determined that even though the blast originated from an act of human agency, "a proper definition of the term casualty does not exclude the intervention of human agency, such as involved in setting off the blast involved in this case, and the prime element is that of suddenness as opposed to some gradually increasing result."<sup>38</sup> The court emphasized that it was the suddenness and unexpectedness of the event causing the damage that qualified it as a deductible casualty loss. The court also indicated that even though the taxpayers knew the blasting was taking place nearby, it did not automatically follow that they had assumed the risk.

One important caveat in *Durden* is that the taxpayers had secured a promise from the blasting company that "no unusual blasting would be done."<sup>39</sup> This separate agreement could distinguish the *Durden* victims from the victims of the *Deepwater Horizon* oil spill. Although the United States Mineral Management Service (MMS) regulates Outer Continental Shelf Oil and Gas Operations (OCS) to try to minimize environmental impact and avoid and limit incidents like the *Deepwater Horizon* oil spill, MMS reported on June 17, 2009, that 1,443 offshore drilling "incidents" occurred between 2001 and 2007, including "41 fatalities, 302 injuries, 10 losses of well control, 11 collisions, 476 fires, 356 pollution events, and 224 crane and other lifting events."<sup>40</sup> Thus, in addition to being on notice that oil drilling and refining activities occur routinely near their property, Gulf state residents have MMS statistics and data showing that accidents are a routine part of the industry. The MMS reported that "[t]he majority of incidents occurring in the OCS were related to

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34. *Durden v. Comm'r*, 3 T.C. 1, 4 (1944).

35. *Id.*

36. *Id.* at 2.

37. *Id.* at 3.

38. *Id.* at 4.

39. *Id.*

40. Safety and Environmental Management Systems for Outer Continental Shelf Oil and Gas Operations, 74 Fed. Reg. 28,639, 28,642 (proposed June 17, 2009) (to be codified at 30 C.F.R. pt. 250).

operational and maintenance procedures or human error.”<sup>41</sup> Given the type of notice that the MMS has given to Gulf state property owners, it is unclear whether oil spills fall within the U.S. Tax Court’s holding in *Durden*. The persistent question is *how unexpected* is “unexpected enough” to constitute a casualty.

It is also unclear whether damage to property suffered much later, or outside the immediate vicinity of the *Deepwater Horizon* accident, would qualify as casualty losses, and if so, what limits would apply. In *Pugh v. Commissioner*, the United States Board of Tax Appeals (B.T.A.) held that a diminution in value of farmland contaminated by seeping oil and saltwater from oil wells on the property did not constitute a casualty loss.<sup>42</sup> At least one commentator has suggested that the B.T.A. denied the deduction because “pollution occurring over a long period of time is not a sudden enough event for a casualty loss.”<sup>43</sup> In *Lloyd’s Leasing Ltd. v. Conoco*, a case that was not tried under tax principles but rather under tort law, the Fifth Circuit held that an oil company was not liable for damage from an oil spill when oil spread seventy miles from the location of a grounded tanker.<sup>44</sup> The court found that although the company “might reasonably anticipate that the oil would probably wash ashore somewhere, it had no reason to have anticipated that the oil would probably wash ashore in a heavily populated area and then be tracked into businesses and homes.”<sup>45</sup> This troubling result indicates that there could be similar barriers to recovery in the context of the *Deepwater Horizon* oil spill—either to individual claims against BP, or to successfully receiving deductions under section 165(c)(3).

Section 165(a) explicitly provides that casualty losses are only deductible to the extent that they “are not compensated for by insurance or otherwise.”<sup>46</sup> If compensation for the loss is received during the year that the loss is deducted, the calculus is easy, and the compensation is simply subtracted from the amount to be deducted. If a taxpayer is not compensated in the year of the deduction, but anticipates that he will be, he must subtract the anticipated amount of compensation from the amount he deducts for the casualty loss. On the other hand, if there is “no reasonable prospect of recovery, the entire loss is taken into account when sustained; and any unsuspected

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41. *Id.*

42. *Pugh v. Comm’r*, 17 B.T.A. 429 (1929).

43. Thomas H. Steele, *The Tax Consequences of the Ownership and Cleanup of Environmentally Contaminated Properties*, 26 REAL PROP. PROB. & TR. J. 655, 658 (1991).

44. *Lloyd’s Leasing Ltd. v. Conoco*, 868 F.2d 1447, 1449–50 (5th Cir. 1989).

45. *Id.* at 1449.

46. I.R.C. § 165(a) (2006).

subsequent recovery is taken into income when received, subject to the tax benefit doctrine.”<sup>47</sup>

In *Perry v. United States*, the court justified the Tax Benefit Rule, holding that it “would be inequitable for the taxpayer to reduce his taxes for prior years on account of the [deductions], and not to pay taxes on them when he got them back. This . . . rule . . . is based altogether on equitable considerations.”<sup>48</sup> But the tax consequences of the timing of the compensation can potentially be rather stark: if a taxpayer is compensated for an item he deducted in a previous year, and that compensation “occurs in a high income year . . . the progressive tax rate structure is likely to exact a higher toll than if the taxpayer had foregone the original deduction so that the later recovery would be a return of capital, and therefore not taxable.”<sup>49</sup> If taxpayers do not know when, whether, or how much they will be compensated for their casualty losses, they could very well become financial victims a second time, due to their use of a provision in the Code designed to help them.

The existing jurisprudence on casualty losses does not provide a conclusive determination as to whether an oil spill like the *Deepwater Horizon* disaster would constitute a casualty loss. The IRS has, however, issued guidelines to victims of the *Deepwater Horizon* oil spill indicating that it will honor casualty loss deductions associated with this disaster as long as they fit within the standard requirements for casualty losses.<sup>50</sup> It is unclear whether this allowance is being made based on a strict application of the Code, or whether it is a decision the IRS made based on public policy. Even if this allowance is based on an application of the Code, the opportunities for widespread recovery are limited because the President did not invoke the Stafford Act, and because there are no guidelines about when the property damage must have occurred. Additionally, the other available avenues of recovery, including the OPA, GCCF, and insurance do not

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47. MCMAHON & ZELENAK, *supra* note 21, ¶ 24.04[2].

48. *Perry v. United States*, 160 F. Supp. 270, 271 (Ct. Cl. 1958); *see also* John G. Corlew, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995, 999 (1967) (noting that the tax benefit rule is an equitable doctrine (citing *Perry*, 160 F. Supp. at 271)).

