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The Flurry of Tax Law Changes Following the 2005 Hurricanes: A Strategy for More Predictable and Equitable Tax Treatment of Victims

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ARTICLES

The Flurry of Tax Law Changes Following the 2005 Hurricanes

A STRATEGY FOR MORE PREDICTABLE AND EQUITABLE TAX TREATMENT OF VICTIMS

Patrick E. Tolan, Jr.[†]

I. INTRODUCTION

> Whether we face an active hurricane season, like this year, or a below-normal season, the crucial message for every person is the same: prepare, prepare, prepare.
>
> —Max Mayfield, National Hurricane Center Director, May 2006.[1]

Although experts had predicted the increased hurricane activity of the past two years,[2] the U.S. response to the 2005 hurricanes was anything but adequate.[3] In the months

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[1] National Oceanic and Atmospheric Association [hereinafter NOAA], *NOAA Predicts Very Active 2006 North Atlantic Hurricane Season–Residents in Hurricane Prone Areas Urged to Make Preparations*, NOAA MAGAZINE, May 22, 2006, http://www.noaanews.noaa.gov/stories2006/s2634.htm (last visited Jan. 9, 2007).

[2] "It appears the Atlantic Ocean is beginning to enter another active period, posing more danger to the East Coast than the previous period of activity because of increased population and economic development." H.R. REP. NO. 107-495, at 3-4 (2002), *reprinted in* 2002 U.S.C.C.A.N. 1102, 1104 (Dr. Chris Landsea, NOAA Hurricane Research Division, testimony before the House Committee on Science).

[3] *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE [hereinafter GAO], EXPEDITED ASSISTANCE FOR VICTIMS OF HURRICANES KATRINA AND RITA: FEMA'S CONTROL WEAKNESSES EXPOSED THE GOVERNMENT TO SIGNIFICANT FRAUD AND ABUSE, GAO-06-655 (2006); H.R. REP. NO. 109-396, at 2 (2006) ("It is well-documented that the response at all levels of government was inadequate"). It could be argued that the

following the most destructive hurricane season the world has ever known,[4] virtually every aspect of the U.S. response has been scrutinized.[5] This article examines the tax relief measures that were triggered by Hurricane Katrina and the later hurricanes of 2005. Unfortunately, the tax system is not as predictable as its meteorological counterpart.[6]

While the post-hurricane Internal Revenue Service (IRS) pronouncements and the 2005-2006 legislation arguably afforded the most generous tax relief in U.S. history,[7] at the same time it created six different classes of 2005 victims for tax purposes. Improved tax relief should be extended equally to all victims of disasters. Unless and until our national leaders develop permanent, equitable tax treatment for victims of all disasters, American businesses, especially small businesses, and the American people, particularly the poor, are ill suited to weather the storm.

This article begins by putting emergency tax relief in perspective. The first half of the article is factual. Part II provides background on the magnitude of the hurricanes of 2005 in the context of other national disasters. The section discusses insurance as a traditional safeguard to catastrophic

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magnitude of the 2005 hurricanes could not be predicted, but the record reflects otherwise. *See* GAO, CATASTROPHE INSURANCE RISKS: STATUS OF EFFORTS TO SECURITIZE NATURAL CATASTROPHE AND TERRORISM RISK 1, GAO-03-1033 (2003) (major hurricane loss to U.S. could be as high as $110 billion; major earthquake losses could reach $225 billion).

[4] FRANCES FRAGOS TOWNSEND, THE FEDERAL RESPONSE TO HURRICANE KATRINA: LESSONS LEARNED 1, 5-9 (Feb. 23, 2006), http://www.whitehouse.gov/reports/katrina-lessons-learned.pdf [hereinafter LESSONS LEARNED]. "Measuring destructiveness in terms of damage to property rather than loss of life is a useful way to compare disasters. Loss of life reflects both the magnitude of the disaster, as well as the quality of the response, while property destruction correlates more directly to the magnitude of the disaster alone." *Id.* at 151 n.2.

[5] *Id.* at 51-64 (discussing critical failures that undermined and prevented a more efficient and effective federal response). *See also* H.R. REP. NO. 109-377 (2006); H.R. REP. NO. 109-396 (2006) (discussing flaws in emergency response coordination and control).

[6] For a detailed examination of tropical storm prediction accuracy and methodology, see generally JAMES L. FRANKLIN, NATIONAL HURRICANE CENTER–NOAA/NWS/NCEP/TROPICAL PREDICTION CENTER, 2005 NATIONAL HURRICANE CENTER FORECAST VERIFICATION REPORT 1 (May 21, 2006), http://www.nhc.noaa.gov/verification/pdfs/Verification_2005.pdf. "Not only were the 12-72 h[our] forecasts more accurate in 2005 than they had been over the previous decade, but the forecasts were also more skillful." *Id.* at 6.

[7] The relief prompted by these tragedies continued well into 2006. *See e.g.*, Rev Proc. 2006-32, 2006-28 I.R.B. 61 (detailing safe harbor methods for proving casualty losses); I.R.S. Notice 2006-67, 2006 WL 2209784 (GO Zone bonus depreciation calculations and examples); I.R.S. Notice 2006-56, 2006-28 I.R.B. 56 (expanded Hurricane Katrina relief for certain individual taxpayers).

damage and dilemmas confronting the insurance and reinsurance industries. It then examines long-standing casualty tax relief measures already incorporated in the Internal Revenue Code (also referred to as I.R.C., Code, or tax code), as well as the specific ad hoc tax implications of earlier major national disasters.

Part III examines the tax aftermath flowing immediately from Hurricane Katrina. Part IV looks at the continued tax relief in response to all three major hurricanes of 2005—Katrina, Rita and Wilma. The Gulf Opportunity Zone (GO Zone) approach and disparate treatment for victims in the different disaster areas are also discussed in Part IV.

The second half of the article considers these developments in terms of tax policy. The author contends that (from a tax perspective) these 2005 catastrophes are different in scope only, not in kind, from other catastrophes which make some businesses unable to function, and damage or destroy individuals' homes and property.

Part V of the article examines which of the casualty relief measures ought to be expanded and enhanced for future victims and which should be abandoned. The complementary goals of taxpayer equity and a tax code that is sufficiently predictable to foster desired taxpayer behavior frame the analysis.

The remainder of the article focuses on specific proposals to improve tax treatment of casualty victims. Along these lines, both procedural and substantive changes to the Code are proposed. Changes beneficial to individual taxpayers, as well as small businesses, are emphasized.

Part VI advocates permanent changes to the tax code that would automate procedural relief. Part VII calls for a casualty loss credit, versus a deduction, to better aid the poor. Part VIII advocates relaxing constraints on retirement account access for all casualty victims. Part IX proposes creation of tax advantaged Catastrophe Savings Accounts for individuals, businesses, and the insurance industry to encourage safeguarding against potential losses. Part X calls for tax credits and relief for businesses affected by any presidentially-declared disaster. Part XI discusses a temporary tax credit for retroactive measures to make older buildings more impervious to weather.

Preparation is the key to recovery for those confronted with unparalleled hardship. For this reason, the author argues that equity and efficiency dictate a more predictable, uniform, and compassionate response to all casualty victims. Predictability is fostered by making permanent changes to the tax code with incentives to motivate precautionary financial and tax planning. Tax relief should complement insurance and other federal emergency relief measures designed to allow victims to rebuild their economic lives.[8]

II. BACKGROUND

A. *Bad Weather Is Nothing New*

The National Hurricane Center issued more hurricane forecasts in the Atlantic basin in 2005 than in any previous year.[9] Nevertheless, the United States should expect a major catastrophic hurricane (Category 4 or 5)[10] to make landfall every six to seven years.[11] Even weaker storm systems can cause tremendous flood damage.[12] In North Carolina, for example, Category 2 hurricanes (as opposed to those much stronger) account for forty-two percent of all damage.[13]

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[8] While some discussion of available relief is inevitable to demonstrate how tax measures best complement other federal aid, a comprehensive analysis of available federal and state emergency relief is beyond the scope of this article. For information on Federal Emergency Relief, see generally Robert T. Stafford Disaster Relief and Emergency Assistance Act, Pub. L. No. 100-707, 102 Stat. 4689 (1988) (codified as amended at 42 U.S.C. §§ 5121-5206 and at scattered sections of 26 U.S.C.) [hereinafter Stafford Act]. See also Francine J. Lipman, A*natomy of a Disaster Under the Internal Revenue Code*, 6 FLA. TAX REV. 953, 958 (2005), for an excellent look at the pre-Katrina relationship between emergency relief and tax consequences following a disaster.

[9] The National Hurricane Center tracks all tropical cyclones. FRANKLIN, *supra* note 6, at 5. A "hurricane" is the term used popularly for a strong tropical cyclone in the North Atlantic Ocean—similar storms are known as typhoons in the Northwest Pacific Ocean. Atlantic Oceanographic and Meteorological Lab., Hurricane Research Division, Frequently Asked Questions, http://www.aoml.noaa.gov/hrd/tcfaq/A1.html (last visited Mar. 2, 2007).

[10] Hurricanes are rated on the Saffir-Simpson Scale from Category 1 (mildest; winds 74-95 mph) through Category 5 (most severe; winds greater than 155 mph). HURRICANE! 2006–A HURRICANE PREPAREDNESS BOOKLET 1, 7 (May 2006), http://vortex.accuweather.com/adc2004/pub/images/promos/florida2004/hurricane_book.pdf. Although Hurricane Katrina reached Category 5, it was actually lower at landfall. *See* Hurricane Katrina Advisory Archive, http://www.nhc.noaa.gov/archive/2005/KATRINA.shtml (view the links for Monday, August 29, 2005) (last visited Jan. 9, 2007).

[11] Eric S. Blake et al., *The Deadliest, Costliest, and Most Intense United States Tropical Cyclones from 1851 to 2005* (NOAA Technical Memorandum NWS TPC-4), http://www.nhc.noaa.gov/ Deadliest_Costliest.shtml (last visited Jan. 9, 2007).

[12] H.R. REP. NO. 107-495, at 1103-04 (testimony of Dr. Len Pietrafesa, North Carolina State University, in support of the Inland Flood Forecasting and Warning System Act of 2002).

[13] *Id.* at 1104 ("Category 2 Hurricanes generally have a high moisture content and cause severe . . . flooding.").

Mitigation measures, predominantly improved building codes, have helped to "harden" vulnerable property.[14] However, the lure of the coast continues to bring more people and property into the areas most likely to be affected by hurricanes.[15] Because of these predictable weather profiles and demonstrated demographic trends, the risks from hurricanes will always be present.[16]

Hurricanes are only one form of natural disaster. Tornados, earthquakes, wild fires, blizzards, volcanoes, landslides, mudslides, flooding and hail storms also wreak havoc. Other disasters, such as Tsunamis, could potentially threaten the United States, though the threat, historically, has been comparatively minor.[17]

According to the Federal Emergency Management Agency (FEMA), flooding, severe storms, and hurricanes are the most common and costly causes of disaster declarations in the United States.[18] "[A]t least ten such events since 1989 have each required FEMA relief expenditures in excess of a billion dollars."[19] However, all disasters, not just those disasters meriting presidential attention, leave lives in ruin and personal devastation for their victims. Because these smaller tragedies are vastly more numerous, they continue to impact tens of thousands of Americans each year.[20]

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[14] *See generally* Dr. Robert P. Hartwig, Senior Vice President & Chief Economist of the Ins. Info. Inst., Presentation to the Wharton Risk Management and Decision Processes Center Roundtable, *The Lessons of Hurricane Andrew: Is Florida Really Ready*? (June 11, 2002), http://server.iii.org/yy_obj_data/binary/686021_1_0/hurricanestudy.pdf.

[15] For example, in the past twenty-five years, "communities along the . . . East Coast have dramatically increased development . . . despite the knowledge that a hurricane or large tropical storm could cause significant damage to property and life." H.R. REP. NO. 107-495, at 1104. *See also* Ins. Info. Inst. [hereinafter I.I.I.], *Hurricanes: Facts and Statistics*, http://www.iii.org/media/facts/statsbyissue/ hurricanes (last visited Mar. 2, 2007) (property values in coastal areas doubled over past decade).

[16] Forecasters have long predicted a "damaging period of frequent storms" that could cost more than $110 billion if it hit New England. H.R. REP. NO. 107-495, at 1104. *See also* H.R. REP. NO. 106-526, at 18, 19 (2000) (testimony in support of Homeowners' Insurance Availability Act of 2000).

[17] "[T]he frequency of damaging tsunamis in the United States has been low, compared with other natural hazards." GAO, U.S. TSUNAMI PREPAREDNESS: FEDERAL AND STATE PARTNERS COLLABORATE TO HELP COMMUNITIES REDUCE POTENTIAL IMPACTS, BUT SIGNIFICANT CHALLENGES REMAIN 10, GAO-06-519 (2006). According to NOAA, the last significant tsunami struck Skagway, Alaska, in 1994 causing "one death and $25 million in damages." *Id.* at 10-11.

[18] *Id.* at 11.

[19] *Id.*

[20] Press release, American Red Cross, Survey Reveals Americans Not as Prepared as They Think (May 23, 2006), http://www.redcross.org/pressrelease/

In the United States, catastrophic disasters causing at least $25 million in direct damages occur on average about twice a month.[21] While the major hurricanes of 2005 captured all of the media attention, over the same timeframe, the American Red Cross responded to a record 72,883 disasters, most of them fire-related.[22] "Fire kills more Americans each year than all other disasters combined."[23]

Whether the disaster is large or small, man-made or natural, if it hits you, it hurts you. Few would argue that the victims of arson or terrorist attacks are any less worthy of tax relief than the victims of a natural disaster. Who can forget or ignore the tragedy and loss of September 11, 2001? Because disasters harm whomever they strike, all victims of casualty losses should be treated equally under the tax code.

B. *Insurance as a Safeguard*

Insurance as a means of protection against perils has been around for hundreds of years.[24] Standard insurance for perils such as fires, vandalism, burglary, or theft has historically been available to homeowners as part of their basic policy coverage.[25] Homeowners' policies typically insure against some severe weather damage, such as wind and hail coverage, but the insurance against water damage from storms is seriously limited.[26] Much of the catastrophic damage from

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0,1077,0_314_5398,00.html [hereinafter "American Red Cross"] (last visited Jan. 9, 2007).

[21] Lipman, *supra* note 8, at 958 (citing I.I.I., *Catastrophes: Facts and Statistics: Insured Losses for U.S. Catastrophes 1994-2003*, http://www.iii.org/media/facts/statsbyissue/catastrophes/ (last visited Jul. 3, 2004)). The most recent data confirms this frequency in 2004-2006. I.I.I., *Catastrophes: Facts and Statistics: Insured Losses for U.S. Catastrophes 1997-2006*, http://www.iii.org/media/facts/statsbyissue/catastrophes/ (last visited Mar. 2, 2007).

[22] American Red Cross, *supra* note 20.

[23] Christina Ward, *Quiet Disasters: House Fires Destroy Lives Every Day*, RED CROSS. ORG., Apr. 6, 2006, http://www.redcross.org/news/ds/fires/010406housefires.html. *See also* U.S. Fire Administration, USFA National Fire Statistics, http://www.usfa.dhs.gov/statistics/national/ (last visited Jan. 11, 2007).

[24] *See*, *e.g.*, Ins. Co. v. Dunham, 78 U.S. (11 Wall.) 1, 31-33 (1870) (discussing evolution of maritime insurance over the past ten centuries).

[25] *See* National Flood Insurance Act of 1968, Pub. L. No. 90-448, 82 Stat. 476 (codified as amended at 42 U.S.C. §§ 4001-4029). *See also* I.I.I., Hot Topics & Issues Updates, *Catastrophes: Insurance Issues*, (March 2007), http://www.iii.org/media/hottopics/insurance/xxx [hereinafter *Catastrophes: Insurance Issues*] (commercial policies generally cover the same causes of loss, but vary somewhat based on coverage selected).

[26] *See*, *e.g.*, Leonard v. Nationwide Mut. Ins. Co., 438 F. Supp. 2d 684, (S.D. Miss. 2006) (policy precluded damage from flooding and storm surge during Hurricane

hurricanes results from flood damage due to the storm surge and heavy rains.[27] Unfortunately, most policies contain an express "flood exclusion."[28]

Flood insurance has not been commercially available through the private insurance industry "[b]ecause of the high risks and the lack of under-writing standards."[29] Therefore, in 1968, Congress created a voluntary National Flood Insurance Program (NFIP) underwritten by the federal government.[30] Over the years, the federal government assumed responsibility for providing relief and for partial indemnification for property losses resulting from floods.[31]

Historically, floods have been one of the most destructive national hazards facing the people of the United States.[32] The year 2005 was no exception. In Louisiana alone, Hurricane Katrina caused over $38 billion in flood and storm surge damage, most of it uninsured.[33] Louisiana was also hardest hit with insured Katrina-related losses of over $24 billion.[34]

For decades, Congress has been "acutely aware of the national need for a reliable and comprehensive flood insurance

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Katrina, but covered damage caused by wind). The I.I.I. indicates a typical homeowners policy contains a provision stating, "We do not pay for loss to the interior of a building or to personal property inside, caused by rain, snow, sleet, sand or dust *unless the wind or hail first damages the roof or walls and the wind forces rain, snow, sleet, sand or dust through the opening*." Dr. Robert P. Hartwig, Senior Vice President & Chief Economist of the I.I.I., Presentation, *Hurricane Season of 2005: Impacts on US P/C Insurance Markets In 2006 & Beyond* 1, 145 (Mar. 2006), http://server.iii.org/yy_obj_data/binary/744085_1_0/katrina.pdf [hereinafter Hartwig, *Impact of 2005 Hurricanes on US P/C Insurance Markets*].

27 For example, Hurricane Katrina damages due to storm surge and flooding were estimated at $44 billion, compared to $38 billion for all other property damage. Hartwig, *Impact of 2005 Hurricanes on US P/C Insurance Markets*, *supra* note 26, at 36, 48.

28 *Id.* at 146.

29 S. REP. NO. 93-583 at 3219 (1973), *as reprinted in* 1973 U.S.C.C.A.N. 3217-19.

30 National Flood Insurance Act of 1968 § 4001 (codified at 42 U.S.C. § 4001). *See also* S. REP. NO. 93-583, at 3219.

31 *See* S. REP. NO. 93-583, at 3220.

32 GAO, CHALLENGES FACING THE NATIONAL FLOOD INSURANCE PROGRAM, Highlights, GAO-03-606T (2003), *available at* http://www.gao.gov/new.items/d03606t.pdf.

33 Dr. Robert P. Hartwig, Presentation to Baton Rouge Press Club, *Louisiana Insurance Market Overview: Beyond Hurricanes Katrina and Rita* 1, 26 (May 15, 2006), http://server.iii.org/yy_obj_data/binary/754699_1_0/louisiana.pdf [hereinafter Hartwig, *Beyond Katrina*].

34 *Id.* at 42 (includes $1.47 billion in flood-damaged vehicles covered by comprehensive policies).

program"[35] because as many as ninety percent of all natural disasters in this country involve flooding.[36] However, as demonstrated in 2005, Congress has yet to strike the right balance with the NFIP.[37]

In 2006 testimony before Congress, the Comptroller General declared the NFIP program "essentially bankrupt."[38] Congress agreed to a $17 billion bailout of the NFIP[39] and began crafting legislation to improve the capacity of the program to deal with the most significant catastrophes.[40]

The NFIP is broken for a variety of reasons. Most who need flood insurance do not purchase it.[41] Premiums are also "woefully inadequate given the technical bankruptcy of the NFIP."[42] Even for homeowners who do insure, because of subsidies, homeowners do not bear the true share of costs

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[35] S. REP NO. 93-583, at 3218.

[36] GAO, FEDERAL EMERGENCY MANAGEMENT AGENCY: IMPROVEMENTS NEEDED TO ENHANCE OVERSIGHT AND MANAGEMENT OF THE NATIONAL FLOOD INSURANCE PROGRAM, GAO-06-119 (2005). *See also* JANE G. GRAVELLE, TAX POLICY OPTIONS AFTER HURRICANE KATRINA, CONG. RES. SERVICE (C.R.S.) RL33088 (Sept. 16, 2005), http://fpc.state.gov/documents/organization/53669.pdf.

[37] GAO, FISCAL EXPOSURES: IMPROVING THE BUDGETARY FOCUS ON LONG-TERM COSTS AND UNCERTAINTIES, GAO-03-213 (2003) (federal insurance exposes government to future, potentially significant, unbudgeted costs).