49. Corlew, *supra* note 48, at 995.

50. *See, e.g.*, IRS, GULF OIL SPILL: QUESTIONS AND ANSWERS 2 (2010), available at <http://www.irs.gov/pub/irs-pdf/p4873a.pdf> (“A taxpayer may be able to claim a casualty loss deduction if the payments . . . the taxpayer receives or reasonably expects to receive, are less than the taxpayer’s adjusted basis in the property.”); IRS, OVERVIEW AND GUIDANCE FOR ASSISTING TAXPAYERS IMPACTED BY THE GULF OIL SPILL 10 (2011), available at <http://www.irs.gov/pub/irs-pdf/p4906.pdf> (same).

guarantee uniform odds of recovery, which could result in detrimental financial consequences due to the Tax Benefit Rule. The limitations of the existing availability of casualty loss deductions for the *Deepwater Horizon* disaster and other oil spills weighs in favor of developing a more widespread, equitable recovery system for oil spill victims.

## II. CASUALTY LOSSES AND GENERAL DECLINE IN PROPERTY VALUE: AN ARGUMENT IN FAVOR OF ADOPTING THE ELEVENTH CIRCUIT'S APPROACH TO CASUALTY LOSSES FOR OIL SPILL VICTIMS

In an August 2010 article, economist Mark Fleming said, in relation to Gulf state property values following the *Deepwater Horizon* oil spill, "It's not only about whether the oil arrives . . . . There's evidence [that] something as catastrophic as this scares people away."<sup>51</sup> The same article reported that coastal homes along the Gulf of Mexico "may lose as much as \$56,000 each in value as buyers shun areas marred by the worst oil spill in U.S. history . . . ."<sup>52</sup> Even Kenneth Feinberg, administrator of the Gulf Coast Claims Facility, admitted that the spill caused declines in property value, saying, "There's no question that the property value has diminished as a result of the spill . . . ."<sup>53</sup> But, he qualified, "[t]hat doesn't mean that every property is entitled to compensation."<sup>54</sup> Part of the problem with calculating declines in property values in the Gulf states is that, in the wake of the housing bubble, Florida in particular was hit very hard with plummeting property values. The same article reports that in 2010, Florida had "the third-highest rate of foreclosure filings in the nation, behind Nevada and Arizona . . . ."<sup>55</sup> But CoreLogic, a real estate data firm that conducted a property value study on the affected area, took this into account in its study. While the OPA allows for compensation based on a decline in property value,<sup>56</sup> those assessments are made on a case-by-case basis, and Kenneth Feinberg himself said that not every property owner would be entitled to a recovery for a decline in his property's value.

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51. John Gittelsohn, *BP Spill May Cost Gulf Coast Homes \$56,000 Apiece in Value*, BLOOMBERG (Aug. 2, 2010, 12:01 AM), available at <http://www.bloomberg.com/news/2010-08-02/gulf-coast-homes-to-lose-up-to-56-000-in-value-as-bp-spill-spoils-beaches.html>.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. See discussion *infra* Part III.A (discussing the OPA).

In *Finkbohner v. United States*, the Eleventh Circuit showed a willingness to allow casualty loss deductions for a decline in property value even when the taxpayer's property itself incurred no physical damage.<sup>57</sup> This is a boon to Florida taxpayers who might not have suffered contamination or other damage to their property but who nonetheless suffered an economic loss from a drop in property value. But the Ninth Circuit disagrees with the Eleventh Circuit over whether there is a requirement of actual physical damage for a section 165(c)(3) casualty loss, or alternatively whether permanent diminution in property value even without physical damage suffices. Florida taxpayers are covered for now, but *Deepwater Horizon* victims in other circuits might not fare so well; and if the Supreme Court weighs in, Florida's luck might run out, too. It is clear that the *Deepwater Horizon* spill has created not only direct losses in value due to physical damage to property, but also indirect losses in property value due to immediate and lingering public concern about the environmental impact of the disaster. Neither the GCCF nor the federal courts have been able to arrive at a uniform way of compensating victims whose property value declined as part of the aggregate decline in value due to the disaster. This results in disparate treatment of victims, and this disparity cries out for an official resolution.

In *Finkbohner*, the Eleventh Circuit held that when a disaster results in "changes in the neighborhood . . . that will outlast the fresh recollection of disaster," and not merely temporary buyer resistance, a property owner can deduct the permanent decline in property value even if his property did not itself sustain physical damage.<sup>58</sup> The taxpayer's home was situated on a cul-de-sac with eleven other houses, and after a flood, seven of those houses had to be demolished because of flood damage, leaving the taxpayer's home "in a lonesome neighborhood, more exposed to crime, and with much diminished privacy."<sup>59</sup> The court held that although it would not allow a casualty loss deduction for temporary buyer resistance, the situation in this case was distinguishable because of the permanent changes to the neighborhood that would "outlast the fresh recollection of disaster," and allowed the deduction.<sup>60</sup>

In a 1994 California memorandum opinion, the U.S. Tax Court indicated that it would allow a section 165(c)(3) deduction for a decline in the value of a taxpayer's home in California due to the

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57. *Finkbohner v. United States*, 788 F.2d 723 (11th Cir. 1986).

58. *Id.* at 727.

59. *Id.* at 724.

60. *Id.* at 727.

destruction of trees on adjacent lots.<sup>61</sup> After the damage to the trees, “the house . . . [stood] in a field, rather than a forest.”<sup>62</sup> Although the house itself suffered no damage, the court allowed a \$20,000 casualty loss deduction, attributable to both “the lost trees and the overall reduction in the aesthetic value.”<sup>63</sup> But the holding in this case is likely distinguishable from other Ninth Circuit<sup>64</sup> cases because the taxpayer owned the home *and* the damaged adjacent lots, and the court found that the taxpayer’s lots “constitute[d] a single piece of property” for the purposes of determining the adjusted basis of the property.<sup>65</sup> Applying this outcome to *Deepwater Horizon* victims would likely only result in limited recovery by property owners who own multiple, adjacent parcels of property.

This distinction is particularly likely in light of a subsequent opinion in which the U.S. Tax Court reaffirmed the Ninth Circuit’s disallowance of deductions for a decline in property value. In *Chamales v. Commissioner*, the U.S. Tax Court did not follow the Eleventh Circuit’s holding in *Finkbohner* in assessing whether taxpayers suffered a casualty loss due to a decline in their home value in Brentwood, California, following the O.J. Simpson murder trial.<sup>66</sup> The court based its decision on the premise that the Ninth Circuit has “consistently held that an essential element of a deductible casualty loss is physical damage.”<sup>67</sup> In dicta, the court said assuming *arguendo* that it did apply the Eleventh Circuit’s rule, the damage to the taxpayer’s property was “more akin to a fluctuation in value” than a “permanent devaluation . . . which no court has found to support a deduction under Section 165(c)(3).”<sup>68</sup> The court disallowed

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61. *Beams v. Comm’r*, 67 T.C.M. (CCH) 3152 (1994).

62. *Id.* at 3154.