[38] GAO, HURRICANE KATRINA: GAO'S PRELIMINARY OBSERVATIONS REGARDING PREPAREDNESS, RESPONSE, AND RECOVERY 1, 38, GAO-06-442T (2006). "The magnitude and severity of the flood losses from Hurricanes Katrina and Rita overwhelmed the ability of the NFIP to absorb the costs of paying claims, providing an illustration of the extent to which the federal government is exposed to claims coverage in catastrophic loss years." *Id.*

[39] National Flood Insurance Program Further Enhanced Borrowing Authority Act of 2005, Pub. L. No. 109-106, 119 Stat. 2288 (Nov. 2005) (to be codified at 42 U.S.C. § 4016(a)) (increasing maximum loan from $3.5 to 18.5 million), *amending* National Flood Insurance Program Enhanced Borrowing Authority Act of 2005, Pub. L. No. 109-65, 119 Stat. 1998 (Sept. 2005) (increasing maximum loan from $1.5 to $3.5 million).

[40] H.R. REP. NO. 109-410 (to accompany H.R. 4973, Flood Insurance Reform and Modernization Act of 2006). As this article went to press in Spring 2007, four Bills addressing flood insurance issues were pending in the 110th Congress: H.R. 91, Homeowners Insurance Protection Act of 2007 (mandating GAO study of NFIP and Hurricane-Related Flooding); H.R. 920, Multiple Peril Insurance Act of 2007 (expanding NFIP to also cover damage from hurricanes, tornados, cyclones, typhoons or other windstorms); H.R. 921, Flood Insurance Community Outreach Grant Program Act of 2007 (authorizing FEMA to make grants to poor communities to encourage flood insurance); H.R. 922, National Flood Insurance Program Participation Evaluation Act of 2007 (requiring GAO to study NFIP participation); http://www.thomas.gov (enter "flood insurance") (last visited Mar. 8, 2007).

[41] "More than 11 million U.S. homes are in flood zones," but "[o]nly about one in four homeowners who live in areas vulnerable to floods purchase federal flood insurance." *Catastrophes: Insurance Issues*, *supra* note 25.

[42] Hartwig, *Impact of 2005 Hurricanes on US P/C Insurance Markets*, *supra* note 26, at 138.

associated with their risks.[43] In this regard, subsidies, like federal emergency relief itself, could actually stimulate overdevelopment of risky areas.[44]

For property damage covered by private insurance, eight of the ten most costly catastrophes in the history of the United States were the result of hurricane activity.[45] The September 11, 2001, terrorist attack was the only man-made disaster of similar magnitude.[46] The Northridge, California earthquake of 1994 rounds out the list.[47] Notably, seven of the ten most costly hurricanes occurred in 2004-2005.[48]

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[43] DR. L. JAMES VALVERDE, JR., DIRECTOR, ECONOMICS, AND RISK MANAGEMENT, I.I.I., MANAGING NATURAL DISASTER RISK: WHAT ROLE SHOULD THE FEDERAL GOVERNMENT PLAY? 1, 5 (Jan. 2006), http://server.iii.org/yy_obj_data/binary/749407_1_0/Disaster_Risk.pdf ("[F]ederal insurance programs are rarely actuarially sound").

[44] *See Catastrophes: Insurance Issues*, *supra* note 25. *See also* Hartwig, *Impact of 2005 Hurricanes on US P/C Insurance Markets*, *supra* note 26, at 15, 57. "Overdevelopment of high risk areas is encouraged by public subsidies, as are catastrophe losses that people fail to mitigate and insure." *Homeowners Insurance Availability in Disaster Prone Areas: Hearing Before the House Subcommittee on Housing and Community Opportunity*, 105th Cong. 33 (1997) (statement of Dr. Robert W. Klein, Dir. of Ctr. for Risk Mgmt. and Ins. Res., Georgia State Univ.), http://commdocs.house.gov/committees/bank/hba41548.000/ hba41548_0.HTM#0.

[45] I.I.I., *Catastrophes: Facts and Statistics*, http://www.iii.org/media/facts/statsbyissue/catastrophes/ (last visited Mar. 2, 2007).

[46] It was the worst in terms of fatalities (2976), and property losses exceeded $20 billion. *Id.*

[47] In 2006 dollars, damage is estimated at $18-27 billion. I.I.I., *Earthquakes: Facts and Statistics*, http://www.iii.org/media/facts/statsbyissue/earthquakes/ (last visited Mar. 2, 2007).

[48] In 2007, the Insurance Information Institute published the following data on its website:

The Ten Most Costly Hurricanes in the United States ($ Millions)

		Estimated insured loss (1)	
Rank	Hurricane	Dollars when occurred	In 2006 dollars (2)
1	Katrina (2005)	$40,600	$41,910
2	Andrew (1992)	15,500	22,272
3	Wilma (2005)	10,300	10,632
4	Charley (2004)	7,475	7,978
5	Ivan (2004)	7,110	7,588
6	Hugo (1989)	4,195	6,820
7	Rita (2005)	5,627	5,809
8	Frances (2004)	4,595	4,904
9	Jeanne (2004)	3,440	3,671
10	Georges (1998)	2,900	3,587

(1) Property coverage only.
(2) Adjusted to 2006 dollars by the Insurance Information Institute.
Source: ISO; Insurance Institute

Due to insured losses hitting record proportions, Congress began considering federalizing reinsurance of the hurricane insurance market.[49] Despite the fact that many in the private insurance industry are opposed to such federalization (citing ability to withstand the highest loss years on record with sufficient policy reserves),[50] there is open debate in the industry about the need for federal reinsurance.[51] As the debate over how to structure catastrophic insurance lingers, no one disputes the need for homeowners to have access to affordable insurance.

Currently, fifty-nine percent of homeowners are uninsured or underinsured.[52] With the real estate boom of the early twenty-first century, most home owners in coastal areas could find themselves woefully underinsured. Regardless of whether the government or private industry offers insurance, tax relief measures should serve as incentives for people to carry adequate insurance.[53]

In summary, while individuals can affordably insure against most perils with their property coverage carrier, some risks may be so unpredictable and of such great magnitude as to be beyond the scope of typical private insurance.[54] Supplemental major catastrophe insurance (flood insurance, earthquake insurance, and, perhaps in the near future, hurricane insurance or other "mega-catastrophe" policies) must

I.I.I., *Hurricanes: Facts and Statistics*, http://www.iii.org/media/facts/statsbyissue/hurricanes/ (last visited Mar. 2, 2007).

49 *See*, *e.g.*, H.R. 846, 109th Cong. (2005) (federal auctions of catastrophe reinsurance contracts); H.R. 4366, 109th Cong. (2005); H.R. 4507, 109th Cong. (2005) (allowing States with catastrophe insurance programs to purchase federal reinsurance).

50 *See generally Is America's Housing Market Prepared for the Next Natural Catastrophe*: *Hearing before the House Subcommittee on Housing and Community Opportunity* 109th Cong. (June 28, 2006) (statement of Dennis C. Burke, Vice President of State Relations, Reinsurance Assoc. of Am.), http://financialservices.house.gov/media/pdf/062806dcb.pdf.

51 VALVERDE, *supra* note 43, at 4-5. *See also Is America's Housing Market Prepared for the Next Natural Catastrophe*: *Hearing before the House Subcommittee on Housing and Community Opportunity* 109th Cong. (June 28, 2006) (statement of Alex Soto, on Behalf of the Independent Insurance Agents and Brokers of America), http://financialservices.house.gov/media/pdf/062806as.pdf (lack of insurance industry consensus hampering pending legislation).

52 Hartwig, *Beyond Katrina*, *supra* note 33, at 110 (although the numbers have improved in the past few years, most homes are still undervalued by 22%).

53 Indeed, 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 governmental assistance." 42 U.S.C. § 5121(b)(4) (2000).

54 VALVERDE, *supra* note 43, at 3.

be separately obtained. Regrettably, too few Americans secure this additional coverage.[55]

As discussed in the next two sections, tax relief for victims of disaster is a relatively new phenomenon. Congress must take care that such relief encourages prudent decisions (such as motivating individuals to obtain sufficient insurance—including flood insurance for those at risk), versus exacerbating a false sense of security that a government bailout could promote.[56]

C. Tax Relief for Victims of All Casualties

With any hurricane or other substantial disaster, property is lost and residents are often displaced from their homes and possibly their jobs. Some victims receive government or charitable aid in the form of food, shelter, or even outright cash.[57] In addition to the turmoil of the moment—safeguarding family members and trying to put their lives back together—taxpayers may be confronted with lost or destroyed records. Paying their taxes may be the last thing on their minds.

Fortunately, the federal government has historically afforded some relief to victims of all casualties.[58] The principal provision allowing compensation for property loss is Code Section 165, which allows a tax deduction for casualty losses.[59] In addition to losses due to storms, the Code allows relief for fires, shipwreck, theft, or other casualties.[60] Section 165 extends broadly to those suffering a great variety of casualty losses; entitlement to this deduction is independent of any

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55 For example, it is estimated by the insurance industry that "[o]nly 13% of [California] homeowners buy earthquake insurance." Hartwig, *Beyond Katrina*, *supra* note 33, at 67.

56 *See Catastrophes: Insurance Issues*, *supra* note 25 (illustrating that the damage Katrina caused "has triggered a reexamination . . . of how the United States deals with the financial consequences of such massive property damage and personal loss").

57 *See* GRAVELLE, *supra* note 36, at 1.

58 For an excellent discussion of the pre-2005 tax treatment of disasters, see Lipman, *supra* note 8.

59 I.R.C. § 165(a) (West 2006). All sections of the Internal Revenue Code ("I.R.C." or "Code") are codified in Title 26 of the U.S. Code. All references to the Code are current as of March 2007.

60 For individuals, deductible losses must be incurred in a trade or business, derive from some other profit-seeking activity, or, except as provided in subsection (h), arise from fire, storm, shipwreck, theft, or other casualty. I.R.C. § 165(c).

nationally declared emergency.[61] A disadvantage is that it is only available to taxpayers who itemize and is subject to other limitations reducing its efficacy. The drawbacks of Section 165 are discussed in more detail in Part VII, *infra*.[62]

The IRS has long recognized that government payments to individuals on the basis of need also promote the public welfare.[63] Despite the statutory presumption that (unless otherwise excluded) all accessions to wealth constitute income pursuant to Section 61 of the Code, the IRS has acknowledged that welfare payments need not be reported as income.[64] Note that unemployment compensation is a replacement for income versus a welfare payment, and thus remains taxable.[65]

Disaster relief is a type of welfare payment, because it helps individuals and families who are put in need based on the emergency confronting them.[66] "The assistance that a government grants its citizens who sustain personal injury and property damage as the result of hurricanes, tornadoes, earthquakes, and other natural disasters is motivated by its obligation to assist in alleviating the suffering and damage caused by the disaster."[67]

The "need" for the welfare is established by the emergency circumstances prompting the disaster relief and is independent of the taxpayer's income.[68] After the terrorist bombings of September 11, 2001, Code Section 139 was promulgated to codify that recipients are not taxed on qualified disaster relief payments.[69] Further, reimbursements paid by

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[61] *But see id.* § 165(i) (timing advantage in declared emergency).

[62] *See* notes 354-78 and accompanying text.

[63] *See*, *e.g.*, Rev. Rul. 74-205, 1974-1 C.B. 21 (social benefit program payments not includible in income). Note, emergency grants to businesses are not tax exempt. Rev. Rul. 2005-46, 2005-30 I.R.B. 120.

[64] Rev. Rul. 74-205, *supra* note 63. *See also* I.R.S. Notice 2002-76, 2002-2 C.B. 917, Questions and Answers: Q-1–A-2, (tax-exempt grants following Sept. 11, 2001).

[65] I.R.C. § 85; Rev. Rul. 79-299, 1979-2 C.B. 32.

[66] Rev. Rul. 76-144, 1976-1 C.B. 17 (disaster relief in interest of general welfare—not income); Rev. Rul. 98-19, 1998-1 C.B. 840 (relocation payments for moving from flood-damaged residence not taxable).

[67] Rev. Rul. 76-144, *supra* note 66.

[68] I.R.S. Notice 2002-76, *supra* note 64 (Nonessential, decorative, and luxury items fall outside the gambit of necessary disaster-related expenses.).

[69] I.R.C. § 139 (Qualified disasters include presidentially-declared disasters, disasters from terrorist or military activity, disasters resulting from accidents involving common carriers, or other events determined by the Secretary to be catastrophic. Amounts paid by federal, state, or local governments determined to warrant assistance are also not taxable.). The general welfare policy was codified, but not supplanted by I.R.C. § 139. *See* I.R.S. Notice 2002-76, *supra* note 64.

state agencies, charities, or employers, for expenses incurred by those assisting in emergency relief efforts, are likewise excluded from gross income.[70]

There is more flexibility in the tax code for victims of presidentially-declared disasters than for victims of other casualties.[71] Section 165(i) allows victims of presidentially-declared disasters an election to take the deduction for casualty losses in the immediately preceding tax year.[72]

The benefit of the preference is two-fold. Allowing the option to choose the year to take the deduction allows the taxpayer the benefit of selecting whatever tax year yields a better result (the earlier tax year may well reflect greater income due to the lack of catastrophic interruption—therefore relief for the earlier period may well be from a higher marginal tax rate). Even where the amount would be identical, making the election affords earlier tax relief for the loss.

The Code also allows other advantages for victims of presidentially-declared tragedies.[73] For example, Code Section 7508A allows the Secretary of the Treasury discretion to disregard deadlines for filing and payment of taxes in declared disaster areas.[74] It states: "In the case of a taxpayer determined by the Secretary to be affected by a Presidentially declared disaster . . . the Secretary *may specify* a period of up to 1 year that may be disregarded in determining . . . [whether filing or payment of tax][75] were performed within the time

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[70] Rev. Rul. 2003-12, 2003-1 C.B. 283.

[71] "Declared" is used throughout as an equivalent to "presidentially-declared." Both relate to areas declared by the President to be National Disaster Areas pursuant to § 401 of the Stafford Act (42 U.S.C. § 5170).

[72] I.R.C. § 165(i)(1) (The election is irrevocable after ninety days). Treas. Reg. § 1.165-11 (codified at 26 C.F.R. § 1.165-11). All sections of the Treasury Regulations are codified in Title 26 of the Code of Federal Regulation and are current as of March 2007.

[73] *See*, *e.g.*, I.R.C. § 1033(h) (favorable treatment of insurance proceeds and doubling of time to replace involuntarily converted property). *See infra* notes 99-105 and accompanying text.

[74] I.R.C. § 7508A.

[75] I.R.C. § 7508(a) allows the following relief:

> (A) Filing any return of income, estate, gift, employment, or excise tax;
>
> (B) Payment of any income, estate, gift, employment, or excise tax or any installment thereof or of any other liability to the United States in respect thereof;
>
> (C) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
>
> (D) Allowance of a credit or refund of any tax;

prescribed . . . the amount of any interest, penalty, additional amount, or addition to the tax . . . [and] the amount of any credit or refund."[76]

When the Secretary has not exercised this discretion or when the taxpayer fails to qualify as an "affected taxpayer" in the declared disaster region, the IRS will consider extensions and abatement of late payment penalties on a case-by-case basis.[77] Code Sections 6081 and 6161 allow the Secretary discretion to extend deadlines for a reasonable time not to exceed six months.[78]

D. Tax Relief for Specific Disasters

Some victims of particular disasters have been granted additional tax relief. The following sections detail tax relief afforded to the victims of some noteworthy recent disasters. The discussion is not exhaustive, but illustrates representative responses to major disasters, as well as the trend toward increased emphasis on tax relief. It is appropriate to examine previous assistance to gauge how tax relief could best be used in the future.

> (E) Filing a claim for credit or refund of any tax;
>
> (F) Bringing suit upon any such claim for credit or refund;
>
> (G) Assessment of any tax;
>
> (H) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
>
> (I) Collection, by the Secretary, by levy or otherwise, of the amount of any liability in respect of any tax;
>
> (J) Bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax; and
>
> (K) Any other act required or permitted under the internal revenue laws specified by the Secretary[.]

Id.

[76] I.R.C. § 7508A (emphasis added).

[77] Internal Revenue Manual 25.16.1.1 (2003). For example, if a taxpayer arranged for a loan to pay taxes due on his business, but the bank scheduled to close on the loan was not open due to severe damages, the IRS would consider abatement "using reasonable cause criteria." *Id.*

[78] I.R.C. §§ 6081, 6161.

1. Hurricane Hugo (1989)

Although no legislative tax relief was provided to the victims of Hurricane Hugo, the IRS afforded victims some procedural as well as substantive relief. For example, taxpayers in disaster areas were granted extensions of time to file and pay taxes where the deadlines were otherwise imminent.[79]

Further, for those taxpayers who had already received six-month extensions (so that Sections 6081 and 6161 precluded further extensions), the Secretary determined categorically that these affected taxpayers were deemed to have reasonable cause for late filing so that late filing penalties would automatically be waived, so long as returns were postmarked and payment made before the extended date.[80] Taxpayers were directed to flag the return for special handling by marking "HUGO" on the top center of the return.[81] Taxpayers with addresses outside the designated disaster area were told they "should also include a brief statement as to how Hugo affected them."[82]

Congress provided cost-sharing assistance to the victims of Hurricane Hugo for the purposes of encouraging tree owners to reestablish stands of trees.[83] The Secretary of Agriculture was charged to develop and implement a program to provide financial assistance to owners of private timber stands damaged in 1989 by Hurricane Hugo.[84] The assistance was only for those living in counties declared by the president to be Hurricane Hugo disaster areas and those living in contiguous counties.[85] The law created a benefit of up to $50,000 based upon a federal cost-share (including labor) of seventy-five percent of total cost to the victim.[86]

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79 I.R.S. Notice 89-136, 1989-2 C.B. 451-52.

80 *Id.* (waiving penalties under I.R.C. § 6651 and noting that statutory interest could not be waived). *See also* I.R.S. Notice 89-107, 1989-2 C.B. 445 (considering "taxpayers affected by Hurricane Hugo as having reasonable cause for late filing" and payment of excise taxes related to pension and employee benefit plans).

81 I.R.S. Notice 89-107, *supr*a note 80.

82 *Id.*

83 Pub. L. No. 101-624, § 2235(b), 104 Stat. 3359, 3960 (1990).

84 *Id.* at 3960.

85 *Id.*

86 *Id.* at 3961.

Congress also authorized $65 million to help persons engaged in commercial fisheries.[87] This relief was much more flexible and included direct relief to victims as well as indirect relief through States and local governments and nonprofit organizations, "for measures to alleviate harm incurred as a direct result of a fishery resource disaster."[88] The relief was not limited to Hurricane Hugo disaster areas, but also included damages arising from later hurricanes (specifically, Andrew and Iniki), "or any other natural disaster."[89] Such relief was "first-come, first-serve" since amounts appropriated were only available until expended.[90]

While Congress used both of the aforementioned measures to afford targeted relief to challenged business sectors, neither employed the tax code as the means to effectuate this relief.

2. Hurricanes Andrew and Iniki (1992)

Hurricane Andrew caused $15.5 billion in insured damage (over $20 billion in 2006 dollars) and was the costliest natural disaster in U.S. history before Hurricane Katrina.[91] "With peak wind gusts of almost 200 mph, the hurricane flattened whole communities", destroying thousands of homes and businesses, battering crops, and "leaving in its wake a wasteland of debris."[92] Within weeks, Typhoon Omar struck the tiny Island of Guam and Hurricane Iniki roared across Hawaii, the worst hurricane to hit the Hawaiian Islands in a century.[93]

In addition to the aid to commercial fisheries discussed above, Congress authorized federal agencies to "accept gifts of property, money, or anything else of value."[94] The new law directed agencies to "establish written procedures to implement this program" and authorized agencies to accept gifts designated for individual employees.[95] It allowed donations

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87 Pub. L. No. 102-396, § 9135, 106 Stat. 1876 (codified at 16 U.S.C. § 4107 (d)(1) (2000)).

88 16 U.S.C. § 4107(d)(1) (2000).

89 *Id.*

90 *Id.*

91 *Hurricane Facts and Statistics*, *supra* note 48.

92 *Id.*

93 *See* Proclamation No. 6491, 57 Fed. Reg. 47,553 (Oct. 14, 1992).

94 Pub. L. No. 102-368, § 901, 106 Stat. 1117, 1156 (1992).

95 *Id.*

"from non-Federal sources for extraordinary and unanticipated expenses incurred by agency employees in their personal capacity within the areas designated as [national] disaster areas."[96]

The Congress also provided explicit tax relief to these disaster victims.[97] It retroactively afforded relief to victims of presidentially-declared disasters after September 1, 1991.[98] Significantly, the new law afforded victims of declared emergencies four years (versus two years) to replace their home and its scheduled contents without recognizing a taxable gain.[99] Congress also created tax advantages for insured individuals to the extent their principal residence and its contents were destroyed (involuntarily converted) as a result of a declared disaster.[100]

Specifically, the law allowed an exclusion from income of any and all gain from insurance proceeds paid on involuntarily converted personal property that was not identified on a specific insurance schedule.[101] Most household goods—furniture, clothing, appliances, foodstocks, etc.—qualify for this special tax treatment.[102] Furthermore, the law generously provided that all other insurance proceeds would be treated as a single item in calculating nonrecognition of gain.[103]

In a subsequent Revenue Ruling, the Service determined that all costs to replace a qualifying victim's house, plus its scheduled and unscheduled contents, would be compared with the lump sum insurance proceeds from the converted house and scheduled converted property only (thereby excluding the entire recovery for unscheduled property from the gain calculation).[104] In that case, the taxpayer, who had received $300x insurance on his house, $10x in scheduled proceeds, and $35x in unscheduled proceeds,

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[96] *Id.*

[97] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13431, 107 Stat. 312, 567 (codified as amended at 26 U.S.C. § 1033(h) (2005)).

[98] *Id.* § 13431(b). This benefit would include victims of Hurricanes Andrew and Iniki, Typhoon Omar, any other declared disasters occurring in 1992, and all subsequent disasters.

[99] I.R.C. § 1033(h)(1)(B).

[100] *Id.* § 1033(h)(1)(A).

[101] Typically only high value items, such as jewelry, furs, silverware, or collectibles are scheduled. *See generally* Rev. Rul. 95-22, 1995-12 I.R.B. 4.

[102] *Id.*

[103] I.R.C. § 1033(h)(1)(A)(ii).

[104] Rev. Rul. 95-22, *supra* note 101.

needed to spend only $310x to purchase a replacement dwelling and all of its contents.[105]

The IRS was even more active in 1992 than it was after Hurricane Hugo. Like the 1989 relief, the IRS granted extensions of time to file and pay taxes up to the maximum permissible leeway under Code Section 6081 and waived late payment penalties under Code Section 6651(a)(2).[106] Taxpayers were directed to flag the return for special handling by marking "ANDREW"[107] or "INIKI" on the top center of the return.[108] Taxpayers with addresses outside the designated disaster area were told they "should also include a brief statement as to how the disaster adversely affected their ability to meet their tax obligations."[109] The IRS also afforded a new type of relief: it suspended for thirty days all normal collection and examination actions for affected taxpayers in the disaster areas.[110]

In addition to this individual relief, the IRS announced that it would expedite review of applications for tax exempt status by groups newly formed to aid the disaster victims.[111] It also indicated it would not raise issues concerning approved charitable organizations that might otherwise affect an organization's qualification for tax exempt status—such as an organization rendering assistance in good faith to its own employees who were victims of the disasters.[112] Finally, for designated counties and parishes impacted by Hurricane Andrew, the IRS provided relief from certain low income housing credit requirements.[113]

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[105] *Id.*

[106] I.R.S. Notice 92-40, 1992-2 C.B. 371; I.R.S. Notice 92-44, 1992-2 C.B. 373.

[107] I.R.S. Notice 92-40, *supra* note 106.

[108] I.R.S. Notice 92-44, *supra* note 106.

[109] I.R.S. Notice 92-40, *supra* note 106; I.R.S. Notice 92-44, *supra* note 106.

[110] I.R.S. News Release IR-92-88 (Aug. 28, 1992); I.R.S. News Release IR-92-91 (Sept. 16, 1992).

[111] I.R.S. Announcement 92-128, 1992-38 I.R.B. 42 (Sept. 8, 1992); I.R.S. Announcement 92-140, 1992-41 I.R.B. 75 (Sept. 24, 1992).

[112] I.R.S. Notice 92-45, 1992-2 C.B. 375.

[113] I.R.S. Notice 92-43, 1992-2 C.B. 373 (authorizing relief from carryover allocations under I.R.C. § 42(h)(1)(E) and recapture under § 42(j)(4)(E)).

3. Northridge (Los Angeles) Earthquake (1994)

The Northridge Earthquake was the second most costly U.S. natural disaster before Hurricane Katrina.[114] Measuring 6.8 on the Richter scale, the quake "jolted the San Fernando Valley, 20 miles northwest of downtown Los Angeles, on January 17, 1994."[115] The Northridge earthquake caused more than sixty deaths and 12,000 injuries.[116] It destroyed 8,000 homes and damaged more than 114,000 buildings.[117] According to the Institute for Business and Home Safety (IBHS), it caused $15.3 billion in insured losses.[118]

The Congress provided no tax relief to the disaster victims. The IRS relief was similar to, but less extensive than, the relief to the 1992 hurricane victims. Like the earlier relief, the IRS granted extensions of time to file and pay taxes, but the extension was only for ten calendar days.[119] The IRS also suspended normal collection and examination actions for two weeks (versus thirty days for affected taxpayers in the 1992 hurricane disaster areas).[120] Finally, the IRS announced that it would expedite review of applications for tax exempt status by groups newly formed to aid the disaster victims, and it would not raise certain issues concerning charitable organizations that might affect an organization's tax exempt status.[121]

Following Hurricane Andrew, Hurricane Iniki, and the Northridge Earthquake, the states of Florida, California, and Hawaii intervened to prevent a near total collapse in their respective homeowners' insurance markets.[122] Perhaps these state bail-outs averted the need for serious discussion of federal

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[114] Hartwig, *Impact of 2005 Hurricanes on US P/C Insurance Markets*, *supra* note 26, at 13.

[115] *Catastrophes: Insurance Issues*, *supra* note 25.

[116] *Id.*

[117] *Id.*

[118] *Id.*

[119] I.R.S. News Release 1994 WL 14750 (Jan. 19, 1994) (IRS Offices to Provide Disaster Tax Assistance). Taxpayers were directed to mark the return "LA EARTHQUAKE." *Id.*

[120] I.R.S. News Release IR-92-88, *supra* note 110; I.R.S. News Release IR-92-91, *supra* note 110; I.R.S. News Release 1994 WL 14750, *supra* note 119.

[121] I.R.S. Notice 1994-7 I.R.B. 54, 1994-1 C.B. 337.

[122] *See*, *e.g.*, H.R. REP. NO. 106-526. Other risk-prone states lacking state insurance programs saw applications to state FAIR (Fair Access Insurance Requirements) plans and beach plans (markets of last resort for homeowners' insurance which generally provide less coverage at a greater price) "increase dramatically during the last half of the 1990s." *Id.*

tax relief. In any event, other than the limited relief discussed above, no tax relief was spawned by these mighty tragedies.[123]

4. September 11, 2001—Tax Relief and Creation of the Liberty Zone

Although not much tax relief had been provided to victims of natural disasters, the Congress was quick to pass legislation in the form of federal tax relief for the victims of 9/11. The Victims of Terrorism Tax Relief Act of 2001[124] granted the victims of these atrocities substantial tax relief, including (among other things): relief from income taxes (at a minimum, $10,000);[125] exclusion of certain death benefits;[126] estate tax reduction;[127] exclusion of disaster relief payments;[128] and exclusion of certain cancellations of indebtedness.[129] It also allowed payments by charitable organizations to be treated as exempt payments.[130] Finally, the Act delegated authority to the IRS to postpone certain deadlines for up to one year in cases of natural disaster, and both military and terrorist attacks.[131]

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[123] Perhaps the most notable byproduct of Hurricane Andrew was the call for better building codes and better enforcement of existing codes. *Catastrophes: Insurance Issues*, *supra* note 25, at 19.

[124] Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, 115 Stat. 2427 (2002) (codified as amended at scattered sections of the I.R.C.).

[125] *Id.* at § 101 (codified at I.R.C. § 692). The IRS allowed full abatement of all tax liability for tax years 2000 and 2001 for victims killed in the attacks. I.R.S. News Release IR-2002-07 (Jan. 23, 2002). At the same time, the IRS forgave the tax liability for 1994 and 1995 for the victims of the Oklahoma City bombing. *Id.*

[126] Victims of Terrorism Tax Relief Act of 2001 § 102, 115 Stat. at 2429 (codified at I.R.C. § 101).

[127] *Id.* § 103 (codified at I.R.C. § 2201).

[128] *Id.* § 104 (codified at I.R.C. § 139). I.R.C. § 139(b)(4) codifies the general welfare exclusion for qualified disaster relief payments to individuals. I.R.S. Notice 2002-76, 2002-2 C.B. 917. Because of extraordinary circumstances surrounding such disasters, the IRS anticipates that individuals will not be required to account for actual expenses so long as the amount of relief is commensurate with the anticipated expenses incurred. *Id.*

[129] Victims of Terrorism Tax Relief Act of 2001 § 105, 115 Stat. at 2432 (codified at I.R.C. § 108).

[130] *Id.* § 104 (codified at I.R.C. § 501).

[131] *Id.* § 112 (codified at I.R.C. § 7508A).

The tax benefits for the New York Liberty Zone[132] also included substantial tax advantages for Liberty Zone businesses: employment credits;[133] bonus and accelerated depreciation and increased expensing for qualified Liberty Zone property;[134] tax exempt bond advantages;[135] and an extension from two to five years for nonrecognition of gains for property involuntarily converted (where replacement property is in the Liberty Zone).[136] Some of the tax advantages for individuals and businesses foreshadowed a similar Congressional response to the massive 2005 hurricane disasters.

As might be expected, the IRS granted extensions of time to file tax returns.[137] Unlike the extensions discussed above, however, which preceded enactment of Code Section 7508A, the IRS took full advantage of its discretion by coupling its ability to disregard time under Section 7508A with its ability to extend the deadlines for filing and payment under Sections 6081 and 6161.[138] Under the then existing state of the law, Section 7508A allowed 120 days to be disregarded, which the IRS allowed to run consecutively with a six month extension for all affected taxpayers.[139] The IRS later clarified that interest, as well as penalties, would be waived.[140]

The term "affected taxpayers" was also broadly construed to include all victims on the four commercial hijacked aircraft or on the ground during the crashes; all workers assisting in relief efforts, regardless of whether

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[132] "'New York Liberty Zone' means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York." I.R.C. § 1400L(h). Liberty Zone businesses are those employing no more than 200 employees which rebuilt in the footprint of the terrorist bombings of Sept. 11, 2001 (commonly thought of as ground zero) as well as any businesses damaged or destroyed by the attacks that relocated anywhere else within New York City. I.R.C. § 1400L(a)(2)(C), (h).

[133] *See* I.R.C. § 51.

[134] *See* I.R.C. § 168(k)(2).

[135] *See* I.R.C. § 1400L(d), (e).

[136] These business advantages are codified, as amended, at I.R.C. § 1400L.

[137] I.R.S. Notice 2001-61, 2001-2 C.B. 305.

[138] *Id.*

[139] *Id. See also* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 802(a), 115 Stat. 38, 149 (increasing maximum relief from 90 to 120 days). Earlier in 2001, in response to the New Mexico wildfires, the IRS had similarly construed its § 7508A authority to run consecutively (versus concurrently) with its extension authorities under §§ 6081 and 6161. I.R.S. Notice 2001-30, 2001-1 C.B. 989.

[140] I.R.S. Notice 2002-40, 2002-1 C.B. 1152 (based on new authority from Victims of Terrorism Tax Relief Act of 2001).

affiliated with a recognized government or philanthropic relief organization; and all those who work (or used to work) in the declared disaster area.[141] In addition, taxpayers experiencing transportation or mail or delivery service disturbances resulting from the terrorist attacks were afforded an extension until November 15, 2001.[142]

In terms of relief to helping organizations, the IRS again agreed to expedite tax-exempt status requests.[143] The IRS also agreed to treat any payments made in good faith to the victims or their surviving family members as "related to the charity's exempt purpose," so long as the payments were made using objective standards.[144] [This relief presumably overcomes the necessity of showing that the recipients are "needy," consistent with the purpose for which many charitable organization exemptions have been approved (for example the Salvation Army), and also allows charities to overcome the 501(c)(3) prohibition that an organization be operated exclusively for public purpose and that no part of the benefits inure to any private individual].[145]

5. Hurricanes Ivan, Charley, Frances, and Jeanne (2004)

While the 2004 hurricane season was, at that time, the most expensive ever,[146] the widespread loss did not lead to any federal legislative tax relief. However, the IRS exercised its discretion to grant relief for several declared disasters, including Hurricanes Charley, Frances, Ivan, and Jeanne, and Tropical Storm Bonnie.[147] The IRS granted extensions of time to file and pay taxes;[148] relief from deadlines involved in Section 1031 like-kind exchange transactions;[149] and, a suspension of

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[141] I.R.S. Notice 2001-61, *supra* note 137.

[142] *Id.*

[143] I.R.S. News Release IR-2001-82 (Sept. 18, 2001).

[144] I.R.S. Notice 2001-78, 2001-2 C.B. 576.

[145] *See generally* S. REP. NO. 107-211, at 53-54 (2002) (proposed CARE Act of 2002, payments by charitable organizations to victims of war on terrorism).

[146] Blake et al., *supra* note 11.

[147] *See*, *e.g.*, I.R.S. News Release IR-2004-108 (Aug. 16, 2004) (extending time to file and pay taxes for areas affected by Bonnie and Charley); I.R.S. News Release IR-2004-115 (Sept. 10, 2004) (extending time to file and pay taxes for Hurricane Frances); I.R.S. Notice 2004-62, 2004-2 C.B. 565 (additional relief for areas affected by Bonnie, Charley, and Frances); I.R.S. Notice 2004-76, 2004-2 C.B. 878 (relief from certain requirements due to Hurricanes Charley, Frances, Ivan, and Jeanne).

[148] I.R.S. News Releases IR-2004-108 and IR-2004-115, *supra* note 147; I.R.S. News Release IR-2004-118 (Sept. 22, 2004).

[149] I.R.S. Notice 2005-3, 2005-1 C.B. 447.

the income limitations (ordinarily required for occupants of low-income housing) to allow landlords of such property to provide temporary lodging to individuals displaced by Hurricanes Charley, Frances, Ivan, and Jeanne.[150]

In Florida, after the devastating 2004 hurricane season, the notion of a hurricane savings account was first introduced.[151] The hurricane savings account was forecast "to cover an insurance deductible or other uninsured portion of the risks of loss from a hurricane, rising flood waters, or other catastrophic windstorm event."[152] Because they would only be created to safeguard homesteads, the accounts would be beyond the reach of creditors.[153] However, benefits of such an account are not realized unless or until the federal government creates such a tax-exempt or tax-deferred savings vehicle.[154]

III. HURRICANE KATRINA AND ITS TAX AFTERMATH

A. *The IRS Response*

The IRS response to Hurricane Katrina was swift and sustained. Within days of the disaster, the IRS Commissioner, Mark Everson, announced deadline extensions to those with taxes otherwise coming due.[155] Through Everson, the IRS pledged, "We will do everything we can to help taxpayers, business and tax professionals while ensuring the smooth continuity of our nation's tax system."[156] In the following thirty

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150 I.R.S. Notice 2004-76, *supra* note 147; *see also* I.R.S. Notice 2004-74, 2004-2 C.B. 875 (relief in Alabama due to Ivan); I.R.S. Notice 2004-75, 2004-2 C.B. 876 (relief in Ohio due to post-hurricane severe storms and flooding).

151 Florida Staff Analysis, S.B. 660 (Feb. 8, 2005), *available at* Westlaw (Find by Citation: Florida Staff Analysis, S.B. 660; Florida Staff Analysis, S.B. 660, 2/8/2005).

152 Florida Senate Journal, 2005 Reg. Sess., No. 14 (Apr. 13, 2005), *available at* Westlaw (Find by Citation: FL S. Jour., 2005 Reg. Sess., No. 14; run search).

153 FLA. STAT. § 222.22 (2006). This statute exempts hurricane savings accounts and other preferred savings programs from legal process. However, this benefit attaches only when "the federal government provides tax-exempt or tax-deferred status to a hurricane savings account." *Id.* § 222.22(4)(c).

154 *Id.* § 222.22. Although the federal government has not yet created such a favored tax position, Florida's congressional delegation has filed legislation in Congress which would give hurricane savings accounts preferential tax treatment. *See* H.R. 4836, 109th Cong. (2006). Benefits of such an account are discussed in Part IX, *infra*.

155 I.R.S. News Release IR-2005-84 (Aug. 30, 2005). Note that relief was further extended to February 28, 2006, by direction of Congress. *See infra* note 221 and accompanying text.

156 Mark W. Everson, Commissioner, I.R.S., Treasury Press Conference on Hurricane Tax Relief (Sept. 8, 2005), http://www.irs.gov/newsroom/article/0,,id=147372,00.html (Prepared Remarks to Accompany IR-2005-96).

days, the IRS kept its promise, issuing twenty-nine News Releases, Announcements, and Notices extending relief.[157]

The immediate relief in the wake of the hurricane was timely and essential, because many important books and records had been lost or destroyed due to the widespread devastation and massive flooding.[158] In addition, where records miraculously survived, those who were evacuated often had no immediate access to them.[159]

B. Legislative Response

The House and Senate were quick to rally to support relief of the hurricane victims. House Resolution 3768 was passed on September 15, 2005 and contained a number of tax relief measures: 1) lifting a three-year requirement for mortgage revenue bonds; 2) allowing persons providing housing to dislocated persons an additional deduction (exemption) of $500 for each dislocated person housed; 3) exempting forgiveness of indebtedness from income; 4) allowing expanded work opportunity tax credits to employers in the disaster area; 5) enabling persons to access individual retirement accounts (IRAs) or pension accounts without tax penalty (and with an opportunity to reinvest as if the money were rolled over); and, most significantly, 6) eliminating the ten percent Adjusted Gross Income (AGI) threshold and $100 reduction from the casualty loss deduction.[160]

A similar Senate Bill, S. 1696, was passed on the same date, but was later vitiated by Senate passage of H.R. 3768, as amended by the Senate.[161] The original Senate Bill differed in

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[157] The count is derived from a Westlaw search of the Federal Taxation – IRS Cumulative Bulletins and Federal Tax–IRS News Releases databases from Aug. 30 to Sept. 29, 2005 (enter "Hurricane Katrina" as the search term).

[158] *See* Rodney C. Runyan, *Small Business in the Face of Crisis: Identifying Barriers to Recovery from a Natural Disaster*, 14 J. OF CONTINGENCIES & CRISIS MGMT. 12 (2006).

[159] *Id.* at 13.

[160] The Joint Committee on Taxation estimated the House bill to cost over $5.2 billion, with the casualty loss deduction the single largest item at over $2.4 billion. JOINT COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF H.R. 3768, Doc. No. JCX-65-05 R, (Sept. 15, 2005) [hereinafter JCX-65-05].

[161] JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF H.R. 3768, THE "KATRINA EMERGENCY TAX RELIEF ACT OF 2005," Doc. No. JCX-69-05 *As Passed by the House and the Senate on September 21, 2005*, at 1 (Sept. 22, 2005) [hereinafter JCX-69-05].

that it also included a forty percent tax credit[162] for employers of retained workers, included an enhanced deduction for food[163] and book[164] donations, and mandated an extension of tax filing deadlines.[165] These provisions were carried forward in the amended version of H.R. 3768. Provisions in S. 1696 "dealing with IRS information sharing and taxpayer assistance . . . were dropped in the compromise."[166]

The Katrina Emergency Tax Relief Act of 2005 (KETRA) was signed by President Bush and became law on September 23, 2005.[167] It captured the proposed tax relief contained in H.R. 3768 as amended by the Senate.[168] KETRA Title I creates special rules for using retirement funds. Title II allows employment relief. Title III contains incentives for charity. The final Title creates miscellaneous additional benefits. These benefits are discussed in detail in the sections that follow. The price tag for KETRA in foregone revenue is estimated at $6.1 billion.[169]

1. Retirement Fund Access

Individuals who sustained economic loss from the hurricane and whose primary residence is located in the Hurricane Katrina disaster area[170] may withdraw, without

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162 S. 1696, 109th Cong. § 202(a) (2005), http://www.govtrack.us/congress/billtext.xpd?bill=s109-1696 (last visited Jan. 12, 2007).

163 S. 1696, 109th Cong. § 303 (2005), http://www.govtrack.us/congress/billtext.xpd?bill=s109-1696 (last visited Jan. 12, 2007).