63. *Id.*

64. The connection between the U.S. Tax Court and other federal courts is complex. In *Golsen v. Comm’r*, 54 T.C. 742 (1970), the U.S. Tax Court held that “better judicial administration requires [the Tax Court] to follow a Court of Appeals decision which is squarely in point where appeal from [the Tax Court’s] decision lies to that Court of Appeals and to that court alone.” *Id.* at 757. Thus, because *Beams*, 67 T.C.M. (CCH) 3152, arose in California, and an appeal to the Tax Court’s decision would have gone to the Court of Appeals for the Ninth Circuit, the Tax Court was bound by its holding in *Golsen* to follow Ninth Circuit precedent, at least in as much as it is clear that the issue in *Beams* is “squarely in point” with the issues addressed in other Ninth Circuit cases. *Golsen*, 54 T.C. at 757.

65. *Beams*, 67 T.C.M. (CCH) at 3154.

66. *Chamales v. Comm’r*, 79 T.C.M. (CCH) 1428 (2003).

67. *Id.* at 1433.

68. *Id.*

the casualty loss deduction, and upheld the Ninth Circuit's requirement of physical damage to support a valid casualty loss.

It is hard to say whether a decline in property value due to the *Deepwater Horizon* oil spill will materialize as a mere "fluctuation in value"<sup>69</sup> or a "permanent devaluation,"<sup>70</sup> but the disparate treatment of declines in property value is likely to result in inequitable outcomes to victims of the spill. Admittedly, this is one of the "gray areas" where it would be extremely difficult to draw a line: How much of a decline in value yields a casualty loss? Should there be an upper limit to the amount that a taxpayer can claim for this kind of casualty loss? How would this type of casualty loss interplay with the Tax Benefit Rule<sup>71</sup> if, in fact, the decline in value is only a temporary fluctuation? The answers to these questions are beyond the scope of this Note, but the ambiguity inherent in this facet of casualty losses in the oil spill context underscores the need for a streamlined approach to maximize equity and efficiency of taxpayer recovery in the wake of this kind of disaster.

### III. A FLAWED FRAMEWORK: THE SHORTCOMINGS OF THE OIL POLLUTION ACT OF 1990, THE GULF COAST CLAIMS FACILITY, AND INSURANCE

The OPA, the GCCF, and insurance (both private and federally funded) are all ways in which victims of oil spill casualty losses can seek compensation for damage to their property. But these means of recovery are not consistently applied, resulting in stark consequences for taxpayers. Not all victims will recover their losses, and, even if they do recover, their recoveries could be inequitable, due to inconsistent judicial interpretations of legislation and ad hoc evaluations of casualty loss claims. Additionally, without a clear expectation of prospects for recovery, individuals claiming casualty loss deductions can encounter significant financial repercussions under the Tax Benefit Rule. These means of recovery certainly have their benefits, but there is a pressing need for a uniform system that incorporates these benefits to create a uniform scheme of compensating casualty loss victims. Gulf County, Florida, Commissioner Bill Williams said it best, in criticizing the Gulf Coast Claims Facility:

In regards to claims in general, it would be our recommendation that Congress provide greater clarity and direction to this process. Probably the greatest frustration for everyone involved,

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69. *Id.*

70. *Id.*

71. *See supra* Part I (discussing the Tax Benefit Rule).

both private and public, were constant changes in the claims process. There were eight different policies, procedures, processes and applications within the first two months. The summer was almost over before our businesses and individuals finally had a solid process.<sup>72</sup>

A. *The OPA and the Problem of Judicial Interpretation*

The OPA<sup>73</sup> is a statutory scheme developed in the aftermath of the *Exxon Valdez* oil spill in 1989. While it creates broad protections for victims of oil spills, its vague language, inadequate financial responsibility requirements, and flexibility leave much to judicial interpretation and chance. The OPA certainly goes a long way toward protecting oil spill victims, but it is by no means comprehensive.

The OPA provides that the responsible party in an oil spill is strictly liable for removal costs caused by the spill,<sup>74</sup> including “any removal costs incurred by any person for acts taken by the person which are consistent with the National Contingency Plan.”<sup>75</sup> The OPA also includes a provision for private rights of action for damage to real or personal property stemming from an oil spill “incident,” defined in the OPA as “any occurrence or series of occurrences having the same origin, involving one or more vessels, facilities, or any combination thereof, resulting in the discharge or substantial threat of discharge of oil.”<sup>76</sup> The OPA establishes a \$75,000,000 cap on liability for other costs for an offshore facility.<sup>77</sup>

One problem with the OPA is that despite the strict liability for cleanup and the private right of action, the way the statute defines “incident” seems to indicate that the incident “is therefore the occurrence (i.e. collision, grounding or explosion) which results in the oil spill, and not the spill itself.”<sup>78</sup> The implications of this semantic

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72. STATEMENT BY BILL WILLIAMS, GULF COUNTY COMMISSIONER (FLORIDA), TO HOUSE OVERSIGHT & GOVERNMENT REFORM COMMITTEE 4 (June 2, 2011), available at [http://oversight.house.gov/wp-content/uploads/2012/01/Bill\\_Williams\\_Testimony.pdf](http://oversight.house.gov/wp-content/uploads/2012/01/Bill_Williams_Testimony.pdf).

73. 33 U.S.C. § 2701 (2006).

74. 33 U.S.C. § 2702(a) (“[E]ach responsible party for a vessel or a facility from which oil is discharged, or which poses the substantial threat of a discharge of oil, into or upon the navigable waters or adjoining shorelines or the exclusive economic zone is liable for the removal costs and damages . . . that result from such incident.”).

75. 33 U.S.C. § 2702(b)(1)(B).

76. 33 U.S.C. § 2701(14).

77. 33 U.S.C. § 2704(a)(3).

78. Thomas J. Wagner, *Recoverable Damages under the Oil Pollution Act of 1990*, 5 U.S.F. MAR. L.J. 283, 293 (1993).

distinction are best seen in the Fifth Circuit's treatment of the issue in a pre-OPA case, *Lloyd's Leasing Ltd. v. Conoco*.<sup>79</sup>

In *Lloyd's Leasing Ltd.*, an oil tanker grounded off the coast of Louisiana and spilled 65,500 barrels of crude oil into the Gulf of Mexico.<sup>80</sup> A group of plaintiffs "who suffered damages from oil tracked onto their premises by tourists and beachgoers" brought suit against the oil company.<sup>81</sup> The plaintiffs' property was damaged due to "the particular combination of tides and winds that existed at the time of the spill," which caused oil to wash ashore approximately seventy miles from the grounding.<sup>82</sup> The court found for the oil company, holding that the harm suffered by the plaintiffs was not foreseeable to the defendants, and that the defendants therefore owed no duty to the plaintiffs:

While the appellee might reasonably anticipate that the oil would probably wash ashore somewhere, it had no reason to have anticipated that the oil would probably wash ashore in a heavily populated area and then be tracked into businesses and homes. "To be found liable a defendant must have knowledge of a danger, not merely possible but probable."<sup>83</sup>

The Fifth Circuit denied recovery since the damage was a result of unforeseeable consequences from the oil spill, not from the initial incident itself. By not providing clear parameters for recovery, the OPA does not guide interpretation of this issue. Writing about the *Exxon Valdez* oil spill, Thomas Wagner commented "one would infer that Congress intended to authorize property damages due to the spread of oil discharged in such an incident . . . [but i]f the recoverable damages need only relate to the spill (and not the originating incident), OPA provides no 'outer limit' to this remedy."<sup>84</sup>

An issue that has yet to arise is what would happen in the event that a hurricane caused the discharged oil to migrate to unexpected locations. A report from June 2010 offered probability statistics showing that at the time there was a 10 percent chance that a hurricane wind field could pass through the oil slick, and a 4 percent chance that the hurricane could be an intense, Category 3–5 hurricane, "with a significant storm surge and the potential to carry

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79. *Id.* at 293 (citing *Lloyd's Leasing Ltd. v. Conoco*, 868 F.2d 1447 (5th Cir. 1989)).

80. *Lloyd's Leasing Ltd.*, 868 F.2d at 1448.

81. *Id.*

82. *Id.*

83. *Id.* at 1449–50 (quoting *Consolidated Aluminum Corp. v. C.F. Bean Corp.*, 833 F.2d 65, 68 (11th Cir. 1987)).

84. Wagner, *supra* note 78, at 294.

tar deposits far inland.”<sup>85</sup> The same report stated that “any hurricane in the vicinity of the slick has the potential to bring waves that break protective booms and allow the oil to be displaced into coastal salt marshes and beaches above the tide line.”<sup>86</sup> The National Flood Insurance Program covers oil damage to policyholders’ property as a result of floods, but as noted in Part III.C below, that program is not foolproof, and because time parameters have not been established around liability under the OPA, it is unclear whether all derivative damage from an oil spill would be covered under the statute.<sup>87</sup>

While at first blush it would seem that the OPA provides adequate remedies to private individuals who are victims of oil spills, the ambiguity in the plain words of the OPA indicates a pressing need for clearly defined, streamlined remedies for individuals whose real or personal property is damaged as a result of a spill.

*B. The Gulf Coast Claims Facility and the Decline in Private Causes of Action: Problems of Timing, Discretion, and Ad Hoc Evaluations*

In the wake of the *Deepwater Horizon* oil spill, President Obama and BP negotiated to create a system for BP to address victims’ claims for costs and damages incurred as a result of the spill. BP set aside a twenty-billion-dollar fund and established the GCCF to administer payments to those seeking restitution. The GCCF was established to supplement the OPA recovery process, and the fund that BP allocated was generous. But since it was created outside of a legislative framework, there are no checks and balances, and the fund is so new that the system is being defined and administered in an impromptu way. This lack of accountability is particularly troublesome since one of the goals of the GCCF is to decrease the instances of private causes of action. The GCCF has the potential to provide victims with relief, but its standards and procedures need to be more narrowly defined.

Tort remedies are available to victims of the spill, but as GCCF administrator Kenneth Feinberg has said,

[U]nder [the GCCF], you will receive, if you’re eligible, compensation without having to go to court for years, without the uncertainty of going to court, since I’ll be much more generous than any court will be . . . . And at the same time, you won’t need to pay lawyers and costs.<sup>88</sup>

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85. ROBERT MUIR-WOOD, *THE MACONDO, GULF OF MEXICO OIL SPILL: INSURANCE IMPLICATIONS* 4 (2010).

86. *Id.*

87. *See infra* Part III.C (discussing the National Flood Insurance Program).

88. Frederic J. Frommer, *Administrator Has To ‘Sell’ BP Victims on Money*, ASSOCIATED PRESS (July 19, 2010, 1:53 PM), <http://www.nbcnews>

He added that those interested in seeking a tort remedy for their damages would be “crazy to do so.”<sup>89</sup> In fact, BP and the GCCF have made free legal assistance available for those filing claims with the GCCF.<sup>90</sup> But for those who choose not to utilize the free legal assistance, “[d]amages for claims for . . . Damage to Real or Personal Property . . . include the reasonable cost of estimating the damages claimed, but not attorney’s fees or administrative costs associated with preparation of the claim.”<sup>91</sup> This effectively discourages private causes of action by individuals for whom legal fees would be cost prohibitive.

The GCCF stated in its first anniversary report that it has consistently acted with “Efficiency and Speed”:

On this first year anniversary date, the GCCF has “processed” virtually *all* of the 947,892 claims submitted by claimants; the majority of claims remaining are those submitted during the past two–three months and those that have not provided sufficient documentation to resolve the claim.<sup>92</sup>

But those statistics do not paint the full picture. Immediately after the oil spill, there was an “interim solution designed to provide

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.com/id/38311190/ns/business-oil\_and\_energy/t/administrator-has-sell-bp-victims-money/.

89. *Id.*

90. BDO CONSULTING, INDEPENDENT EVALUATION OF THE GULF COAST CLAIMS FACILITY: REPORT OF FINDING & OBSERVATIONS TO THE U.S. DEPARTMENT OF JUSTICE 28 (2012) (“The GCCF informed us that, from its inception, it attempted to arrange for a process by which claimants would be able to receive free legal assistance. . . . [T]he GCCF entered into an agreement with the Mississippi Center for Justice, a nonprofit, public interest law firm, to oversee a consortium of legal services providers in the Gulf region that provided legal assistance to all claimants who sought it, regardless of income level. By its terms, the agreement stated that it was not imposing ‘any limitations on the professional judgment of legal services providers, including the ability to advise clients that they should reject a GCCF settlement offer and instead seek compensation from the NPFC or other oil spill fund, commence litigation, or take any other actions.’”).

91. *Id.* Exhibit P, at 5. One attorney reported that he “charges spill victims a 10% fee plus 2% of his costs.” David Bario, *Oil and Water: Plaintiffs’ Lawyers are Splitting Over the Performance of Kenneth Feinberg and BP’s Fund for Oil-Spill Victims*, NAT’L L.J. & LEGAL TIMES, Mar. 7, 2011, at 1.

92. GULF COAST CLAIMS FACILITY, THE GULF COAST CLAIMS FACILITY AFTER ITS FIRST YEAR OF OPERATION 3 (2011).

immediate relief to individuals and smaller businesses.”<sup>93</sup> Payouts were made in thirty-day increments and tended to be small, while the claims process was streamlined.<sup>94</sup> In January 2011, there were reports that the victims, “due to their desperation . . . [were] accept[ing] much smaller ‘quick-pay’ settlements that require[d] granting BP PLC and other oil-spill defendants full release from future lawsuits.”<sup>95</sup> It is clear that although the GCCF and BP fund have been very successful in distributing funds to victims, the system is imperfect.