164 S. 1696, 109th Cong. § 304 (2005), http://www.govtrack.us/congress/billtext.xpd?bill=s109-1696 (last visited Jan. 12, 2007).

165 S. 1696, 109th Cong. § 403 (2005), http://www.govtrack.us/congress/billtext.xpd?bill=s109-1696 (last visited Jan. 12, 2007).

166 Wesley Elmore, Tax Analysts, Inc., *Senate Approves Compromise Hurricane Tax Relief Legislation*, Sept. 16, 2005, *available at* http://www.pgdc.com/uga/item/?item ID=300670.

167 Katrina Emergency Tax Relief Act of 2005, Pub. L. 109-73, 119 Stat. 2016 (2005) [hereinafter KETRA].

168 Subsequent minor concurring changes were approved by both Houses. Legislation following the later 2005 hurricanes supplements or subsumes the KETRA relief. *See infra* notes 223-81 and accompanying text.

169 DAVID L. BRUMBAUGH, MAJOR TAX ISSUES IN THE 109TH CONGRESS, CONG. RES. SERV. (C.R.S.) RL32719 (updated Dec. 8, 2005).

170 Defined as "an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina." KETRA § 2. Note, S. 1696 would have allowed a tax code change to I.R.C. § 72, allowing penalty-free withdrawals for any presidentially-declared national emergency area. S. 1696, 109th Cong. §101 (2005) (Hurricane Katrina Tax Relief Act of 2005) (unanimously passed Sept. 15, 2005; later vitiated the same day).

penalty,[171] up to $100,000 from an eligible retirement plan.[172] These plans include individual retirement accounts,[173] annuities,[174] and qualifying deferred compensation plans[175] and trusts.[176] Any money withdrawn from eligible plans that constitutes income remains taxable; however, the individual may spread the income over a three year period.[177]

Individuals who receive qualified Hurricane Katrina distributions may make one or more replacement contributions within three years of receiving the distribution and treat any amounts repaid as a qualified rollover.[178] Unless the repayment is made before any income tax is due, the individual would need to amend her return once repayments are made.[179]

A victim may also borrow up to $100,000 from a qualified employer plan [I.R.C. § 401(a) or § 403(a) or (b) plan].[180] This is double the amount of the traditional maximum loan that can be excluded from treatment as a distribution.[181] Relaxing these limits allows the taxpayer to access the funds without adverse tax consequences, providing the taxpayer agrees to repay over five years.[182] In calculating the repayment period, the time from August 25, 2005, to December 31, 2006, is disregarded for all qualified victims with loans outstanding.[183]

Together, these measures should afford quick access to cash for many middle class victims. Most low-income taxpayers probably do not have substantial retirement reserves and many high-income taxpayers probably do not need this relief. Nevertheless, the measures afford a creative and

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171 I.R.C. § 72 generally imposes a ten percent penalty on early withdrawal.

172 KETRA § 101.

173 I.R.C. § 408(a).

174 I.R.C. §§ 403, 408(b).

175 I.R.C. § 457(b).

176 I.R.C. § 402(c)(8)(A).

177 KETRA § 101(e) presumes the income will be spread, unless the individual elects to have it taxed lump sum in the year received. *Id.*

178 *Id.* § 101(c)(1). To qualify, repayments must be made to an eligible retirement plan "in an aggregate amount not to exceed the amount of [the] distribution." *Id.*

179 *See generally* I.R.C. §§ 6072, 6161.

180 KETRA § 103(a). As defined in I.R.C. § 72(p)(4), "qualified employer plan" means plans governed by I.R.C. §§ 401(a) and 403(a) and (b). Relief pertaining to minimum funding standards for a plan to remain qualified was also granted. I.R.S. Notice 2005-84 (Oct. 29, 2005).

181 *See* I.R.C. § 72(p)(1)-(2).

182 KETRA § 103(b).

183 *Id.*

important mechanism for those who need improved cash flow and can benefit now while repaying later.

2. Employment Relief

Two important tax credits were promulgated in KETRA as incentives to employers. The first was available to all employers who hire "Hurricane Katrina employees;" the second was initially only available to small businesses[184] located in the Hurricane Katrina core disaster area.[185] The first credit was a special application of the Work Opportunity Tax Credit (WOTC).[186] The second was a new form of tax credit aimed uniquely at the businesses that had to shut down, at least for one day, due to Hurricane Katrina.[187] The provisions are highly complementary: one rewards employers in the disaster area who retained and paid their employees; the other rewards any business who picked up those workers who lost their jobs.

The WOTC allows businesses a credit of forty percent of the first $6,000 of wages paid to any member of any targeted group.[188] As applied to Hurricane Katrina employees, it provides a credit to businesses within or outside the core disaster area who hire employees whose principal place of abode is either within the core disaster area or who have been displaced from a principal abode in the core disaster area due to the hurricane.[189] Any Katrina employees hired between August 28, 2005, and August 27, 2007, by a business located in the core disaster area qualify for the credit.[190] For employers outside the core disaster area, only displaced employees hired before December 31, 2005, are considered Hurricane Katrina employees.[191]

The original KETRA Employee Retention Credit had more strings attached. To qualify, a business must have

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[184] KETRA § 202(c) (limiting eligible businesses to fewer than 200 employees) was repealed by the Gulf Zone Opportunity Act of 2005, and was replaced with an identical credit for eligible businesses of any size. GO Zone Act of 2005 § 201, I.R.C. § 1400R(a)(2)(A). For full citation information of the GO Zone Act, see *infra* note 223.

[185] KETRA defines "core disaster area" more strictly than "Hurricane Katrina disaster area" to limit eligibility to those areas determined by FEMA to warrant individual or individual and public assistance. KETRA § 2.

[186] *See* I.R.C. § 51.

[187] KETRA § 202(b)(1).

[188] I.R.C. § 51(a), (b)(3).

[189] KETRA § 201.

[190] *Id.* § 201(b)(1).

[191] *Id.* § 201(b)(2).

employed fewer than 200 employees and must have been located in a core disaster area on August 28, 2005.[192] The business must have become inoperable between this date and January 1, 2006, as a result of damages from Katrina.[193] The business must also have had employees who worked in the core disaster area before the hurricane and who were paid wages between August 29, and December 31, 2005.[194]

For employers meeting all of these requirements, the tax relief is very similar to the WOTC credit. The qualifying business can claim forty percent of the first $6,000 for each retained employee.[195] For a company retaining a large number of workers, the relief could be substantial. For example, a company retaining 150 workers could potentially claim a $360,000 credit.

The credit amount is based upon "qualified wages," however, so is thereby limited to wages paid after the business became inoperable and before the business resumed significant operations.[196] Thus, if a business was only shut down for two days and payroll to each eligible employee was $50 per day, the credit would only be $6,000, versus $360,000 based on the example above. This additional restriction is sensible given the circumstances because it prevents a business only incidentally impacted from receiving a windfall.

3. Incentives for Charity

Following the Gulf Coast hurricanes, charities raised more than $2.5 billion.[197] This amount rivals the $2.7 billion in donations following the terrorist attacks of September 11, 2001.[198] Despite the near record levels of giving, the Government Accountability Office (GAO) has noted some difficulties in coordination between government relief efforts and charitable relief efforts, and among the various charitable organizations themselves.[199] The GAO also identified

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[192] *Id.* § 202(b)(1), (c).

[193] *Id.* § 202(b)(1)(B).

[194] *Id.* § 202(b)(3).

[195] KETRA § 202(a).

[196] *Id.* § 202(b)(3).

[197] GAO, HURRICANES KATRINA AND RITA: PROVISION OF CHARITABLE ASSISTANCE 2, GAO-06-297T (2005).

[198] *Id.* at 3.

[199] *Id.* at 7. *See also* GAO, HURRICANES KATRINA AND RITA: COORDINATION BETWEEN FEMA AND THE RED CROSS SHOULD BE IMPROVED FOR THE 2006 HURRICANE

significant shortfalls in the appropriate use and accountability of $126 million in international assistance.[200]

KETRA contains six general charitable incentives or rewards. Two are significant—the temporary lifting of deduction limitations for charitable donations and the additional exemption for those housing displaced individuals—and will be dealt with in greater detail below. The other four are more minor. The mileage rate for charitable use of a vehicle was substantially increased.[201] In the alternative, reimbursement for charitable use of a vehicle to provide Hurricane Katrina relief was excluded from income.[202] Donors of books to public schools were given explicit relief from downward adjustments of the deduction (to offset capital gains as required by Section 170(e)).[203] Finally, businesses were encouraged to donate food inventory (up to ten percent of the businesses' aggregate income) before December 31, 2005.[204]

KETRA Section 302, the additional exemption for housing individuals displaced by Hurricane Katrina, provides perhaps the most novel tax relief. It allows a $500 exemption in 2005 or 2006 for each Katrina victim taken in.[205] The maximum reduction of income for any taxpayer is limited to $2,000 (four displaced persons).[206] Relief is restricted to situations where the taxpayer does not receive rent from the displaced individual (or any other amount from any source) in connection with providing the housing.[207] Also, the displaced

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SEASON 3, GAO-06-712 (2006) (differing views about responsibilities hampered efforts to coordinate federal mass care assistance).

200 *See* GAO, HURRICANE KATRINA: COMPREHENSIVE POLICIES AND PROCEDURES ARE NEEDED TO ENSURE APPROPRIATE USE OF AND ACCOUNTABILITY FOR INTERNATIONAL ASSISTANCE 3, GAO-06-460 (2006). As of March 16, 2006, $60 million remained undistributed and there were no plans for use of $400 million of pledged and expected donations. *Id.* at 10, 12.

201 *Compare* I.R.C. § 170(i) (14 cents per mile), *with* KETRA § 303 (70% of standard business rate—yielding 32 cents per mile). I.R.S. Rev. Proc. 2005-78 (Dec. 2, 2005).

202 KETRA § 304.

203 While undoubtedly prompted by the need to restock public schools following Katrina, tax relief was not limited to donations to those affected by Hurricane Katrina. *Id.* § 306(a). However, the December 31, 2005, termination eliminates its utility for future crisis situations. *Id.* § 306(b).

204 *Id.* § 305.

205 *Id.* § 302.

206 *Id.* § 302(b)(1).

207 *Id.* § 302(c).

individual cannot be the spouse or dependent of the taxpayer.[208] Note that there is no restriction on other relatives.[209]

The final incentive to charitable donations was a lifting of the ceiling on charitable deductions.[210] The ceiling is typically ten percent of a corporate taxpayer's taxable income[211] or one-half of an individual taxpayer's adjusted gross income.[212] KETRA also lifts the overall limitation on itemized deductions for individuals in Code Section 68.[213] KETRA allows these ceilings to be ignored for any individual charitable contributions made after August 28, 2005, and before December 31, 2005.[214] Unlike the tax relief for individuals, for corporations to qualify, the contribution must be earmarked for Hurricane Katrina relief.[215]

4. Additional Relief

Several types of additional targeted tax relief were also authorized. The casualty deduction was improved by eliminating the $100 reduction and the ten percent AGI threshold for Katrina victims;[216] the rules for determining earned income were relaxed;[217] special rules were crafted to enable hurricane disaster areas to qualify as targeted areas for mortgage revenue bonds;[218] the time period to avoid recognition of a capital gain upon involuntary conversion of real property (by purchasing suitable replacement property) was extended to

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[208] KETRA § 302(c)(3).

[209] *Id.* With respect to taxable years 2005 and 2006, the Secretary has authority to ensure that taxpayers do not lose any deduction or credit, or experience a change of filing status, by reason of temporary relocations caused by Hurricane Katrina. *Id.* § 407. Of course, only one taxpayer may claim an individual as a dependent.

[210] KETRA § 301; *see* I.R.C. § 170(b)(1)(A) (limiting most charitable deductions to 50% of the taxpayer's contribution base); I.R.C. § 170(b)(1)(B) (limiting other charitable deductions to 30% of the taxpayer's contribution base). Ordinarily, excess donations may be carried forward for the next five years. I.R.C. § 170(d).

[211] I.R.C. § 170(b)(2).

[212] *See* I.R.C. § 170(b)(1)(A), (B). The taxpayer's contribution base is AGI, computed without regard to any net operating loss carryback. I.R.C. § 170(b)(1)(F); *see also* I.R.C. § 172.

[213] KETRA § 301(c).

[214] *Id.* § 301(a), (d)(1)(A).

[215] *Id.* § 301(d)(1)(B).

[216] *Id.* § 402.

[217] *Id.* § 406.

[218] *Id.* § 404.

five years for Hurricane Katrina victims;[219] victims whose debt was forgiven were allowed to exclude such relief from income;[220] and Congress required the IRS to extend filing and payment of taxes for those in the disaster area until at least February 28, 2006.[221]

IV. GO ZONE RELIEF AND SELECTIVE RELIEF FOR VICTIMS OF HURRICANES RITA AND WILMA

KETRA opened the door to wide-ranging tax relief for hurricane victims. After the continued devastation wrought by Hurricanes Rita and Wilma over the following weeks, it would hardly be fair to ignore the needs of the new victims. However, when the later hurricanes struck, Congress had not yet passed the long-term tax incentives it was working on for Hurricane Katrina victims.[222] The tax relief for those affected by the later hurricanes was therefore wrapped into the more far-reaching relief for those affected by Hurricane Katrina. Although this approach had the tremendous advantage of expediting relief to the victims of the later catastrophes, a layer of complexity was added, because the relief was not uniform for all victims and all areas.

The Gulf Opportunity Zone Act of 2005 (GO Zone Act) was passed on December 15, 2005, and signed on December 21, 2005.[223] The "core disaster area" for Hurricane Katrina was renamed the "Gulf Opportunity Zone," or "GO Zone,"[224] and similar tax advantaged areas were established for the victims of Hurricanes Rita and Wilma—the "Rita GO Zone"[225] and "Wilma GO Zone."[226] As with the initial KETRA relief, only those areas determined by the President to warrant individual

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[219] *Compare* KETRA § 405, *with* I.R.C. § 1033(h). Property is involuntarily converted when seized, stolen, condemned, or destroyed. I.R.C. § 1033(a).

[220] KETRA § 401(a).

[221] *Id.* § 403(b).

[222] Before Rita struck, the President had announced a desire to create an opportunity zone for redevelopment, and Congress was working to pass such legislation. *Grassley Says Next Relief Package Will Focus on Long-Term Tax Incentives*, TAX NOTES TODAY (Falls Church, Va.), Sept. 23, 2005 [hereinafter *Grassley*] ("We're looking at depreciation changes, tax-exempt bond authority, tax-exempt bond refunding, and enterprise-zone initiatives.").

[223] Pub. L. 109-135, 119 Stat. 2577 (codified at I.R.C. §§1400M-1400T) [hereinafter GO Zone Act].

[224] *See id.* § 101(a), I.R.C. § 1400M(1); KETRA § 2(2).

[225] GO Zone Act § 101(a), I.R.C. § 1400M(3).

[226] *Id.* § 101(a), I.R.C. § 1400M(5).

or individual and public assistance from the federal government qualified for special GO Zone tax benefits.[227]

Title II of the GO Zone Act expressly extended certain tax relief measures adopted for Hurricane Katrina to Hurricanes Rita and Wilma.[228] These measures directly parallel the KETRA relief and are summarized in Section A. The GO Zone Act also created new tax relief and incentives. Section B details the new tax relief common to all of the disasters. Section C examines the unique new relief for certain victims of Hurricane Katrina.[229] In addition to the credits and incentives discussed above, Congress included additional tax breaks in the GO Zone Act as an economic stimulus for the redevelopment of those areas hardest struck by Hurricane Katrina.

A. Tax Relief Expanded to Victims of Rita and Wilma

Special rules for use of retirement funds first adopted in KETRA were extended to also include individuals who sustained economic loss from Hurricanes Rita and Wilma.[230] Victims whose primary residences were located in the designated Hurricane Rita and Wilma disaster areas may also withdraw, without penalty, up to $100,000 from an eligible retirement plan.[231] As in KETRA, individuals may prorate income over three years,[232] repay within three years (and characterize the distribution as a rollover),[233] or, if preferred, borrow up to $100,000 from their employer retirement savings plan and repay within five years.[234]

The GO Zone Act broadly enhanced charitable giving incentives.[235] To enjoy relief from the limitations on charitable giving, corporate taxpayers were allowed to make contributions to relief efforts supporting any of these three hurricanes.[236]

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227 *Id.* § 101(a), I.R.C. § 1400M(1), (3), (5).

228 *Id.* § 201(a), I.R.C. §§ 1400Q-1400T.

229 Note, some of the victims of Hurricane Katrina were also victims of Hurricane Rita; if they qualify for individual or individual and public relief due to Katrina, these measures protect them. *Id.* § 101(a), I.R.C. § 1400M(1).

230 *Id.* § 201(a), I.R.C. § 1400Q.

231 GO Zone Act § 201(a), I.R.C. § 1400Q. As in KETRA, I.R.C. § 402(c)(8)(B) defines a qualified retirement plan.

232 *Id.* § 201(a), I.R.C. § 1400Q(a)(5)).

233 *Id.* § 201(a), I.R.C. § 1400Q(a)(3).

234 *Id.* § 201(a), I.R.C. § 1400Q(c).

235 *Id.* § 201(a), I.R.C. § 1400S(a).

236 *Id.* § 201(a), I.R.C. § 1400S(a)(4)(A)(ii).

Individual taxpayers enjoyed tax relief, so long as cash donations were made after August 28, 2005, and before December 31, 2005, regardless of whether the donations were linked to hurricane relief.[237]

Those suffering casualty losses (Code Section 165) attributable to Hurricanes Rita and Wilma were allowed the same relief from the ten percent AGI and $100 reductions on casualty losses as allowed to the Katrina victims.[238] The dates of the losses necessarily needed to correspond to the periods after the respective hurricanes made landfall.[239]

Special rules for determining earned income related to the Earned Income Credit and the refundable component of the Child Tax Credit were likewise afforded to "qualified individuals" in the Wilma and Rita disaster areas.[240] As with the Hurricane Katrina victims, to qualify, the individual had to either be displaced from his or her principal place of abode by the hurricane, or had to qualify for individual or individual and public assistance from the federal government.[241]

Finally, procedural relief was extended to the new victims in the Hurricane Rita and Hurricane Wilma disaster areas. Congress required the Secretary of the Treasury to extend under Code Section 7508A the period for filing and payment of taxes (and other tax-related deadlines) to all taxpayers in the three declared disaster areas, "for a period ending not earlier than February 28, 2006."[242]

B. New Tax Relief—All GO Zones

Other than the benefits discussed above, no additional benefits were created for individual taxpayers affected by the later hurricanes. However, some limited additional business benefits were created for all of the GO Zones.

Special rules were crafted for mortgage revenue bonds to finance owner-occupied residences within any of the three GO Zones. Most significantly, the maximum amount of qualifying home improvement loans was increased from $15,000 to $150,000 where proceeds were used to repair homes

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237 GO Zone Act § 201(a), I.R.C. § 1400S(a)(4)(A)(i).

238 *Id.* § 201(a), I.R.C. § 1400S(b).

239 *Id.* § 201(a), I.R.C. § 1400S(b).

240 *Id.* § 201(a), I.R.C. § 1400S(d)(2)(C), (D).

241 *Id.* § 201(a), I.R.C. § 1400S(d)(2)(C), (D).

242 *Id.* § 201(a), I.R.C. § 1400S(c).

located in the GO Zones.[243] The GO Zone Act also reflected "the sense of the Congress that the Secretary of the Treasury, or the Secretary's delegate, should designate one or more series of [U.S. savings] bonds or certificates . . . as 'Gulf Coast Recovery Bonds' in response to Hurricanes Katrina, Rita, and Wilma."[244]

Employee retention credits[245] of up to forty percent of the first $6,000 paid per retained employee were extended to eligible employers in the GO Zone, the Hurricane Rita GO Zone,[246] and the Hurricane Wilma GO Zone.[247] The new provision effectively repealed the similar KETRA provision (discussed in Part III.B.2). Significantly, the KETRA limitation—that the credit was not available to large businesses—was removed.[248] It is also worth noting that the Work Opportunity Tax Credit,[249] which had been offered to those hiring Hurricane Katrina employees (including displaced employees), was not extended to employers hiring those affected by the later hurricanes.[250]

Code Section 168(k) allows a taxpayer a thirty percent depreciation allowance for qualifying property placed in service after September 10, 2001, and before January 1, 2005.[251] The GO Zone Act created discretionary authority for the Secretary to extend the "placed in service date" for any property to qualify for bonus depreciation, so long as the property was manufactured and placed in service within one of the three GO Zones by a person affected by the hurricanes.[252] The Secretary is to exercise this discretion on a "taxpayer by taxpayer basis," but in no event is the Secretary to extend the period by more than one year.[253]

Small timber producers in all three GO Zones got a boost from the Act.[254] Those taxpayers holding under five

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[243] GO Zone Act § 201(a), I.R.C. § 1400T(a).