By discouraging private causes of action, the GCCF lowers transaction costs for individuals and for BP in adjudicating claims and compensating victims. The creation of the GCCF was a boon to *Deepwater Horizon* victims, since the OPA caps liability for any spill at \$75,000,000. But payouts were not uniform, the timeframe for recovery has been unclear, and victims have been willing to take lower payments in return for quicker settlements. The system is fraught with issues of inequitable treatment and lacks the kind of uniformity needed to address the needs of taxpayers with casualty losses following major oil spills.

*C. Homeowner’s Insurance and the National Flood Insurance Program: Inadequacy of Coverage in the Wake of Oil Spills*

Insurance is an alternative avenue of recovery for oil spill victims, albeit a limited one. First of all, private homeowner’s insurance by and large does not cover damage from oil spills.<sup>96</sup> But flood insurance does. The Federal Emergency Management Agency (FEMA) oversees the National Flood Insurance Program (NFIP).<sup>97</sup> The NFIP offers flood insurance, reduces flood damage through floodplain management

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93. Alfred R. Light, *Designing the Gulf Coast Claims Facility in the Shadow of the Law: A Template from the Superfund § 301(e) Report*, 40 ENVTL. L. REP. NEWS & ANALYSIS 11121, 11122 (2010).

94. *Id.*

95. Barrio, *supra* note 91, at 1–4.

96. See Kenneth S. Abraham, *Catastrophic Oil Spills and the Problem of Insurance*, 64 VAND. L. REV. 1769, 1773 (2011) (“Homeowners policies are issued to the owners of residential property to cover the risk of direct physical loss to property. Most pollution damage affecting homeowners, however, would not be covered by such policies. The standard-form homeowners policy, for example, excludes coverage of loss to covered property caused by ‘the discharge, dispersal, seepage, migration, release or escape of pollutants’ unless the discharge, etc., is itself the result of one of a number of named perils or causes. The only named cause of loss that might result in pollution is ‘explosion.’ But few spills are caused by explosions or by any of the other named ‘perils’ that are exceptions to the exclusions in a homeowners policy, including the pollution exclusion.” (internal citations and quotation marks omitted)).

97. DANIEL A. FARBER ET AL., *DISASTER LAW AND POLICY* 311 (2010).

regulations, and identifies and maps American floodplains, creating “broad-based awareness of the flood hazards and provid[ing] the data needed for floodplain management programs and to actuarially rate new construction for flood insurance.”<sup>98</sup> Although this federally funded flood insurance is widely available,<sup>99</sup> it is elective.<sup>100</sup> Congress enacted the NFIP to remedy deficiencies in the flood insurance market, and property owners in communities that adopt and enforce the criteria set forth by the NFIP may buy into the insurance program.<sup>101</sup> Perhaps most importantly, the NFIP subsidizes the insuring owners of “existing buildings” that were constructed prior to the enactment of NFIP or prior to a community’s adoption of NFIP.<sup>102</sup>

A widely voiced concern in the months following the *Deepwater Horizon* disaster was the possibility of oil contamination of property due to flooding during hurricane season.<sup>103</sup> FEMA Claims Director James Sadler issued a memorandum on June 7, 2010, stating that as long as there is a defined flood, “[d]amage caused by the oil in flood waters is covered subject to the provisions of the [NFIP].”<sup>104</sup> But the NFIP limits the amount recoverable for damage caused by pollutants to \$10,000, and damage “to ground, soil, or land caused by flood, oil,

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98. *Id.* at 311–12 (quoting FEMA, NATIONAL FLOOD INSURANCE PROGRAM: PROGRAM DESCRIPTION 2 (Aug. 1, 2002)).

99. *Id.* at 311 (“Over 19,700 communities presently participate in the NFIP. These include nearly all communities with significant flood hazards.” (quoting FEMA, *supra* note 98, at 2)).

100. *Id.* at 312 (“Section 1304 of the 1968 Act authorizes the Director of FEMA to establish and carry out ‘a national flood insurance program which will enable interested persons to purchase insurance against loss resulting from physical damage to or loss of real property or personal property.’” (quoting FEMA, *supra* note 98, at 22)).

101. *Id.* (citing FEMA, *supra* note 98, at 22)

102. *Id.* (quoting FEMA, *supra* note 98, at 2).

103. See, e.g., Richard Rainey, *Flood Insurance Will Cover Oil Damage, but Only to Buildings*, NOLA.COM (June 2, 2010, 8:59 PM) [http://www.nola.com/news/gulf-oil-spill/index.ssf/2010/06/flood\\_insurance\\_will\\_cover\\_oil.html](http://www.nola.com/news/gulf-oil-spill/index.ssf/2010/06/flood_insurance_will_cover_oil.html) (explaining how flood insurance will work in the event that flood waters carry oil).

104. Memorandum from James A. Sadler, Claims Director, FEMA, to Write Your Own Principal Coordinators and the National Flood Insurance Program Servicing Agent 1 (June 7, 2010) [hereinafter Sadler Memorandum], available at <http://www.nfipiservice.com/pdf/bulletin/w-10065a.pdf>. FEMA defines “flood” as “a general and temporary condition of partial or complete inundation of two or more acres of normally dry land area or two or more properties . . . at least one of which is the policyholder’s property . . . from: overflow of inland or tidal waters[,] unusual and rapid accumulation of runoff or surface waters from any source[, or] mudflow.” *Id.* at 2.

or flood water mixed with oil is not covered.”<sup>105</sup> Ground contamination is likely covered through the OPA,<sup>106</sup> but the taxpayer would have to submit a claim to both the NFIP and to the claims facility organized under the OPA (the GCCF, for *Deepwater Horizon* victims) to be compensated. When a taxpayer accepts a payment from the NFIP, the taxpayer subrogates his or her right to recover payment from the party responsible for the oil spill to FEMA. And “[i]f the policyholder makes a claim against an entity who caused a loss and recovers any money, the policyholder must pay FEMA . . . back before they may keep any of the money.”<sup>107</sup>

This is obviously problematic. The taxpayer pays for flood insurance that covers only damage to his or her dwelling. The taxpayer has to submit one claim to the NFIP for that damage and a separate claim under the OPA to cover the costs of cleaning up the contaminated land. When the taxpayer is compensated by the party responsible for the oil spill, either through the OPA or a fund like the GCCF, the taxpayer then has to determine what portion of that compensation must be returned to FEMA under the NFIP. Two systems designed to assist victims offer disjointed recovery and result in added time and expense as the taxpayer determines the portion of the recoveries to which he or she is entitled. There must be an easier way.