[244] *Id.* § 301.

[245] *Id.* § 201(a), I.R.C. § 1400R.

[246] *Id.* §§ 101(a), 201(a), I.R.C. §§ 1400M(3), 1400R(b).

[247] *Id.* §§ 101(a), 201(a), I.R.C. §§ 1400M(5), 1400R(c).

[248] *Compare id.* § 201(a), I.R.C. § 1400R, *with* KETRA § 202(c).

[249] I.R.C. § 51 (discussed *supra* Part III.B.2).

[250] *See* KETRA § 201. Katrina employees were identified as members of a targeted group under I.R.C. § 51 for purposes of this credit; the deadline for hiring displaced workers was Dec. 31, 2005. *Id.*

[251] I.R.C. § 168(k).

[252] GO Zone Act § 105.

[253] *Id.*

[254] *Id.* § 101(a), I.R.C § 1400N(i).

hundred acres of qualified timber property,[255] any part of which lies within a GO Zone, may carry net operating losses back five years and characterize the losses as farming losses; increased expensing is also allowed.[256]

Finally, for housing purposes, all three GO Zones are to be treated as "difficult development areas" under Section 42 of the Code.[257] The designation facilitates Low-Income Housing Credits for any property placed in service in these areas from 2006 through the end of 2008.[258] Note that the credit is increased for the hurricane Katrina GO Zone.[259]

C. Katrina Unique GO Zone Benefits

1. Enhanced Education Tax Credits

In this second wave of legislation, Congress provided an enhanced education tax credit, for tax years 2005 and 2006, for students who attended educational institutions in the Gulf Opportunity Zone.[260] This relief effectively doubled the Hope or Lifetime Learning tax credit amounts for individuals under Code Section 25A.[261] It also relaxed the definition of "qualified tuition and related expenses" so that room and board expenses could be considered.[262] Such relief would be especially important to the thousands of students who had to transfer temporarily to other institutions.

2. Economic Stimulus for the GO Zone

a. Bonds and Community Development Credits

Congress authorized nearly $8 billion in tax-exempt bond financing for the States of Louisiana, Mississippi, and Alabama.[263] Such bonds were allowed to be used to pay for construction of residential rental projects, for construction (or

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255 *See* I.R.C. § 194(c)(1).

256 GO Zone Act § 101(a), I.R.C. § 1400N(i).

257 *Id.* § 101(a), I.R.C. § 1400N(c)(3).

258 *Id.*

259 *Id.* § 101(a), I.R.C. § 1400N(c)(1).

260 *Id.* § 102(a), I.R.C. § 1400O.

261 *Id.*

262 GO Zone Act § 102(a), I.R.C. § 1400O.

263 *Id.* § 101(a), I.R.C. § 1400N(b).

reconstruction or improvement) of nonresidential real property, or for public utility construction in the GO Zone.[264]

Seven hundred million dollars in additional tax credits were created for redevelopment of the GO Zone.[265] The new markets tax credit was available only to qualified community development agencies making qualified low-income community investments within the GO Zone.[266]

b. Housing Incentives

As noted above, the GO Zone was included as a difficult development area and was also singled out for enhanced low-income housing credit. In the past, the IRS had granted similar relief under its discretionary authority pursuant to I.R.C. Section 42(n).[267] Such relief was available in response to a request from the affected State.[268] The statutory relief obviated the need for the state to come forward and request it.

The GO Zone tax-relief measures also included a tax credit for employer-provided housing.[269] The credit is equal to thirty percent of the amount excludable from the gross income of qualifying employees [up to $600 per month] for lodging furnished by the employer from January 1, 2006, to July 1, 2006.

c. Other Business Incentives

Businesses in the GO Zone are entitled to a special depreciation allowance for GO Zone Property placed into service from August 28, 2005, through the end of 2007 (2008 for nonresidential real property and residential rental property).[270] Fifty percent of the adjusted basis of the property (adjusted basis is typically the property's cost) can be written off the first

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264 *Id.* § 101(a), I.R.C. § 1400N(a)(4).

265 *Id.* § 101(a), I.R.C. § 1400N(m).

266 *Id.* § 102(a), I.R.C. § 1400O.

267 *See, e.g.*, I.R.S. Notice 2004-76, *supra* note 147 (describing relief in Florida from damage due to Charley, Frances, Ivan, and Jeanne); I.R.S. Notice 2004-74, *supra* note 150 (describing relief in Alabama from damage due to Ivan); I.R.S. Notice 2004-75, *supra* note 150 (describing relief in Ohio due to post-hurricane storms and flooding).

268 *See generally* I.R.S. Notice 2004-76, *supra* note 147; I.R.S. Notice 2004-74, *supra* note 150; I.R.S. Notice 2004-75, *supra* note 150 (describing state requests).

269 GO Zone Act § 103(a), I.R.C. § 1400P(a), (b), (f).

270 *Id.* § 101(a), I.R.C. § 1400N(d).

year, plus ordinary depreciation can then be taken on the remaining fifty percent.[271]

The amount of immediate tax relief is also substantially enhanced because of increased expensing allowances for durable business property.[272] The limits under Code Section 179 are increased by up to $100,000 on the capital property (otherwise required to be depreciated over time) that can be deducted in the immediate year as a current expense.[273]

Taxpayers are also allowed to elect to take up to fifty percent of any GO Zone clean-up cost as a deduction for the taxable year in which the cost is incurred.[274] They can also deduct one hundred percent of any environmental remediation costs, including remediation of hazardous substances as well as petroleum products, in the year clean-up costs are incurred.[275] To qualify for either of these special provisions, the clean-up must be conducted before December 31, 2007.[276]

The rules regarding GO Zone casualty losses are incredibly generous. Instead of the typical two-year carryback period,[277] the Act allows a five-year carryback for any "qualified Gulf Opportunity Zone loss."[278] This term is defined as the lesser of (1) net operating loss (NOL) minus ten-year carryback loss,[279] or (2) the sum of GO Zone casualty losses, plus deductions of moving expenses paid to vacate a home as a result of Katrina, plus amounts paid to temporarily house employees, plus depreciation of GO Zone property, plus clean-up and repair costs due to Katrina.[280]

In addition to the sweeping relief described above, special tax treatment is also extended to designated industries. For example, the public utility industry is afforded more generous casualty loss relief.[281]

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[271] *Id.* For a $100,000 machine, the qualifying taxpayer would receive a $50,000 depreciation bonus.

[272] *Id.* § 101(a), I.R.C. § 1400N(e); *see also* I.R.C. § 179(b).

[273] GO Zone Act § 101(a), I.R.C. § 1400N(e); *see also* I.R.C. § 179(b).

[274] GO Zone Act § 101(a), I.R.C. § 1400N(f).

[275] *Id.* § 101(a), I.R.C. § 1400N(g).

[276] *Id.* § 101(a), I.R.C. § 1400N(f), (g).

[277] I.R.C. § 172(b)(1).

[278] GO Zone Act § 101(a), I.R.C. § 1400N(k).

[279] I.R.C. § 172(b)(1)(C).

[280] GO Zone Act § 101(a), I.R.C. § 1400N(k)(2).

[281] *Id.* § 101(a), I.R.C. § 1400N(j).

V. IMPROVING TAX POLICY THROUGH PREDICTABILITY AND VICTIM EQUITY

There are two principal contentions in the materials that follow: (1) those meritorious tax measures designed to aid the victims of Hurricanes Katrina, Rita, and Wilma should be improved and expanded to reach victims of all casualties, and (2) these beneficial changes should be incorporated into the tax code so that financial and tax planning can be more predictable. The discussion looks not only at what has been done, but also at what could be done, including measures currently proposed. Equity and predictability serve as the barometers for the analysis.

Although some of the tax relief measures flowing from the 2005 hurricanes should be abandoned, many should be extended to victims of all casualties, and some of the relief measures should go even further to improve both horizontal and vertical equity.

Horizontal equity is treating similarly situated taxpayers in a similar manner.[282] Vertical equity ensures fairness among taxpayers with different income levels.[283] Under our progressive tax system, vertical equity requires that taxpayers in lower brackets bear less of the tax burden than those with higher incomes (and presumably more ability to pay).[284]

There are a number of difficulties in applying tax relief and incentives to provide relief to victims of disasters. For example, tax benefits are not easily targeted to lower income individuals.[285] Also, unbridled tax relief is akin to unconstrained federal spending—they both can break the bank.

That being said, if these difficulties can be surmounted, then tax relief could be used to improve the dire circumstances of a great many Americans at a time when they are facing perhaps their lives' greatest tragedy. To insure fiscal responsibility, the relief should be carefully tailored to maximize the benefits to those most in need. To better appreciate the proposals in the parts that follow, the remainder

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[282] David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43 (2006).

[283] JOEL S. NEWMAN, FEDERAL INCOME TAXATION: CASES, PROBLEMS AND MATERIALS 25 (3d ed. 2005).

[284] *Id.* at 15, 17-25.

[285] GRAVELLE, *supra* note 36, at 2.

of this section focuses on the flaws in the recent hurricane tax incentives and the present tax regime.

While noble in its attempts to afford relief to the numerous victims of the disasters, Congress' ad hoc legislative response to the 2005 hurricanes resulted in measures either too broad or too narrow to constitute effective tax policy. In particular, tax-related relief from Congress and the Internal Revenue Service has been voluminous and at times redundant, complex, and confusing.[286] Legislators and bureaucrats have not always been on the same page.[287] Now that the waters have settled, it is fitting to examine the lessons learned.

To receive the optimal benefit, money must quickly reach those who have been devastated the most. The true way to "fast-track" relief is to approve it now for all future victims. Congress should work closely with the IRS to foster ready implementation of appropriate tax relief to reach those businesses and individuals most affected. The trigger for such recovery should be both predictable and equitable.

Even though the specific answers to the tax relief problem should be the focus of further academic and Congressional discussion, now is the time to acknowledge the problem and begin the debate. The following suggestions may offer hope of a more promising and beneficial future.[288]

A. *Incentives for Charitable Donations Aided the Wealthy and Were Inadequately Linked to Relief for Those Struck by the Tragedy*

Charity for those in need is a virtue,[289] and the charitable outpouring that flowed from the hurricanes was

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[286] The two new laws affording a myriad of tax relief measures (KETRA, *supra* note 167, and GO Zone Act, *supra* note 223) were accompanied by no fewer than eighty IRS pronouncements in the months following Katrina. The count is derived from searches for the term "Hurricane Katrina" in the Westlaw databases Federal Taxation – IRS Cumulative Bulletins and Federal Tax – IRS News Releases databases.

[287] *See*, *e.g.*, *infra* notes 305-08 and accompanying text.

[288] Note that deliberation about tax relief for victims of catastrophes is warranted, even if the income tax is replaced with a flat tax or consumption tax. Jerome Kurtz, *Two Cheers for the Income Tax*, 27 OHIO N.U. L. REV. 161, 165-66 (2001) (noting political impracticality of Congress refusing tax relief to disaster victims under any tax system).

[289] *See, e.g.*, Catechism of the Catholic Church, pt. 3, § 1, ch. 1, art. 7, ¶¶ 1822-29, *available at* http://www.usccb.org/catechism/text/pt3sect1chpt1art7.htm (last visited Jan. 9, 2007).

remarkable.[290] However, it was more likely the magnitude of the disasters, rather than the promise of additional tax relief, that prompted most of this widespread generosity.[291] Indeed, most of the donations from within the United States were made before KETRA was passed,[292] and $126 million worth of aid was donated from abroad.[293] Clearly, none of this aid was prompted by the promise of U.S. tax relief.

Undoubtedly, some taxpayers did choose to donate more to charity in the latter half of 2005 because of the promise of tax relief. The tax relief accruing to Vice President Cheney for his family's $6.8 million in charitable donations for tax year 2005 even drew media attention (with commentators noting that the relief did not go to disaster victims).[294] The Cheneys should not be faulted for their generosity; rather, the example should illustrate the underlying problems with the tax relief itself.

This tax policy violates vertical equity, because only those with donations above the suspended limits would benefit. Those likely to benefit the most would have to have sufficient wealth to be able to subsist on less than fifty percent of their AGI.[295] Perhaps when you make millions or billions of dollars in income you can afford to give much of it away.[296] However,

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[290] *See* GAO-06-297T, *supra* note 197 ($2.5 billion contributed to charities in a little over three months); *see also* Press Release, Giving USA Found., Charitable Giving Rises 6 Percent to More Than $260 Billion in 2005: Disaster Relief Tops All Records and Totals 3 Percent of All Giving (June 19, 2006), http://www.aafrc.org/press_releases/trustreleases/0606_PR.pdf.

[291] Stephanie Strom, *Many Dismissing 'Donor Fatigue' as Myth*, N.Y. TIMES, Apr. 30, 2006, at A22 ("Fund-raising experts said it was unlikely that the tax break accounted for [gains in donations] because many charities did not know about it in time to capitalize on it.").

[292] *See* GRAVELLE, *supra* note 36, at 9 (citing Elizabeth Williamson, *Charitable Giving: A Generous Response Tends to Slow*, WASH. POST, Sept. 14, 2005, at A25).

[293] GAO-06-460, *supra* note 200.

[294] *See* Christopher Lee, *Bushes Paid $187,768 in Federal Income Tax; First Couple's Earnings Totaled About $735,000; Cheneys Made $8.8 Million*, WASH. POST, Apr. 15, 2006, at A9; Marc D. Hoffman, *Vice President and Mrs. Cheney Too Generous?* PLANNED GIVING DESIGN CENTER, Apr. 21, 2006, http://www.pgdc.com/usa/item/?itemID=346546. Note the Cheneys have made disaster relief donations in the past. *See, e.g.*, Stephanie Kriner, *Lynne Cheney Donates Book Proceeds to Disaster Relief Fund*, AM. RED CROSS, Dec. 14, 2001, http://www.redcross.org/news/ds/donations/011214cheney.html.

[295] I.R.C. § 68 normally requires high-income itemizers to reduce deductions by 3% of the amount by which their AGI exceeds $100,000 (as adjusted for inflation) or by 80% of their itemized amount (whichever is less). I.R.C. § 170 normally caps allowable donations at 50% of AGI for the taxable year (though donations in excess of that amount may be carried forward for up to five years).

[296] *See* Lee, *supra* note 294. Warren Buffett's record-setting multibillion dollar donations in 2006 would tend to confirm that the ultra-wealthy can afford huge

most middle class or poor taxpayers simply could not afford to be prompted by these measures.[297] Additionally, because of the way the Code is structured, only taxpayers who itemize could benefit from the relief.[298]

Even if taxpayers were motivated to donate more because of tax relief, the amount that went to aid the victims is highly suspect. Studies show that taxpayers who donate more than fifty percent of their AGI tend to designate churches, educational institutions (such as colleges and universities), and private foundations as the principal recipients.[299] Money donated to private organizations is often saved and not spent immediately.[300] Money donated to schools, other than those in the disaster area, is unlikely to benefit the victims. Even donations to religious organizations tend predominantly to support religious services and infrastructure costs, versus aid to the poor.[301]

Although the tax measures allowed flexibility in terms of recipients, the fear of "donor fatigue," the notion that taxpayers may shortchange other charities by diverting relief to the victims of the disasters, never materialized.[302] According to Giving USA, a foundation devoted to research and education in philanthropy, while disaster relief topped all records in 2005, the average charitable giving per household in the United States remained at 2.2% of disposable income, exactly the same as the forty-year average.[303] Furthermore, the amount of charitable donations targeted toward disaster relief was a meager three percent of all charitable donations.[304]

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donations. *See* Editorial, *Buffett Gives Up His Fortune: Largest Charitable Gift in History Will Benefit Those Who Need Help Most*, BUFFALO NEWS (N.Y.), June 28, 2006, at A8.

297 *See* GRAVELLE, *supra* note 36, at 8-9.

298 Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 121, temporarily allowed a charitable deduction for taxpayers who did not itemize; this capability for non-itemizers terminated in 1986. S. REP. NO. 107-211, at *4 n.3 (2002), 2002 WL 1590762. Unlike the proposed CARE Act of 2002, H.R. 7, 107th Cong. (*see* S. REP. NO. 107-211, at *4-*6, 2002 WL 1590762), recent tax reform legislation does not authorize charitable deductions for non-itemizers. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780.

299 GRAVELLE, *supra* note 36, at 9.

300 *Id.*

301 "[A]bout 70% of spending of religious organizations goes for services (the church building, the minister), and only about 6% goes to poor people." *Id.* at 9 n.12 (citing Jeff E. Biddle, *Religious Organizations*, *in* WHO BENEFITS FROM THE NONPROFIT SECTOR? 92, 92-133 (Charles T. Clotfelter ed., 1992)).

302 Strom, *supra* note 291.

303 Press Release, Giving USA Found., *supra* note 290, at 2.

304 *Id.* at 1.

B. Ad Hoc Relief Is Inefficient and Inequitable

1. Not on Same Sheet of Music

A defining feature of an emergency is that time is of the essence. For this reason, prior planning is essential. In the absence of prior planning, people are often forced to react without benefit of all available information. The stress of the moment may cause them to react rashly, or may paralyze them into inactivity. Confusion is almost certain to ensue, as there may be little time for coordination and decision-making.

In addressing tax relief for families, Congressman Rahm Emanuel and Senator Barack Obama proposed in a September 14, 2005, letter to Treasury Secretary John W. Snow that the Earned Income Tax Credit (EITC), Child Tax Credit, and education incentives be immediately accelerated.[305] They proposed to capture such relief in a Bill entitled the "Hurricane Katrina Accelerated Tax Refund Act."[306] The letter acknowledged a policy goal of allowing "Americans who have lost so much [to] receive their refunds now rather than later."[307]

The administration resisted this program, noting: "The significant resources that the legislation would require might outweigh the benefit of a short acceleration of the refunds."[308] Congressional good intentions met with an administrative inability to quickly execute those intentions. It is precisely for these reasons that the Code should be rewritten so that a well-planned network of readily executable and predictable consequences automatically ensues in the wake of a natural disaster.

2. Post-Hurricane Tax Relief Was Inequitable

Horizontal equity requires treating similar taxpayers similarly. All other things being equal, it simply would not be fair to allow blue-eyed taxpayers to itemize while denying this

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[305] Letter from U.S. Rep. Rahm Emanuel and U.S. Sen. Barack Obama to John W. Snow, Sec'y, U.S. Dep't of the Treasury (Sept. 14, 2005), *available at* 2005 WL 3370031.

[306] *Id.* The bill was never proposed. For a discussion of proposed legislation, see *supra* notes 160-68 and accompanying text.

[307] *Id.* The letter erroneously asserted a precedent for "fast-tracking" refunds based on the tragic events of September 11, 2001. *See id.*; Letter from Eric Solomon, Acting Deputy Assistant Sec'y (Tax Policy), to U.S. Rep. Rahm Emanuel (Nov. 2, 2005).

[308] Letter from Eric Solomon, *supra* note 307.

opportunity to brown-eyed taxpayers. In other words, there must be some justification for treating individuals with identical incomes in different manners. The greatest fault of the 2005 tax-relief measures is their failure to ensure horizontal equity. Based on the Code, as amended by the two Acts, there are six different classes of 2005 disaster victims—GO Zone residents (Katrina core disaster area); other Katrina disaster area victims; Rita and Wilma GO Zone residents; other Rita and Wilma disaster area victims; victims in other declared disaster areas; and other victims not in a declared disaster area.[309] Creation of preferred classes of victims makes little sense.

For example, it is nonsensical that mileage allowances are higher for volunteers who engaged in Hurricane Katrina relief efforts than those who responded to Hurricanes Rita or Wilma, or to any other disaster for that matter. In each scenario, people need help, and others are willing to volunteer to provide it. All these noble volunteers should be equally entitled to the same tax refunds or tax-free reimbursements. Under the Code, the allowable mileage rate has been lower for such volunteer costs than for business costs,[310] and Congress is the best arbiter of what the appropriate ratio should be as a matter of public policy. However, once that decision is made, the ratio should be a constant for all disaster response. Then, as gas prices escalate and the business mileage rates rise, commensurate relief would be afforded to all rescuers, relief workers, and other volunteers.

All of the benefits unique to Hurricane Katrina should be scrutinized based on considerations of horizontal equity. The only measures that should withstand such scrutiny are those for which Hurricane Katrina warrants disparate treatment on other policy grounds. In other words, a justification needs to be articulated to warrant additional relief to Hurricane Katrina victims. Where there is no such justification, and the measures are otherwise meritorious, limiting such relief either to Hurricane Katrina victims or to Hurricane Katrina, Rita, and Wilma victims makes these

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[309] See *supra* Parts III and IV for a detailed discussion of the different tax treatment of victims following the hurricanes of 2005.

[310] *Compare* I.R.C. § 170(i) (limiting charitable mileage to fourteen cents per mile), *with* Treas. Reg. § 1.274-5(j)(2) (allowing standard business mileage at rates established by IRS). Since 1998, the standard business mileage rate has been at or above 31 cents per mile. *See* Rev. Proc. 98-63, 1998-2 C.B. 818.

measures under-inclusive of others who would benefit from the same tax treatment.

As an analogy, if public transportation benefits those without a car who live two miles from work, then it stands to reason it also benefits those without a car who live three miles from work. If the government decided it would be sound policy to offer free transportation to those in need, limiting the relief to those who live two miles from work would be under-inclusive. The policy would be over-inclusive if it afforded relief to those who did not require it, such as affording free public transportation to those living two miles from work who own cars.

It is less obvious, but equally the case, that the 2005 tax relief has been over-inclusive. For example, to the extent that time extensions were given to those who did not need it (those in the core disaster areas that were not flooded or did not lose records), relief was over-inclusive. Perhaps allowing the disaster areas to serve as surrogates for those impacted by the disaster is warranted if it makes tax administration easier, especially where Congress is trying to economically stimulate renewed spending and investment in the local communities. However, where tax measures afford significant financial relief, our lawmakers need to be mindful of these additional costs.

C. *Excessive Relief Stimulates Undesirable Behavior*

Those who choose to live in higher-risk areas should bear those risks. Indeed, if there is no accountability for bad choices, then those choices will continue to be made. Ultimately, if the federal government absorbs or absolves individuals of all costs of their risky behavior, the costs are never internalized into the decision-making process.[311]

Some have argued that those who choose to live in higher-risk areas should also bear a higher share of the emergency response and recovery costs.[312] They contend that "tax benefit equity requires that the costs of local emergency

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[311] For an interesting analysis of how flood insurance and protective measures may actually induce increased risk of catastrophic loss, see Raymond J. Burby, *Hurricane Katrina and the Paradoxes of Government Disaster Policy: Bringing About Wise Governmental Decisions for Hazardous Areas*, ANNALS AM. ACAD. POL. & SOC. SCI., Mar. 2006, at 171.

[312] Robert E. Deyle & Mary Kay Falconer, *Revenue Options for a Risk-Based Assessment of Developed Property in Hurricane Hazard Zones*, 18 J. LAND USE & ENVTL. L. 299, 300-01 (2003).

management services necessitated by development of land exposed to hurricanes be allocated among property owners in proportion to the demand they create for such services."[313] Difficulties arise, however, in allocating proportions of emergency service costs to hurricanes and in estimating such costs, because "most jurisdictions have had no more than one hurricane within the past 10 or 20 years."[314]

Ironically, federal aid through FEMA and emergency relief through non-profit organizations such as the Red Cross may have exacerbated difficulties for small businesses by affording cash to people who would otherwise have been working.[315] This relief may have served as a disincentive to laborers, whom local businesses could have put to productive use.

VI. ENHANCED PROCEDURAL RELIEF IS NEEDED

Relief should be geared to that which is predictable. But what is predictable? Following a tragedy, taxpayers may not have access to their personal papers, tax documents, or other such items; people and businesses will be in a disadvantaged economic position; lives will be torn apart; and people may die. For most disasters, someone will want to help.[316] While the tax code cannot bring the dead back to life, it can be used to help restore or improve the economic life of all casualty victims. Essentially, both substantive and procedural relief should be afforded to all taxpayers suffering a casualty loss.

We could all use more time and money. Obviously, there are costs of foregone revenue, to the extent the government allows any monetary tax relief (whether in the form of credits, deductions, or exclusions from income). To the extent the IRS grants additional time, on the other hand, the government is deferring, versus reducing, income. Due to the time value of money, deferral carries with it some intrinsic costs (a dollar repaid next year is not worth as much as one

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[313] *Id.* at 305.

[314] *Id.* at 304.

[315] Runyan, *supra* note 158, at 23 (writing that small business owners saw FEMA handouts as disincentives for employees to return to work).

[316] The I.R.C. treatment of gifts helps individuals get back on their feet by excluding the value of the gift from income. I.R.C. § 102. Further, the Red Cross helps many in need, even when no disaster has been declared. Allowing this relief to be free from taxation aids the victims. *See generally* I.R.C. § 139.

paid today);[317] however, when it comes to disaster victims, these costs are negligible compared to the public policy benefits.

The potential for so much good is justification enough to at least explore whether certain tax measures might sensibly be employed as tools to aid victims of disaster. To the extent that tax-related proposals are equitable, simple, and inexpensive to administer, they should be thoughtfully considered now, before the next disaster strikes.

The IRS has been sensitive to hardships faced by victims and has granted relief in the past.[318] Indeed, the IRS has itself been the victim of Mother Nature.[319] When IRS facilities were struck by Hurricane Rita, the Service granted itself an extension for performing government actions associated with processing disaster-related returns.[320] The principles here should be governed more by common sense and fair dealing than by concerns about maximizing every penny of tax revenue—the U.S. government ought not kick individuals when they are down. Based upon principles of horizontal equity, these changes should be extended to all casualty victims.

Code Section 7508A, affording the IRS *discretionary* authority to extend filing and payment deadlines, could easily be modified to *mandate* such essential relief. KETRA, for example, mandated that the IRS extend deadlines for the Katrina disaster area "at least until February 28, 2006."[321] An identical mandate was contained in the GO Zone Act for all those within the declared disaster areas of the other

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[317] To combat the effects of deferral, ordinarily the IRS collects interest under I.R.C. § 6404, even when penalties are waived based on hardship or just cause.

[318] *See supra* Part II.D.

[319] IRS headquarters at 1111 Constitution Avenue, was closed for at least a month in 2006 and sustained millions of dollars in damage due to torrential rains in the Washington, D.C., area. Megan Greenwell, *IRS HQ Partly Closed Until January*, WASH. POST, July 11, 2006, 2006 WLNR 11951703.

[320] I.R.S. Notice 2005-82, 2005-47 I.R.B. 978.

> Documents maintained by the IRS within the covered disaster area may have been lost or destroyed as a result of Hurricane Rita, or remain in buildings that are inaccessible. The destruction, loss or inaccessibility of these documents will materially interfere with the IRS's ability to timely administer the internal revenue laws with respect to certain taxpayers.

Id. at 978-79.

[321] KETRA § 403(b). Katrina relief included automatic waivers of filing deadlines and payment of taxes, automated abatement of any interest and penalties, and time extensions for all actions identified in I.R.C. § 7508(a)(1). *Id.*

hurricanes.[322] Congress could just as easily grant six months of relief to every taxpayer in a declared disaster area, or even to every taxpayer claiming a casualty loss.

For victims of Hurricanes Hugo, Andrew, and Iniki, and the hurricanes of 2004, the IRS granted generous global extensions to taxpayers in the designated disaster areas or those who alleged to have been affected by these disasters.[323] Similar relief was afforded to victims of September 11, 2001.[324] The IRS has also granted extensions due to earthquakes, fires, blackouts, and floods.[325] The amount of relief for these declared disasters has varied from a few days or weeks to many months.[326]

In 2006, the IRS automated the extension process for *all* taxpayers (not just disaster victims).[327] The new process grants taxpayers a six month extension for filing, but taxpayers remain liable for paying estimated taxes and face late payment penalties and interest if they have not made an adequate payment at the time taxes are originally due.[328] In light of the potential administrative burden of extending the deadlines for all taxpayers (of whom those impacted by disasters are only a small percentage), the only consequence to the government of automated relief for disaster victims is the waiver of interest and penalties.

Congress should take the next step to make relief from interest and penalties mandatory, versus discretionary, for all declared disaster areas. Such a change would lead to greater tax equity among those impacted by presidentially-declared

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[322] I.R.C. § 1400S(c). The IRS later used its statutory discretion to extend further the filing and payment deadlines until August 28, 2006, but for Hurricane Katrina victims only. I.R.S. Notice 2006-20, 2006-10 I.R.B. 560-61 (redefining "covered disaster area" to include only the GO Zone).

[323] *See supra* Part II.D.

[324] I.R.S. Notice 2001-61, 2001-2 C.B. 305, 305-06.

[325] *E.g.*, I.R.S. News Release IR-94-5 (Jan. 19, 1994) (Los Angeles earthquake); I.R.S. Notice 94-87, 1994-2 C.B. 559, 559-60 (Southeast floods); I.R.S. News Release IR-2003-100 (Aug. 15, 2003) (Northeast blackout); I.R.S. Notice 2001-30, 2001-1 C.B. 989, 989-90 (Cerro Grande fire).

[326] *See, e.g.*, I.R.S. News Release IR-2003-100, *supra* note 325 (granting seven days for the blackout); I.R.S. News Release IR-94-5, *supra* note 325 (granting ten days for the earthquake); I.R.S. News Release IR-2004-118, *supra* note 148 (granting 108 days for Hurricane Ivan); I.R.S. Notice 2001-30, 2001-1 C.B. 989, *supra* note 325 (granting nine months for the Cerro Grande fire).

[327] I.R.S. News Release IR-2006-58 (Apr. 10, 2006).

[328] *Id. See also* I.R.C. § 6081 (authorizing Secretary to extend filing deadline up to six months); Treas. Reg. § 1.6081-4T(c) (requiring timely tax payment notwithstanding filing extension).

disasters by imposing predictable and uniform consequences, instead of an ad hoc disaster-by-disaster approach by the IRS. It should also be easier for the IRS to implement than a system where each disaster must be individually considered.

Even where disasters have not been declared, Congress should grant an automatic six month extension waiving interest and penalties for every casualty loss. Penalty relief has been available in the past to such casualty victims, but it has not been guaranteed; rather, each case has been evaluated on its merits, and the IRS has made individual determinations as to whether to grant relief.[329] Such a case-by-case determination method is intrinsically time-consuming, requiring taxpayer initiation of a request for relief, IRS investigation and corroboration of the factual assertions, and ultimately an IRS determination.[330] Even where relief is granted, it may take the bureaucracy months to come to this determination.[331] Interest has not been similarly relieved.[332]

A better approach would be to statutorily grant six months of relief under Code Section 7508A to any victim based

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[329] I.R.S., U.S. DEP'T OF THE TREASURY, INTERNAL REVENUE MANUAL § 20.1.1.3.2.5 (Aug. 20, 1998), http://www.irs.gov/irm/part20/ch01s01.html. Bona fide reasons for relief include taxpayers being unable to access their records or, as the result of an accident, taxpayers being hospitalized and thus unable to file the return or pay the tax. *Id.* Fire, casualty, natural disaster, or other disturbances are merely factors to consider, not necessarily sufficient in and of themselves to justify penalty relief. *Id.*

[330] The *Internal Revenue Manual* provides:

> (4) Penalty relief may be appropriate if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control they were unable to comply with the law.
>
> (5) Factors to consider include:
> - Timing.
> - Effect on the taxpayer's business.
> - Steps taken to attempt to comply.
> - If the taxpayer complied when it became possible.
>
> (6) The determination to grant relief from each penalty must be based on the facts and circumstances surrounding each individual case.

Id.

[331] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2005-47-021 (Nov. 25, 2005) (waiver based on 2004 hurricanes granted late 2005); I.R.S. Priv. Ltr. Rul. 2005-46-044 (Nov. 18, 2005) (waiving sixty-day period for IRA rollover requested in April 2005, granted in August 2005).

[332] Unless suspended under I.R.C. § 7508A, the Code presently allows abatement of interest only where an assessment is excessive, or erroneously or illegally assessed. I.R.C. § 6404.

upon the taxpayer's bona fide assertion of a casualty.[333] While such an extension might accrue to those whose records are intact and do not need an extension, the incentive to file sooner to obtain relief more quickly should be a sufficient motivator to prompt them to file as soon as they are able to do so.

The IRS should be allowed the discretion to grant up to an additional year based on circumstances.[334] This presents a more equitable approach (not favoring victims of one hurricane, fire, or flood over another)[335] and a more efficient and timely process for the government.[336] It also affords casualty victims the assurance that they will not face penalties if they are unable to meet original deadlines. The cost of standardization and simplification would only be the time value of money for those who owe from the time their taxes were originally due until actually paid.[337]

Finally, proof problems in establishing casualty losses with sufficient certainty would likely be reduced,[338] as the six month relief would allow victims time to obtain government copies of their previous tax records and estimates for repairs and replacement of damaged property. This increased information should eliminate some of the evidentiary problems confronting taxpayers when records have been destroyed and

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[333] Assertions would be subject to later verification by audit if necessary. Additionally, Congress could define a bona fide assertion to require the taxpayer to have proof of an insured loss. Such a precaution could both foster insurance and shift the burden of initial corroboration from the IRS to the private insurance industry.

[334] The same procedures as employed at present–notice for declared disasters and case-by-case determinations for other situations–could be used. The key advantage to the victim in the latter case is that the application for additional relief could be processed during the six-month automatic extension.

[335] On the heels of KETRA, Senator Chuck Grassley indicated, "We also want to help protect Katrina victims from undeserved IRS problems." *Grassley*, *supra* note 222, at 1. Such protection should equally extend to all disaster victims.

[336] In all but the most extreme cases, taxpayers ought to be able to regenerate sufficient records and documentation to substantiate their return within the six-month period. In addition to relieving the IRS of initial case-by-case determinations altogether, a taxpayer's filing of actual returns at the end of the six-month period means that both the IRS and the taxpayer will be in a better position to determine actual tax liability than if the individual had to guess when submitting an estimated return based upon incomplete information. For years, victims have been flagging their returns (most recently in red ink) to notify the IRS of a disaster, *see*, *e.g.*, *supra* Part II.D.; the same procedure could easily apply. In essence, compassionate treatment of victims trumps administrative convenience. This is the appropriate moral balance.

[337] Where taxpayers are due a refund, the government does not lose anything.

[338] *See* James A. Fellows, *Tax Issues*, 34 REAL EST. L.J. 484, 485-88 (2006) (measuring and proving value of destroyed property for tax purposes is highly problematic). Proof problems related to lost records and uncertainty in valuation would be eliminated if a credit was used instead of a deduction. *See infra* Part VII.

also allow both the taxpayer and the IRS to make more well-informed decisions.[339]

If the government is concerned about potential fraud, simple protective measures could be implemented. For example, a taxpayer could be required to attach verification of receipt of insurance proceeds to create a presumption that he or she has suffered a qualifying casualty loss.[340] Such a measure would allow the IRS to rely on the insurance industry to screen out spurious claims and would serve the dual purpose of motivating taxpayers to secure flood or other casualty insurance.

VII. CASUALTY LOSS CREDIT WOULD BETTER AID THE POOR

Modern methods of advance preparation, early warning, and evacuation in response to projected landfall of major hurricanes have helped to save lives, but although you can move people to safety, the same is not true of their homes and property.[341]

Direct federal aid is one way to provide relief to victims of major disasters. Disaster relief programs, benefiting both individuals and businesses, are administered by FEMA and the Small Business Administration (SBA).[342] One potential drawback of direct aid from the federal government is the

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339 Fellows, *supra* note 338, at 495-98 (citing recent tax court decisions denying casualty losses even while acknowledging records may have been destroyed in the underlying disasters). Note that the proof of loss by "closed and completed transactions" required by Treas. Reg. § 1.165-1(b) may also vitiate the utility of the I.R.C. § 165(i) election to take casualty losses in the previous year (for some victims), because taxpayers must already know which losses will be reimbursed and the extent of such reimbursement.

340 The IRS created several "safe harbor" methods that individuals could use after Katrina, Rita, and Wilma to overcome proof problems; one method deemed reports prepared by the individual's homeowner's or flood insurance company acceptable to show estimated loss. Rev. Proc. 2006-32, 2006-28 I.R.B. 61, 62, 65.

341 As this article was being written, a tornado ravaged Troy, Illinois, shattering forty-to-eighty-foot trees and sending trunks, limbs, and branches into nearby houses. Although the author's mother-in-law is among the victims, she will not be entitled to the waiver of the $100 or 10% AGI limits because the damage did not arise from Hurricanes Wilma, Rita, or Katrina. Even if eligible, she would not benefit because she does not itemize.

342 Surprisingly, "the majority of SBA disaster assistance is directed to homeowners, to help rebuild their homes." *Impact of Hurricane Katrina on Small Bus.: Hearing Before the S. Comm. on Small Bus. & Entrepreneurship*, 109th Cong. 1 (2005) (testimony of Hector V. Barreto, Admin., U.S. Small Bus. Admin.), [hereinafter Barreto statement]. As of September 22, 2005, the SBA had "distributed approximately 850,000 applications for loans to individuals and businesses." *Id.* at 3 (statement of Sen. Olympia J. Snowe, Chair, S. Comm. on Small Bus. and Entrepreneurship).

bureaucracy that accompanies such aid.[343] Often, those who stand to benefit are not familiar with the programs available, and there are lengthy delays or cumbersome requirements associated with qualifying for the relief.[344] Another drawback is that federal relief is only triggered in major emergencies (where state and local assistance are inadequate) and does not extend to the victims of arson, an isolated lightning strike, or other more particularized casualty.[345]

While a detailed analysis of the potential difficulties involved in direct relief[346] is beyond the scope of this article, it is worth noting that avenues outside the tax code are available, and arguably more effective, than traditional tax measures.[347]

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343 Past relief efforts have at times been criticized for delays and denials; relief has been slow or has been imperfect. *See* LESSONS LEARNED, *supra* note 4, at 59 ("[V]ictims confronted an enormously bureaucratic, inefficient and frustrating process that failed to effectively meet their needs."); GAO-06-712, *supra* note 199, at 18 ("To help ensure that FEMA's resource tracking system will meet the needs of those requesting FEMA assistance, we recommend that the Secretary of [Homeland Security] direct FEMA to ensure that it obtains input from the Red Cross as it develops a resource tracking system.").

344 *See* GAO-06-442T, *supra* note 38, at 1-2, 40 (describing the public's widespread dissatisfaction with SBA and its backlog of about 100,000 hurricane-related loan applications that created delays of approximately ninety-four days).

345 Because state and federal relief does not reach all victims, emergency relief organizations, such as the American Red Cross, are likely to deliver more aid, more quickly, and with less red tape. The National Response Plan now names the American Red Cross as the lead agency for coordinating federal mass care assistance to support local efforts to respond to natural disasters. *See* GAO-06-712, *supra* note 199, at 10.

346 One problem that arises is ensuring direct assistance is distributed properly. FEMA provided over $5.9 billion in direct assistance, "the most ever provided by FEMA to victims of any single natural disaster," and more than twice the amount of Individuals and Households Assistance Program (IHP) dollars for the 1994 Northridge earthquake and Hurricane Andrew combined. Fact Sheet, The White House Office of Commc'ns, *A Commitment to Continued Recovery and Rebuilding in the Gulf Coast* (Dec. 21, 2005), *available at* 2005 WL 348053. Unfortunately, FEMA reportedly provided aid to 16% of individuals who did not really need it. GAO, HURRICANES KATRINA AND RITA DISASTER RELIEF: IMPROPER AND POTENTIALLY FRAUDULENT INDIVIDUAL ASSISTANCE PAYMENTS ESTIMATED TO BE BETWEEN $600 MILLION AND $1.4 BILLION 4, GAO-06-844T (2006). FEMA used limited procedures to review registrations for disaster relief—such as allowing individuals to apply for assistance via telephone or Internet—which "left the government vulnerable to fraud and abuse." GAO-06-655, *supra* note 3, at 2. "Victims" apparently duped FEMA into grants for vacations and jewelry, among other things. *FEMA Hurricane Cards Bought Jewelry, Erotica*, CNN.COM, June 14, 2006, http://www.cnn.com/2006/US/06/14/fema.audit.1908/index.html.

347 Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 721 (1970) ("[M]ost tax incentives have decidedly adverse effects on equity . . . . [They] are highly irrational"). *See also* Maureen B. Cavanaugh, *On the Road to Incoherence: Congress, Economics, and Taxes*, 49 UCLA L. REV. 685, 735 (2002) (arguing that Congress should refrain from inappropriate tax changes to solve every social problem); John G. Steinkamp, *A Case for Federal Transfer Taxation*, 55 ARK. L. REV. 1, 29-30 (2002) (noting that increased reliance on the Code for assistance

Additional relief in the form of tax breaks, however, would help both individuals and businesses get back on their feet.[348] (Although tax incentives to stimulate business recovery and tax incentives for families to recover are equally important,[349] they are sufficiently different to warrant independent discussion of business measures in Part X.)