#### IV. THE STAFFORD ACT AND § 165(h)(3)(c): APPLYING THE CASUALTY LOSS PROVISIONS FOR VICTIMS OF FEDERALLY DECLARED DISASTERS TO VICTIMS OF OIL SPILLS

The Code has specific provisions<sup>108</sup> for victims of federally declared disasters—provisions that are triggered when the President of the United States invokes the Stafford Act.<sup>109</sup> Among other

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105. *Id.*

106. A provision in the OPA makes the party responsible for the oil spill strictly liable for removal costs and damages. 33 U.S.C. § 2702(a)–(b) (2006).

107. Sadler Memorandum, *supra* note 104, at 2.

108. *See, e.g.*, I.R.C. § 165(i)(1) (2006) (“[A]ny loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred.”); I.R.C. § 165(k) (describing the procedure for treatment as a disaster loss where the taxpayer is required to relocate or demolish his or her residence because of a Stafford Act disaster declaration).

109. Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§ 5121–5207 (2006).

provisions, the Code allows disaster victims to elect to take their casualty loss for either the year of the loss or the preceding year.<sup>110</sup> Additionally, Congress has in certain instances made special tax provisions for victims of federally declared disasters<sup>111</sup> under the Stafford Act. The Stafford Act “authorizes the President to issue major disaster or emergency declarations in response to catastrophes in the United States that overwhelm state and local governments.”<sup>112</sup> In the wake of *Deepwater Horizon*, and in anticipation of future oil spills, Congress could use the Code to bolster insufficient insurance payouts or compensation from oil spill funds like the GCCF.<sup>113</sup> This could be done with or without invoking the Stafford Act; however, Congress’s recent actions easing the Code’s casualty loss restrictions have been done in conjunction with the Stafford Act, so it seems likely that Congress would restrict its action to federally declared Stafford Act disasters. The provisions already in the Code also indicate that special tax treatment should be reserved for Stafford Act disasters. Invoking the Stafford Act in response to the *Deepwater Horizon* accident or other oil spills would be inappropriate, given the Stafford Act’s statutory requirements, but the casualty loss allowances in the Code and that Congress has made in the past should be extended to oil spill victims.

Under the Stafford Act, major disasters are restricted to natural catastrophes, including storms, earthquakes, and floods, as well as fires, floods, and explosions, regardless of the cause.<sup>114</sup> After a natural catastrophe occurs, the governor of the affected state requests a major

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110. I.R.C. § 165(i)(1).

111. *See, e.g.*, MOLLY F. SHERLOCK ET AL., CONG. RESEARCH SERV., R 41323, TAX ISSUES AND THE GULF OF MEXICO OIL SPILL: LEGAL ANALYSIS OF PAYMENTS AND TAX RELIEF POLICY OPTIONS 10 (2010), available at [www.fas.org/sgp/crs/misc/R41323.pdf](http://www.fas.org/sgp/crs/misc/R41323.pdf) (“The Emergency Economic Stabilization Act of 2008 . . . 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 . . . ; 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.” (citing Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765)).

112. FRANCIS X. MCCARTHY, CONG. RESEARCH SERV., RL 33053, FEDERAL STAFFORD ACT DISASTER ASSISTANCE: PRESIDENTIAL DECLARATIONS, ELIGIBLE ACTIVITIES, AND FUNDING (Summary) (2011).

113. *See* SHERLOCK ET AL., *supra* note 111, at 8 (“From an economic perspective, tax relief may be justified as achieving distributional objectives or addressing market failures.”).

114. MCCARTHY, *supra* note 112, at 1 (citing 42 U.S.C. § 5121(2) (2006)).

disaster declaration, and the President has three options: issue a major disaster declaration, issue an emergency declaration, or decline the request.<sup>115</sup> Issuing an emergency or major disaster declaration under the Stafford Act allows for rapid and flexible FEMA assistance<sup>116</sup>:

Emergency declarations trigger aid that protects property, public health, and safety and lessens or averts the threat of an incident becoming a catastrophic event. A major disaster declaration, issued after a catastrophe occurs, constitutes broader authority for federal agencies to provide supplemental assistance to help state and local governments, families and individuals, and certain nonprofit organizations recover from the incident.<sup>117</sup>

Issuing a major catastrophe or emergency declaration in response to the *Deepwater Horizon* disaster could have created redundancy issues, since the disaster is already being addressed under the Oil Pollution Act.<sup>118</sup> A larger issue is the availability of tort remedies following a Stafford Act declaration. After the *Exxon Valdez* oil spill in 1989, the President turned down the governor of Alaska's requests for a Stafford Act declaration out of a concern that "a declaration by the President would hinder the government's litigation against Exxon that promised substantial compensation for the incident."<sup>119</sup> An attorney for FEMA explained,

The Department of Justice opposed a declaration of disaster by then-President George H. W. Bush on the basis that it might impact adversely the case of the United States against Exxon. . . . Acting General Counsel of FEMA, George Watson, said . . . that he had issued a legal opinion stating that no declaration of an oil spill could be made under the Stafford Act. . . . FEMA's congressional liaison [issued a statement concluding] that where a parallel statutory scheme offered both compensation and better litigation rights to the United States than the Stafford Act, then the president would not declare a disaster or emergency.<sup>120</sup>

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115. *Id.* at 10.

116. FRANCIS X. MCCARTHY, CONG. RESEARCH SERV., R 41234, POTENTIAL STAFFORD ACT DECLARATIONS FOR THE GULF COAST OIL SPILL: ISSUES FOR CONGRESS (2010).

117. *Id.* at 1.

118. *Id.* (Summary).

119. *Id.* (Summary).

120. *Id.* at 3 (quoting William R. Cumming, Letter to the Editor, 33 NAT. HAZARDS OBSERVER, Jan. 2009, at 22, 22).

In addition to these obstacles, the fact that BP created the fund and established the GCCF means that there is not a pressing need for a disaster or emergency declaration under the Stafford Act. Additionally, one of the goals of the Stafford Act is “encouraging individuals, States, and local governments to protect themselves by obtaining insurance coverage to supplement or replace government assistance.”<sup>121</sup> But one of the overarching goals of the Stafford Act is “providing Federal assistance programs for both public and private losses sustained in disasters.”<sup>122</sup> Congress’s legislation in the wake of Hurricane Katrina—dropping the 10 percent AGI requirement for casualty losses—helped achieve this goal by allowing more people to recover their losses; provisions in the Code that are triggered by the Stafford Act allow individuals to claim a casualty loss in the actual year of the loss or the preceding year, creating more financial flexibility for victims. While the OPA creates a parallel statutory scheme and redundancy issues, and while there is always an inherent moral hazard in the casualty loss provision of the Code, these problems do not outweigh the broader issue that the current framework for recovery by individual oil spill victims is not streamlined enough to provide guaranteed, uniform recovery. The justifications for the Stafford Act and for additional legislation passed by Congress to bolster the tax allowances triggered by the Stafford Act are equally applicable to the oil spill context, and can be used to support a uniform statutory scheme to allow victims of casualty losses to fully recover in the wake of an oil spill.