According to the Congressional Research Service, "[i]n many ways, the tax system is not well suited to helping victims in disaster areas . . . ."[350] However, tax relief to those who are likely to spend most of it—low and moderate income individuals—can effectively provide relief and stimulate the affected economy.[351] Furthermore, as distinguished from pure welfare, income tax relief and incentives help those who are earning income.

As a public policy matter, if the principal justification for intervention is the desire to help people who have faced a significant loss to reclaim their lives, the government is implicitly insuring the victims against loss by spreading the costs of the disaster among taxpayers as a whole.[352] This "distributional" intervention spreads the risk of disaster nationwide.[353] Congress must strike the right balance. Relief as a safety net prevents people from becoming homeless or otherwise burdensome to society; however, too much relief fails to adequately penalize overly risky behavior.

The current tax code strikes the wrong balance. It fails to provide an adequate safety net for the poor.[354] While tax relief aids some victims, the casualty loss benefits are most likely to help higher income individuals.[355] Code Section 165

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may distort tax equities). *But see* Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 188 (2004) (stating that tax expenditure analysis should be grounded in a fuller appreciation of fiscal issues generally).

[348] For a comprehensive discussion of the SBA benefits available to businesses and individuals, see Lipman, *supra* note 8, at 965-67 (discussing, among other relief, low-interest disaster loans of up to $200,000 for home repair).

[349] Letter from Rahm Emanuel, *supra* note 305.

[350] GRAVELLE, *supra* note 36, at 5.

[351] *Id.* at 3 (current spending is substantially related to current income).

[352] *Id.* at 12.

[353] *Id.*

[354] There are several impediments to deducting casualty losses under I.R.C. § 165, most significantly the need to itemize to benefit at all, the ten percent AGI threshold, and the $100 reduction. *See* I.R.C. § 165(h)(1)-(2).

[355] Only 46 million of over 132 million filers itemized for tax year 2004. I.R.S., SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report), tbl. 1.2 (Tax Year 2004), http://www.irs.gov/taxstats/indtaxstats/article/0,,id=134951,00.html [hereinafter IRS, SOI Tax Stats] (last visited Mar. 8, 2007) (click

requires a taxpayer to itemize in order to take the casualty loss deduction. Since the majority of Americans do not itemize,[356] most are not helped by this section.[357]

Even for those individuals who itemize, the deduction is whittled away. Section 165(h) reduces the deduction by $100 for each casualty and also limits the loss to amounts exceeding ten percent of adjusted gross income (AGI). The net result is that the average taxpayer receives less than $40 of tax relief as a result of this deduction.[358]

As noted in Parts III and IV, the Katrina Emergency Tax Relief Act and the Gulf Opportunity Zone Act of 2005 do away with these reductions for the victims of Katrina, Rita, and Wilma only.[359] This relief is generous for the designated victims, but not generous enough for the tens of thousands of other casualty victims of 2005 (not to mention taxpaying generations preceding or to follow). Furthermore, this relief is the most costly component of KETRA and was projected to exceed $2.4 billion in lost tax revenue.[360]

To illustrate the inequities, if a single taxpayer (Taxpayer A) outside the GO Zone earned $50,000 AGI and suffered $10,000 of unreimbursed casualty loss, the most she could deduct would be $4,900.[361] If an identical taxpayer was in the GO Zone, on the other hand, she could deduct the entire $10,000.[362]

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on table 1.2, tax year 2004 under Basic Tables: Returns Filed and Sources of Income). Fewer than one in three taxpayers with an AGI below $40,000 itemize, with far lower percentages at lower income levels. *Id.*

356 *Id.*; *see also* Kurtz, *supra* note 288, at 165-66 (blaming much of the complexity of the tax code on itemized deductions).

357 The value of an itemized deduction is not fully realized unless a taxpayer already has sufficient deductions to exceed the standard deduction. Perhaps this partially explains why less than one in one thousand taxpayers on average have claimed a casualty loss over the past several years. *See* IRS, SOI Tax Stats, *supra* note 355, at tbls. 1.2, 2.1 (tax years 1993-2003). For example, just 89,781 of 130,423,626 returns claimed a casualty or theft loss in 2003. *Id.*

358 *See id*.

359 *See* I.R.C. § 1400S(b); Rev. Proc. 2006-32, 2006-28 I.R.B. 61, 62-63 (applying safe harbor provisions to victims of Katrina, Rita, and Wilma).

360 JCX-65-05, *supra* note 160.

361 Ten percent of $50,000 AGI is $5,000, which is subtracted from the $10,000 loss after the $100 is subtracted. However, if her total itemized deductions did not exceed $5,000, she would be better off taking her $5,000 standard deduction and thus not derive any benefit from the tax break. The standard deduction is governed by I.R.C. § 63(c). *See also* Cost-of-living Adjustments for 2005, Rev. Proc. 2004-71, 2004-50 I.R.B. 970; I.R.S., 2005 1040 Instructions, http://www.irs.gov/pub/irs-prior/i1040--2005.pdf.

362 *See* I.R.C. §§ 165(h), 1400S(b).

A similar taxpayer in the GO Zone earning $200,000 (Taxpayer B) could deduct the full $10,000 of unreimbursed loss, although this same higher income taxpayer would be entitled to no deduction at all if she lived outside of the 2005 designated hurricane relief areas (the ten percent AGI reduction would eliminate the Section 165 deduction).[363]

The ten percent AGI reduction helps maintain a progressive tax code (higher income taxpayers must absorb more of their loss) and serves as an incentive to insure (by penalizing any loss whatsoever), but at the same time, it seriously erodes the amount of tax relief. In the above example, Taxpayer B (in the GO Zone) gets more than twice as much relief as Taxpayer A (outside the GO Zone) even though they sustain the same losses and Taxpayer A earns only one-fourth as much income.

Another fault of the 2005 relief is that it affords more relief to those with higher amounts of uninsured losses. For example, if Taxpayer B was fully insured with a $500 deductible, her GO Zone tax deduction would be limited to $500; if uninsured, her deduction would be $10,000.[364] The tax laws should not reward such risky behavior.

Furthermore, there is an overwhelmingly regressive aspect to Section 165, both as codified and as modified by the 2005 legislation, since the actual dollars of tax relief are driven by the taxpayers' marginal tax rates. Thus, a higher-income taxpayer will realize twenty-five cents or more on the dollar she is able to deduct, compared to, at most, ten or fifteen cents on the dollar for lower-income taxpayers.[365]

A refundable tax credit of up to $1,000 per victim ($2,000 per family for married filing jointly) would be more equitable. Using the illustration above, Taxpayer A in the ten percent bracket would receive $1,000, as opposed to (at most) $490. Taxpayer B in the twenty-five percent bracket would receive $1,000, versus $2,500[366] under the present scheme. Thus, Taxpayer B would have an incentive to carry more

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[363] GO Zone deductions are subject to limitations on overall itemized deductions. *See* I.R.C. § 68; *see also* I.R.C. § 165(h)(1)-(2) (outside the GO Zones, to be allowed any deduction, a $200,000 taxpayer would ordinarily need casualty losses in excess of $20,100).

[364] Since there are no casualty loss reductions under KETRA, a taxpayer who itemizes may deduct their entire loss—ironically the loss of those who fully insure is only their deductible amount. *See* KETRA § 402.

[365] *See generally* I.R.C. § 1(a)-(d), (i).

[366] Subject to limitations on overall itemized deductions. *See* I.R.C. § 68.

insurance. As this simple example illustrates, low income taxpayers would be much better off, and higher income taxpayers would not be favored, if a tax credit replaced the Section 165 deduction.

What should a casualty loss tax credit look like? Certainly a nominal flat rate of $1,000 per single victim and $2,000 per family would be equitable, but this is not the only logical formula.[367] Any credit could be phased out at higher incomes to maintain the progressive structure of the tax code and reduce foregone revenue. Or, to motivate people to carry sufficient insurance, the credit could be either linked to or predicated upon an individual's insurance deductible. A flat rate enjoys the advantage of simplicity.

Because maximizing aid is most important for those with the lowest incomes, any credit for casualty loss should be fully refundable.[368] Only measures focused on refundable credits—those where the government will pay even after tax liability has been reduced to zero—will benefit the most impoverished workers.[369]

The guaranteed $10,000 minimum tax relief to the victims of the September 11, 2001 attacks establishes a precedent for relief in excess of tax obligation out of sympathy for victims.[370] Crafting the same full refundability for casualty losses would be optimally suited to those who are least likely to be able to afford complete insurance coverage and who are least likely to have any savings to fall back on in an emergency.[371] A

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[367] There is no magic in the amount proposed, but over a million families (twice as many single taxpayers) could be helped with such a credit at a cost to the government of less foregone revenue than the $2.4 billion that the casualty loss deduction is expected to cost just for Katrina. *See* JCX-65-05, *supra* note 160.

[368] Additional deductions do not help workers in the lowest income groups (who really pay no income taxes), because their other deductions and exemptions already reduce to zero their tax liability. *See* GRAVELLE, *supra* note 36, at 2.

[369] In the present tax code, the Earned Income Tax Credit, I.R.C. § 32, and the Child Tax Credit, I.R.C. § 24, are examples of refundable credits for qualifying taxpayers.

[370] Victims of Terrorism Tax Relief Act of 2001 § 101, Pub. L. No. 107-134, 115 Stat. 2427 (2002) (codified at I.R.C. § 692).

[371] One study found that about one-third of the advance tax rebate mailed to taxpayers in 2001 was spent in the first three months, and another third in the following three months. GRAVELLE, *supra* note 36, at 3 (citing David G. Johnson et al., *Household Expenditure and the Income Tax Rebates of 2001*, at 20 (Nat'l Bureau of Econ. Res., Working Paper No. 10784, 2004), *available at* http://www.nber.org/papers/w10784). This study also found that spending was greater for households with low levels of wealth, consistent with other evidence that lower income individuals have a higher propensity to spend. *Id.*

credit provides an outstanding procedural benefit as well—eliminating proof problems caused by a lack of records.

A fully refundable, *retroactive* disaster credit would be even better. Even with a tax credit, the difficulty in making tax relief meaningful remains timeliness—getting the money quickly into the hands of those who need it.[372] Congress implicitly recognized this crucial timing issue in I.R.C. Section 165(i). Regrettably, this option to elect to treat casualty loss deductions in the preceding year is only available to those who suffer losses "attributable to a disaster occurring in an area subsequently determined by the President [to warrant federal relief]."[373] Victims in these areas have a tax advantage.[374]

In a sense, the tax code creates "tax-preferred" victims when a presidential disaster area has been declared[375] and allows "super tax-preferred" victims of the 2005 hurricanes.[376] However, all victims of casualty losses should equally benefit from the same compassionate tax treatment.

Although the IRS might complain that it is more onerous to allow relief to be retroactive, the need to treat similarly situated taxpayers fairly should outweigh these incidental costs.[377] The same policy rationale—allowing relief of taxpayer hardship to outweigh increased complexity and administrative burden—applies whether a disaster has been presidentially-declared or not.[378] A simple change to the tax code could allow all victims of casualty losses equal tax treatment.

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372 GRAVELLE, *supra* note 36, at 2.

373 I.R.C. § 165(i)(1).

374 However, those in the lowest tax brackets may likely have had no tax obligation in the preceding taxable year to reduce. The Section 165(i) election is useless to these taxpayers.

375 *See, e.g.*, I.R.C. §§ 139, 165(i).

376 See *supra* Parts III and IV for a detailed discussion of the different tax treatment of victims following the hurricanes of 2005.

377 For 2003, fewer than one in one thousand taxpayers used the casualty loss deduction. *See* IRS, SOI Tax Stats, *supra* note 355, at tbls. 1.2 and 2.1 (tax year 2003). Looking back at all available statistics on the IRS web site, 225,085 was the largest number of filers claiming casualty losses in any tax year (1994). *Id.* at tbl. 2.1 (providing data for tax years 1993-2003). Even if these numbers tripled by extending relief to non-itemizers, they would amount to fewer than one percent of all returns. Changing the deduction to a credit, which eliminates the need for the IRS to verify actual losses, should more than offset administrative difficulties in issuing out-of-cycle relief for these victims.

378 The victim could simply write the name of the declared disaster area (or "casualty" where no disaster has been declared) in red on the top of their return or amended return.

VIII. EXPAND RETIREMENT ACCOUNT ACCESS TO ALL VICTIMS

Just as Social Security serves as a disincentive to saving for retirement, it also provides a vital safety net to those who otherwise could not afford to survive on their own. Similarly, tax relief for casualty victims should only be a safety net, not a substitute for prudent investment and insurance.

Tax incentives for retirement savings, whether employer-provided or Individual Retirement Accounts (IRAs), have motivated people to save for their retirement needs.[379] The government has agreed to defer or forgo tax revenues to foster this desirable public behavior. These measures have helped millions of Americans better posture themselves for retirement.[380] In addition to helping people help themselves, the aid helps to reduce the rolls of those who would otherwise be completely dependent on others (or the government) for survival.

Over the years, Congress has devised a well-balanced menu of options to further this public policy goal. At the heart of all plans, however, is the notion of an individual setting aside some of their present income in exchange for tax-free accumulation and later access to the funds. Both this part and the next part below examine beneficial tax policies based upon the same principal. If tax-deferred accumulation of wealth can be tapped without adverse tax consequences, victims will be better postured to provide for themselves in an emergency.

The relief in KETRA and the GO Zone Act strikes the right balance in allowing these individuals to help themselves: victims may withdraw, without penalty, up to $100,000 from an eligible retirement plan (with an option to reinvest within three years as a rollover) and may prorate income over three years; or taxpayers may instead borrow up to $100,000 from a retirement savings plan at work and repay within five years.[381]

There is no harm in allowing people to have access to their savings or to borrow from themselves in an emergency.[382] To the extent they repay or qualify for a rollover, there is no lost tax revenue compared to having their IRA money locked up

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[379] Victoria L. Bryant & Peter J. Sailer, I.R.S., Accumulation and Distribution of Individual Retirement Arrangements, 2001-2002, SOI Bulletin, Spring 2006, at 233, http://www.irs.gov/pub/irs-soi/02iraart.pdf.

[380] Approximately fifty million taxpayers hold $2.5 trillion in IRAs. *Id.* at 236.

[381] I.R.C. § 1400Q.

[382] In a sense they are borrowing from their "future selves;" failure to repay could hurt them in the future.

until retirement. For those who do not repay or rollover, there is actually greater tax revenue now, as the income is realized in the three years from time of distribution, versus in the future at retirement age. Finally, fewer restrictions on access to IRAs may encourage more people to use these savings vehicles.

As a matter of horizontal equity, anyone who loses their home should have access to their IRA money without penalty, not just the victims of Katrina, Rita, and Wilma. As a practical matter, many taxpayers facing daunting casualty losses may have nowhere else to turn for immediate cash. The Senate agreed that all victims in presidentially-declared disaster areas should enjoy such relief[383] (the later compromise with the House resulted in KETRA relief being narrowed to Hurricane Katrina victims).[384] Enhanced access could categorically be granted to all casualty victims (declared disaster or not).[385]

In terms of vertical equity, the benefit of these measures obviously does not extend to those who have no individual or employer retirement accounts, predominantly the very poor.[386] In addition, the wealthy may have no need for such relief and allowing enhanced retirement account access would be tantamount to an interest-free loan. To combat these concerns, it should be clarified that such access would be in addition to the casualty loss credit proposed above. To prevent abuse, taxpayers with incomes above a certain level (such as $250,000) could be designated as ineligible for this relief.

Relaxed retirement account rules would create an important mechanism for those who need cash now and can afford to repay later. For those who take distributions and do not repay, the immediate relief may come at the expense of their future well-being. However, those desperate enough to compromise their post-retirement security should not face additional tax penalties, compounding their financial injury.

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383 *See* S. 1696, 109th Cong., §101 (2005).

384 KETRA § 101.

385 The pool of eligible beneficiaries could be extended to anyone suffering a casualty loss; vertical equity measures, to prevent a windfall to the wealthy, would be a question of implementing sufficient limitations within the Code itself (such as income limitations for eligibility). These considerations should not prevent Congress from harmonizing relief for future casualty victims with that offered to the victims in the present GO Zones.

386 Only one in five taxpayers with income below $20,000 have an IRA or retirement plan, compared to over half of all taxpayers with incomes over $100,000 (who have an IRA, retirement plan, or both). *See* Bryant & Sailer, *supra* note 380, at 242.

IX. CREATE CATASTROPHE SAVINGS ACCOUNTS

An old adage calls for saving for a rainy day. Perhaps it is time people actually do so. Unlike IRAs and retirement savings plans, there is no tax incentive to save for a potential catastrophe. Given the pathetic savings rate in the United States,[387] Congress should motivate people to set aside funds to help insulate them from the financial consequences of a disaster. These catastrophe savings accounts should be crafted to be more suited to relief for disaster victims than enhanced retirement account access, because they can emphasize and complement insurance as a prerequisite to relief.

For example, the size of these accounts could be capped to correspond to deductibles incurred during a disaster. As the amount of the insurance deductible escalates, so too (to a limit) would the potential for relief. Note that a higher deductible allows for lower premiums for the taxpayer. Because the tax relief only pertains when there has been an actual loss, the savings from the reduced premiums can be invested over time. In this manner, the taxpayer is able to cover her out-of-pocket costs while insurance covers the remaining costs. There is limited potential for abuse, because the money will be needed to cover the deductible.

Two bills were introduced to advance tax relief designed to enhance insurance coverage and make it more affordable.[388] House Bill 4836, introduced by Florida Congressman Tom Feeny, allowed deposits into non-taxable "Catastrophe Savings Accounts."[389] Under this proposal, funds of up to $2,000 may be deposited for individuals with insurance deductibles less than $1,000.[390] For those with larger deductibles, up to twice the amount of their deductible, or $15,000 (whichever is less) may be deposited.[391]

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387 Nathan Dugan, *Time to Rebalance Your Financial Habits?*, INDYCHANNEL.COM, Aug. 7, 2006, http://www.theindychannel.com/money/9638390/detail.html (savings rate in 2005 entered negative territory for first time since 1933).

388 Policyholder Disaster Protection Act of 2005, H.R. 2668, 109th Cong. (2006) (providing for tax-free accumulation of insurers' catastrophic reserves); H.R. 4836, 109th Cong. (2006) (providing for individual tax-free Catastrophe Savings Accounts, analogous to Health Savings Accounts, to offset consumer deductibles and co-pays).

389 H.R. 4836, 109th Cong. (2006). Florida created the notion of such accounts following the 2004 hurricanes. *See supra* notes 151-54.

390 H.R. 4836, § 2 (proposing amendment of I.R.C. § 530A(c)(1)).

391 *Id.* (proposing amendment of I.R.C. § 530A(c)(2)).

Because the allowable deposits are not annual maximums, but rather are based upon insurance deductibles, the ability to contribute changes based upon insurance coverage. Individuals who experience growth in the account up to their existing limits would have to increase the amount of their insurance deductible or face a taxable forced distribution. Presumably, many would increase their deductible to avoid the taxable event. These same individuals would benefit from lower premiums when their deductible amounts increase. Ultimately, the provisions induce taxpayers to bear more of their own risk. At the same time, the accounts ensure a reserve to meet the emergency costs.

Essentially, such tax-deferred accounts both encourage insurance and motivate individuals to save for a rainy day. However, under the proposed legislation, tax-free access to the funds would be limited to presidentially-declared national emergencies.[392] The same accounts could equally benefit victims of all casualty losses. Because of the interconnected nature of the benefit and the insurance requirement, proof of an insured loss, as opposed to a presidential declaration, would be a more equitable trigger for tax-free withdrawal.

In addition to such accounts for individuals, businesses should be allowed to set up accounts allowing tax deferred growth (up to predefined limits based upon their deductibles) and tax exempt access following a casualty loss. By fostering insurance with a savings component to augment the insurance proceeds, businesses would have ready access to needed cash for rebuilding after a disaster. Such mechanisms should reduce the need for other federal post-disaster relief.