## V. REDUCING TRANSACTION COSTS AND STREAMLINING THE SYSTEM THROUGH IRS SUBROGATION

Thus far, this Note has made several observations: Oil spills are casualties within the meaning of Code section 165(c).<sup>123</sup> Without a clear framework for recovery, taxpayers contemporaneously seeking casualty loss deductions from the IRS and recoveries from the responsible party have the potential to suffer the adverse effects of the Tax Benefit Rule.<sup>124</sup> In the oil spill context, the Eleventh Circuit’s holding that a decline in property value absent physical damage constitutes a casualty loss needs to be adopted, over the Ninth Circuit’s objections, either congressionally or judicially.<sup>125</sup> The OPA,

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121. 42 U.S.C. § 5121(b)(4) (2006).

122. 42 U.S.C. § 5121(b)(6).

123. See discussion *supra* Part I (discussing mechanics and application of I.R.C. § 165(c)(3)).

124. See discussion *supra* Part I (discussing the Tax Benefit Rule).

125. See discussion *supra* Part II (discussing circuit split between the United States Courts of Appeals for the Ninth and Eleventh Circuits).

GCCF, homeowner's insurance, and the NFIP do not offer sufficient protection to the victims of oil spills, and are sometimes even in conflict.<sup>126</sup> Oil spills are not disasters within the meaning of the Stafford Act, but the legislative framework of the Stafford Act and Congress's post-Hurricane Katrina tax legislation ought to be applied to the oil spill context.<sup>127</sup> And the current state of affairs for oil spill casualty losses is disjointed and inefficient. There are, no doubt, countless ways to address the shortcomings of the current system, but this Note proposes one solution: IRS subrogation, with an adoption of the Eleventh Circuit's holding that property value decline constitutes a casualty loss, a removal of the Code section 165(h) floors, and an adoption of the Code section 165(i) election provision, allowing recovery to all taxpayers victimized by an oil spill casualty.

Subrogation is defined as "[t]he substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or securities that would otherwise belong to the debtor."<sup>128</sup> A party is subrogated to the rights of another "when the first party steps into the second party's shoes . . . and assumes the second party's rights against a third party."<sup>129</sup> There are three types of subrogation: equitable, contractual, and statutory. Equitable, or legal, subrogation "arises by operation of law,"<sup>130</sup> and "is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice; and is independent of any contractual relations between parties."<sup>131</sup> Courts have laid out different standards to invoke the doctrine of equitable subrogation. A typical formulation of the elements of equitable subrogation is

(1) the party claiming subrogation has paid the debt; (2) the party was not a volunteer, but had a direct interest in the discharge of the debt or lien; (3) the party was secondarily

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126. See discussion *supra* Part III (discussing the OPA, GCCF, and insurance).

127. See discussion *supra* Part IV (discussing the Stafford Act).

128. BLACK'S LAW DICTIONARY 1563–64 (9th ed. 2009).

129. KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 274 (5th ed. 2010) ("For example, suppose that the insured's home is destroyed by a fire negligently set by her neighbor, and the . . . insurer pays the insured the amount of the loss. The insurer is then entitled to recover this amount from the neighbor, either directly in a suit against the neighbor (in what would be called 'active' subrogation), or as the real party in interest in a suit brought by the insured, through a right to be reimbursed out of the proceeds of such a suit (in what might be called 'passive' subrogation).").

130. *Id.*

131. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 136 n.12 (1962) (quoting *Memphis & L.R.R. Co. v. Dow*, 120 U.S. 287, 301–02 (1887)).

liable for the debt or for the discharge of the lien; and (4) no injustice will be done to the other party by the allowance of the equity.<sup>132</sup>

Contractual, or conventional, subrogation “results from an agreement of the parties,”<sup>133</sup> and usually takes the form of a subrogation clause in a contract. Statutory subrogation is codified in a state’s insurance legislation.<sup>134</sup>

The federal government, too, has statutory subrogation rights.<sup>135</sup> For example, the Federal Medical Care Recovery Act<sup>136</sup> gives the United States government the “right to reimbursement as [a] subrogee to third-party tort claims of certain individuals, such as military personnel and their dependents, who receive free medical or dental care.”<sup>137</sup> Likewise, there is a Medicare provision under which the “United States is subrogated to any right of an individual or entity to payment with respect to [an] item or service when Medicare is [the] primary plan.”<sup>138</sup> The NFIP gives FEMA subrogation rights for oil spill damage when an insured receives a financial recovery from a responsible party.<sup>139</sup> President Obama submitted a legislative package to Congress outlining a similar approach for unemployment funds, requiring that BP “reimburse the government for unemployment wages paid to the individual while the individual’s claim is being processed.”<sup>140</sup> Supplemental nutrition assistance and commodity distributions to victims likewise would have been charged to BP

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132. *Pharmacists Mut. Ins. Co. v. Cincinnati Ins. Co.*, 658 F. Supp. 2d 745, 749 n.3 (D.S.C. 2009) (quoting *Kuznik v. Bees Ferry Assoc.*, 538 S.E.2d 15, 30 (S.C. Ct. App. 2000)).

133. ABRAHAM, *supra* note 129, at 274.

134. *See, e.g.,* ROBERT H. JERRY II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* 680 (4th ed. 2007) (“[I]t is common for statutes to create, limit, or prohibit subrogation with respect to uninsured, underinsured, first-party medical, and no-fault coverages.”).

135. *See id.* at 681 n.117 (using the Federal Medical Care Recovery Act as an example of a federal statute giving subrogation rights to the federal government).

136. 42 U.S.C. § 2651 (2006).

137. JERRY & RICHMOND, *supra* note 134, at 681 n.117.

138. *Id.*

139. *See* discussion *supra* Part III.C (discussing NFIP subrogation); note 112 and accompanying text (noting that the damage caused by oil in flood waters is covered by NFIP).

140. Press Release, White House Press Secretary, Fact Sheet: Deepwater Horizon Oil Spill Legislative Package (May 12, 2010), *available at* <http://www.whitehouse.gov/the-press-office/fact-sheet-deepwater-horizon-oil-spill-legislative-package>.

under the proposed legislative package.<sup>141</sup> Statutory subrogation is nothing new for the United States government, and in the context of casualty losses from the *Deepwater Horizon* disaster, it could provide a workable solution to lower transaction costs and ensure that victims are adequately compensated for their losses.

The OPA includes a section on subrogation of claims,<sup>142</sup> providing that “[a]ny person . . . who pays compensation pursuant to this Act to any claimant for removal costs or damages shall be subrogated to all rights, claims, and causes of action that the claimant has under any other law.”<sup>143</sup> This subrogation clause is expansive enough that it could include the IRS.

By implementing subrogation, the IRS “could aim to recover the amount of tax revenue lost directly because of the deduction taken by the tort victim.”<sup>144</sup> In an article proposing subrogation of section 165 casualty loss deductions, Andrew Blair-Stanek proposes three methods by which the IRS could implement subrogation. In the absence of statutory authority, he suggests first that the IRS could “issue regulations giving itself the power to pursue subrogation rights and hope that courts find these regulations worthy of the relevant level of deference.”<sup>145</sup> Second, the IRS could, as an alternative, “simply claim equitable subrogation rights.”<sup>146</sup> He notes that courts would likely be unsympathetic to these two approaches,<sup>147</sup> and he is probably correct. It is difficult to say how an individual court would reasonably interpret the Internal Revenue Code. Equitable subrogation is “an equitable right whereby a nonvolunteer who is secondarily liable for and pays a third party’s debt succeeds to the creditor’s rights against that third party.”<sup>148</sup> The IRS would be a volunteer in this situation and would not be secondarily liable.

His third suggestion is statutory subrogation: “[S]ubrogation would probably require congressional authorization, which could also address procedural details such as venue, notice, available defenses, the effect of contractual waivers, and the deductibility of a tortfeasor’s payments to a prevailing IRS.”<sup>149</sup> This is the most realistic

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141. *Id.*

142. 33 U.S.C. § 2715 (2006).

143. 33 U.S.C. § 2715(a).

144. Blair-Stanek, *supra* note 15, at 342.

145. *Id.* at 343.

146. *Id.*

147. *See id.* (“[C]ourts would likely hesitate to find a subrogation right in a reasonable interpretation of the statute.”).

148. JERRY & RICHMOND, *supra* note 134, at 680.

149. Blair-Stanek, *supra* note 15, at 343–44.

of his three proposals. For one thing, congressional action permitted the elimination of section 165(h) floors following Hurricane Katrina. This precedent for alleviating strains on taxpayers following major crises indicates that Congress might be willing to make similar adjustments based on public policy considerations in the oil spill context.

There would likely be three main arguments against implementing IRS subrogation in this context. First, the administrative costs to the IRS would be high. The IRS would have to set up a system to monitor and evaluate claims, and maybe even set up an auditing system. The current system could, however, be tweaked to allow for this new framework:

When taking § 165 deductions, taxpayers currently must fill out a form listing each property damaged, along with insurance information, date acquired, and fair market values. It would not be difficult to require brief information about the cause of the loss. This information would allow the IRS to perform a quick cost-benefit analysis and decide whether to pursue its subrogation rights.<sup>150</sup>

After allowing the casualty loss deduction, the IRS would then sue the tortfeasor to recover the lost revenue.<sup>151</sup> If successful, the taxpayer has received the deduction, and the IRS has recovered lost revenue from allowing the deduction. Granted, there would be a transaction cost to the IRS in enforcing its subrogation rights that would not be covered by a favorable outcome to such a lawsuit. The OPA offers a solution to this problem:

The Fund shall be available to the President for . . . the payment of Federal administrative, operational, and personnel costs and expenses reasonably necessary for and incidental to the implementation, administration, and enforcement of this Act . . . with respect to prevention, removal, and enforcement related to oil discharges . . .<sup>152</sup>

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150. *Id.* at 343.

151. Blair-Stanek proposes that, at this point, “the victim will probably often join the lawsuit to vindicate her full rights . . . [and] the IRS could simply leave the suit. Should the victim recover, the taxpayer would lose the deduction, thereby restoring the Treasury to the same position as if it had won on its own.” *Id.* at 344. While this point is well taken, it arguably defeats the purpose of lowering transaction costs to individual taxpayers. A more efficient approach may be to have the casualty loss deduction be the final mode of recovery for a taxpayer in this situation.

152. 33 U.S.C. § 2712(a)–(a)(5) (2006).

It remains to be seen whether the President could or would utilize funds under the OPA to compensate the IRS for a subrogation program for casualty losses to individuals, but there is statutory framework in place to support such a decision.

The second criticism to this approach is that low-income taxpayers do not benefit as much from an income tax deduction as high-income taxpayers. A solution to this problem could be to provide a casualty loss credit instead of a casualty loss deduction. The feasibility of this option is beyond the scope of this Note, but it is certainly an option worth considering, because a “refundable tax credit would provide a more equitable benefit across income levels.”<sup>153</sup> A suggestion for limiting this kind of taxpayer recovery is to limit the credit to “a fixed amount, which would limit compensation for taxpayers with higher uninsured losses.”<sup>154</sup> But this kind of limitation could cause run-ins with the insurance issues discussed in Part III.C. The framework and feasibility of such a program would need to be explored further, prior to implementation.

The third criticism questions why the section 165(i) Stafford Act election provision should apply, and why the 165(h) floors should be removed in this context at all. But “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.”<sup>155</sup> Market failures following an oil spill like *Deepwater Horizon* include imperfections in the statutory framework of the OPA, imperfections in the existing insurance options, and the uncharted territory of the GCCF. “From this perspective, the nation broadly shares the risk of large-scale disasters by providing federal relief where insurance markets are incomplete.”<sup>156</sup> While BP is expected to compensate individuals for losses, thus weighing against an argument for reduced tax liability to *Deepwater Horizon* victims, the systemic flaws of the GCCF, OPA, and insurance discussed in Part III indicate that a different framework is necessary to uniformly compensate taxpayers who are in need. Streamlining the recovery process by dropping the floors to allow more widespread recovery, and allowing the taxpayer to choose the year in which to claim the casualty loss deduction to “accelerate the benefit associated with the loss deduction during a time of need,”<sup>157</sup> reduces a taxpayer’s recovery process to making one claim, on his or

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153. SHERLOCK ET AL., *supra* note 111, at 10.

154. *Id.*

155. *Id.* at 8.

156. *Id.*

157. *Id.* at 10.

her tax return, instead of jumping through the hoops of the private insurance, the NFIP, the OPA, and the GCCF.

### CONCLUSION

The current system of casualty loss compensation for taxpayers victimized by oil spills like the *Deepwater Horizon* disaster is flawed. This Note's proposal—IRS subrogation of casualty loss claims coupled with the adoption of Code section 165(i) Stafford Act election and an elimination of the Code section 165(h) floors—is by no means perfect either. But ideas like this are a step in the right direction toward providing a streamlined, equitable system of taxpayer recovery for casualty losses in the wake of future oil spills.

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