House Bill 2668 proposed tax-free investment growth for U.S. insurance companies of dedicated catastrophe reserves.[393] Many other countries already allow tax-preferred accumulation in advance of the occurrence of a crisis.[394] Basically, those in the insurance industry would be permitted "controlled accumulation of pretax dollars in separate reserve funds devoted solely to the payment of claims arising from future major natural disasters."[395] Changes to I.R.C. § 832(c) would allow such amounts to be deducted from insurance

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[392] *Id.* (proposing amendment of I.R.C. § 530A(e)). If not used, funds may also be withdrawn tax free at age sixty-two. *Id.*

[393] H.R. 2668.

[394] Hartwig, *supra* note 26, at 208.

[395] H.R. 2668 § 2.

company income.[396] Like the catastrophe savings accounts for individuals and businesses, allowing the private sector to increasingly absorb the cost of major catastrophes takes some of the burden of the recovery costs off of the federal government.[397]

Other bills proposed state catastrophe insurance pools with federal reinsurance.[398] These proposals do not contain any per se tax implications; however, the state-subsidized insurance programs have been criticized by the insurance industry because taxpayers in that state end up buying down the premiums for those engaged in the most risky behavior.[399] Although protection should be fostered for vulnerable homeowners and businesses, they should pay premiums proportionate to the risk.[400]

X. IMPROVE TAX RELIEF FOR SMALL BUSINESSES

To be most beneficial, tax policy should foster recovery, rebuilding, and re-employment in the wake of a disaster. Tax provisions that already exist can aid victims somewhat, but the relief may be largely ineffective due to the typical delay between time of loss and the receipt of refunds after filing to claim an incentive, credit, or deduction.[401]

KETRA and the GO Zone Act created incentives to aid businesses in recovering and rebuilding.[402] Many of these incentives could be employed whether the need is peculiar to

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[396] *Id.* § 3(a).

[397] Andreas Milidonis & Martin F. Grace, *Tax-Deductible Pre-Event Catastrophe Loss Reserves: The Case of Florida* 40-41 (Ga. St. U. Ctr. for Risk Mgmt. & Ins. Working Paper No. 06-1, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893154 (concluding that based on actuarial assumptions (which could vary), "the government may save significantly on disaster assistance").

[398] Natural Catastrophe Insurance Act of 2005, H.R. 4507, 109th Cong. (covering both residential and real property business losses insured or reinsured by an eligible state program); Homeowners' Insurance Protection Act of 2005, H.R. 4366, 109th Cong. (covering residential damage from any catastrophes (other than flood) insured under a state program); Homeowners' Insurance Availability Act of 2005, H.R. 846, 109th Cong. (covering residential property losses from hurricanes, earthquakes, and their aftermath).

[399] *Catastrophes: Insurance Issues*, *supra* note 25.

[400] The state or federal government could subsidize or insure those living in low-income housing, but should also ensure that such housing is not located in flood zones or hurricane-prone areas.

[401] This principle is recognized implicitly and redressed somewhat in the ability to elect casualty losses in the preceding tax year for certain disasters. I.R.C. § 165(i)(1).

[402] *See, e.g.*, KETRA §§ 201-02; GO Zone Act § 102, I.R.C. § 1400R.

the victim (for example, isolated fire) or broad in scope (for example, town flooded, earthquake, etc.). Others are more suited only to large-scale disaster areas. The first section below addresses tax measures that could be codified to aid all disaster victims. The later sections analyze how automation of special tax opportunities for major national disasters can equitably target future tax relief.

A. *The Special Need to Protect Small Business*

> Our economy has created almost 5 million jobs since August 2003. Small businesses create most new jobs in our country, and small businesses have been a driving force behind America's tremendous economic growth and job creation. By adopting sound economic policies that help small businesses continue to grow and expand, we will keep our economy moving forward and create more jobs for American workers.
>
> —President George W. Bush[403]

Small businesses are more vulnerable to catastrophes than large businesses—they generally have much lower cash flow and fewer cash reserves than their larger counterparts.[404] When small companies or family-owned businesses experience a loss, the loss is much more likely to be a devastating or terminal blow.[405] Small businesses simply lack the financial wherewithal to weather the storm.

A study of small businesses affected by Katrina revealed that few businesses had adequately prepared for a tragedy of such magnitude.[406] For some, their emergency plans included backing up data and bringing it home.[407] These folks did more than most; tragically, most resorted to methods that had allowed them to survive milder previous hurricanes.[408] A sense of complacency and the notion that another hurricane was "no

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[403] Proclamation No. 7990, 71 Fed. Reg. 15,231 (Mar. 23, 2006) (President George W. Bush, Proclamation Supporting Small Business Week).

[404] Runyan, *supra* note 158, at 19.

[405] According to the Institute for Business and Home Safety, following a major disaster, "[a]n estimated 25 percent of businesses do not reopen." SBA, Disaster Preparedness, http://www.sba.gov/npm2006/ (last visited Jan. 9, 2007).

[406] Runyan, *supra* note 158, at 15.

[407] *Id.* at 17. The SBA recommends all vital business records be copied and saved at an offsite location at least 50 miles away from the main business site. SBA, FAQs (Disaster Preparedness), http://www.sba.gov/npm2006/faq.html (last visited Jan. 9, 2007).

[408] Runyan, *supra* note 158, at 17 (boarding up windows and/or doors).

big deal" got the better of many individuals and small businesses.[409]

Another interesting dynamic of small businesses is that their business future and their personal well-being are so dramatically integrated.[410] For many Katrina victims, this meant dealing with health, welfare, and safety issues at home before turning to the business impacts.[411] Many of these people lost their homes in addition to their businesses.[412] As with other hurricane victims, taxes were probably the last thing on their minds. For these reasons, automated extensions of tax deadlines are vital to small businesses.[413]

For tax assistance to be effective, it must be timely. If a business is to be able to pay taxes at all in the future, it must survive today. Retroactive tax relief is therefore critical to these taxpayers if tax measures are to have any immediate benefit. Making relief retroactive cures the time lag otherwise inherent in tax cuts and allows access to refunds at the time funds are most needed.[414]

Allowing a business to amend a previous return and treat casualty losses as if they occurred in the preceding tax year makes the tax subsidy more equivalent to direct aid.[415] This relief is presently available only in declared disaster areas.[416] Horizontal equity requires, however, that similar taxpayers be treated similarly. The opportunity to elect to deduct casualty losses in the previous year (so relief can be obtained sooner) should be extended to all businesses. In the alternative, Congress should at least make this relief available to all small businesses. A preference for small businesses is justified because of their increased dependence on present revenues to meet cash flow demands.

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409 *Id.* Because businesses had been through severe storms in the past, "the tendency was to downplay the 'worst-case scenario' that actually transpired." *Id.*

410 *Id.* at 21.

411 *Id.*

412 *Id.*

413 *See supra* Part VI.

414 Although such relief compromises the matching principle (expenditures are matched to income so that deductions correspond to the same tax year for which income was realized), it makes sound practical sense in this application. *See generally* NEWMAN, *supra* note 283, at 137-38.

415 A cash infusion benefits the taxpayer as well as the relevant community, since such money is available to be spent sooner for necessary repairs, new equipment, etc., thereby bolstering the local economy.

416 This is only allowed by I.R.C. § 165(i) for declared disasters.

Along similar lines, a carryback of deductions for net operating losses (NOLs) is also helpful.[417] The GO Zone Act authorized a five-year carryback.[418] This is especially useful for flexibility to use the loss immediately.[419] For example, if a two-year NOL was allowed, but the business had not realized a profit in either of the two preceding years, it would get no relief; whereas the five-year carryback may allow them to reach back to a profitable period. Or, if the business had a huge loss but a narrow profit margin in the past, the NOL could be carried back to all five years simultaneously.

Allowing a standard five-year carryback for all victims of all disasters would be more equitable than only affording this relief in 2005. As with the above recommendation, based upon their heightened vulnerability, all small businesses should be allowed this relief. Congress gets more bang for its foregone tax buck by extending five-year NOL carrybacks to small businesses from all disasters, rather than all businesses affected by a particular disaster.

Of course, any deductions carried back would be lost for the current year. Therefore, this relief is essentially revenue neutral—the government is only allowing business losses (which it would allow anyway) to be taken earlier. Yet, such a change would allow small businesses to pocket the tax savings at a critical juncture. Given the turmoil of the disaster itself and the need to rebuild, one would expect a very positive benefit to those small businesses most seriously affected (the ones that most need the money immediately to rebuild).

B. Opportunity Zones

This section continues upon the notion of the tax system as a springboard to recovery. While it is easy to envision that relief should be equitably extended so that none fall through the safety net, the recovery concept may also make sense when

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[417] The Code currently allows a two-year NOL carryback. I.R.C. § 172(b)(1)(A)(i).

[418] GO Zone Act § 101(a), I.R.C. § 1400N(k).

[419] Many small businesses begin in a loss position and do not become profitable until later. The federal set-aside program for small disadvantaged businesses recognizes a five to nine year timeframe until "graduation," when the business can exist in a profit position on its own. *See* 15 U.S.C. § 637(a) (discussing small business set-aside program generally); 15 U.S.C. § 636(j)(15) (defining graduation and time limits of program).

trying to promote redevelopment in a target area especially devastated by disaster.

Over a decade ago, the federal government created programs which use tax benefits to revitalize economically depressed areas. While the legislation creating "Empowerment Zones" (EZs) and "Enterprise Communities" (ECs) contained a combination of grants, tax benefits, loans, and loan guarantees,[420] the more recent "Renewal Community" (RC) legislation[421] relies most heavily on tax benefits.[422]

In 1994, when the programs commenced, the only tax advantage to early ECs was the ability to receive up to $3 million in bond proceeds from tax-exempt state and local bonds.[423] EZs could receive several forms of tax relief, including a twenty percent credit on the first $15,000 in wages paid to EZ residents who work in the EZ.[424] The Joint Committee on Taxation estimated these programs would cost $2.5 billion in lost tax revenues from 1994-1998.[425]

Renewal Communities were a byproduct of the Community Renewal Tax Relief Act of 2000.[426] As the name implies, tax incentives serve as the impetus for community rejuvenation. In addition to employment tax credits (fifteen percent of the first $10,000), the RCs enjoyed increased expensing under Section 179, as well as a choice of bonus or accelerated depreciation.[427] The Joint Committee on Taxation estimated the newer programs would reduce tax revenues by $14.8 billion over the ensuing fifteen years.[428]

Unfortunately, insufficient data exists to show whether these tax incentives are having the desired effects.[429]

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[420] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13301-02, 107 Stat. 312, 543-57 (codified as amended at scattered sections of 26 U.S.C.; EZ and EC qualifications and eligibility codified at I.R.C. §§ 1391-97).

[421] Consolidated Appropriations—FY 2001, Pub. L. No. 106-554, § 101, 114 Stat. 2763, 2763A-589 (codified as amended at scattered sections of 26 U.S.C.).

[422] GAO, COMMUNITY DEVELOPMENT: FEDERAL REVITALIZATION PROGRAMS ARE BEING IMPLEMENTED, BUT DATA ON THE USE OF TAX BENEFITS ARE LIMITED 1, GAO-04-306 (2004), http://www.gao.gov/new.items/d04306.pdf.

[423] *Id.* at 18.

[424] *Id.* at 3. Measures include tax credit for wages paid to employees who live and work in the enterprise zone, increased expensing (current year deductions) for depreciable property, tax-exempt bonds for facilities, and postponement of capital gains on the sale of qualified EZ assets. *Id.* at 17-19.

[425] *Id.* at 17.

[426] *See* Consolidated Appropriations Act—FY 2001 § 101(a).

[427] *See* I.R.C. §§ 1400H-1400J.

[428] GAO-04-306, *supra* note 422, at 17.

[429] *Id.* at 3, 6-7.

Nevertheless, they serve as a useful basis of comparison with the more recent Liberty Zone and GO Zone Legislation, and as a practical starting point for analyzing the merits of using targeted tax relief at all.

In the case of rebuilding areas devastated by terrorists or hurricanes, "the question is whether the standard arguments for enterprise zones can be applied to rebuilding areas that are not (at least in their entirety) chronically depressed, but have been destroyed . . . . It is not clear that they can be."[430] This author posits that while casualty loss relief to individual business victims should be universal, at the same time, opportunity zone relief (particularly tax-exempt bond advantages and tax relief from cancellation of indebtedness) should be severely restricted to scenarios of the utmost devastation.

No one can forget the haunting images and devastation of "Ground Zero" following the 2001 terrorist attacks. If ever a community needed a boost for economic recovery it was these citizens.[431] The Liberty Zone, discussed in Part II.D.4, picked up on the notion of tax relief for community renewal. The tax relief package included employment credits, bonus and accelerated depreciation, increased expensing for money reinvested in Liberty Zone businesses, and an extension of time (to five years) to replace destroyed property with like kind property in the Liberty Zone.[432] The last advantage had already been codified at four years for victims of other declared disasters.[433] The remaining advantages are discussed in more detail below.

1. Employment Credits

Employee retention credits are desirable for motivating businesses to retain their workforce in the wake of a disaster. Unlike the Work Opportunity Tax Credit (WOTC), employee retention credits only accrue to businesses that had to shut

[430] GRAVELLE, *supra* note 36, at 11.

[431] Indeed, even in 2007, Congress was discussing further extending Liberty Zone incentives. Bonus Depreciation Extension Act of 2007, H.R. 827, 110th Cong. (Feb. 5, 2007).

[432] I.R.C. § 1400L. *But cf.* GRAVELLE, *supra* note 36, at 1 (targeting tax subsidies after 2001 terrorist attacks not effective to speed up rebuilding, but may be desirable means of compensating victims).

[433] I.R.C. § 1033(h). It is debatable whether there is any material difference between four years and five years.

down and reopen in the disaster area.[434] For this reason, they are more suitable than the WOTC to stimulate rebuilding versus relocating.

However, these credits are expensive. As originally envisioned, this type of relief was targeted at businesses with fewer than two hundred employees.[435] With a maximum credit of $2,400 per eligible employee,[436] the tax benefit could reach a theoretical cap of $480,000 per business. When the GO Zone Act was passed, the small business limitation was removed, so large businesses could obtain even more relief.[437] With the employee limit lifted, the theoretical cap went out the window. Lost too was the ability to funnel relief to those most in need—the smallest businesses.

Employee retention credits are a good idea to promote rebuilding. To make relief more widespread and equitable, the credit should be extended on a scaled-down version to all small business victims of declared disasters. A small business limit helps make this measure more fiscally responsible. Capping the credit at $1,000 per employee and limiting it to the first one hundred employees[438] would benefit those most in need while cutting the potential cost of the program dramatically.

The declared disaster requirement serves a useful screening purpose; it targets relief to disasters so large that employees might be dislocated from the region. Each time lightning strikes there is justification for casualty loss relief, even if only one taxpayer is devastated. On the other hand, where tax relief is being used for regional rejuvenation or recovery, an additional threshold inquiry into the severity of the need is sensible to justify the lost tax revenue.

Based upon past practice, the designation by the President of a National Disaster Area has served as a useful

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[434] Under KETRA, the Work Opportunity Tax Credit could be taken by any business (wherever located) that hired Katrina core area workers. KETRA § 201(b)(2).

[435] *Id.* § 202(c). The Liberty Zone Credit was limited to businesses with fewer than 200 employees. I.R.C. § 1400L(a)(2)(C)(ii). Although using the WOTC construct, the Liberty Zone Credit limits relief to businesses and employees located in New York City. *Id.* § 1400L(a)(2)(C)(i), (h).

[436] KETRA § 202(a) (credit of 40% for each employee's annual wages up to $6,000); I.R.C. §§ 51, 1400L(a)(2)(D)(iv)(II), 1400R (same).

[437] *See* GO Zone Act § 201 (repealing KETRA § 202), I.R.C. § 1400R.

[438] There should be no magic to the KETRA and Liberty Zone limits of 200 employees. Federal size qualifications for small businesses usually vary based upon North American Industrial Classification System (NAICS) standards for the relevant industry. 13 C.F.R. §121.101(b) (2006). The State of New York uses a bright-line, 100 employee rule for state aid. N.Y. ECON. DEV. LAW § 131 (McKinney 2006).

expedient to trigger certain tax relief. For the Gulf Opportunity Zones, further narrowing of relief to declared "GO Zone" disaster areas, which FEMA had identified for individual or public assistance, ensured that the benefits were even better focused. Similarly, the proposed reemployment credit should be maximally focused on the specific zones FEMA determines are eligible for individual or public assistance, striking the best balance between relief and fiscal responsibility.

2. Increased Expensing and Depreciation

Bonus depreciation, the ability to expense capital items, (especially clean-up and remediation costs) in the present year, and accelerated depreciation would help every business trying to withstand a devastating blow. These measures do not allow the business to avoid income taxes; instead, they relate to the timing of when tax deductions occur. When businesses take increased deductions up front, they necessarily lose the same deductions down the road.[439] Unlike the employee retention credits, these benefits do not cost the public anything other than the time value of money.

To the extent they are needed at all, bonus depreciation, the ability to expense capital items (especially clean-up and remediation costs) in the present year, and accelerated depreciation should be reserved exclusively for small businesses. Small businesses are afforded a plethora of government benefits because of our societal recognition of both their value and their fragility.[440] At the same time, affording such relief to large businesses is far more likely to be unnecessary for their corporate survival.[441]

If Congress determines that these measures are warranted (the costs are outweighed by the value of

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[439] For a detailed explanation and useful illustrative examples, see I.R.S. Notice 2006-67, *supra* note 7.

[440] For an excellent historical review of the evolution of small and disadvantaged business programs, see Maj. Thomas Jefferson Hasty, III, *Minority Business Enterprise Development and the Small Business Administration's 8(a) Program: Past, Present, and (is there a) Future?*, 145 MIL. L. REV. 1 (1994). For observations of present trends, see Patrick E. Tolan, Jr., *Federal and New York Contracting Preferences for Small, Minority and Women-Owned Businesses*, 8 N.Y.S.B.A. GOV'T L. & POL'Y J. 34 (2006).

[441] Based on the availability of SBA loans to disaster victims, a powerful argument can be made that low-interest loans should be used to motivate capital investments as opposed to tax relief. *See* Barreto statement, *supra* note 342, at 2 ("Physical disaster loans provide qualified businesses of any size that have sustained uninsured losses up to $1.5 million with funds to repair or replace business property.").

stimulating a post-disaster economy), then equity considerations should prevail so that such relief is automated upon a presidential determination that a catastrophe was so severe as to warrant classifying it as a national disaster area. Extending the same advantages to all small business victims of declared major disasters allows all devastated communities an equal hand in rebuilding.

3. Automate Low-Income Housing Credit (LIHC)

Housing shortages are also predictable following major catastrophes. Virtually identical suspensions of LIHC requirements have stemmed from recent catastrophic natural disasters.[442] Why not automate temporary suspension of income limitations so displaced individuals can reside in vacant low-income housing units? Such relief could be effective the date the president declares the area a national disaster area. An advantage of automated statutory relief is that the government could address the issue of displaced persons globally, as it did after Hurricane Katrina, versus issuing proclamations individually in response to requests by affected states.[443]

Congress could easily codify such relief for all future declared disaster areas where FEMA has qualified individuals for relief. Statutory relief would offer significant procedural benefits by eliminating requirements for the affected states to request relief and the IRS to process and approve such requests. The provisions included in the typical IRS Notice—to promote sheltering the victims of disasters, while protecting the rights of current residents of low income housing—could simply be included in the statute.[444] The identical record-keeping, rent restrictions, and protections for existing tenants should be retained to ensure the relief is not abused.

Furthermore, the codified relief could mandate that the benefits be subject to approval of the state housing agency (a

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[442] I.R.S. Notice 2004-74, *supra* note 150 (relief in Alabama due to Ivan), is virtually identical to I.R.S. Notice 2004-76, *supra* note 147 (relief in Florida due to Charley, Frances, Ivan, and Jeanne), and I.R.S. Notice 2004-75, *supra* note 150 (relief in Ohio after Ivan). *See also* I.R.S. Notice 2005-69, 2005-40 I.R.B. 622 (Hurricane Katrina LIHC relief); I.R.S. Notice 2006-11, 2006-7 I.R.B. 457 (following Hurricane Rita).

[443] *See* I.R.S. Notice 2005-69, *supra* note 442; I.R.S. Notice 2006-11, *supra* note 442.

[444] *See, e.g.*, I.R.S. Notice 2004-76, *supra* note 147; I.R.S. Notice 2004-74, *supra* note 150; I.R.S. Notice 2004-75, *supra* note 150.

provision found in previous IRS LIHC relief statutes).[445] Such a provision is all that is needed for a state housing authority to refuse such relief when no housing shortage ensues from a disaster; it would effectively allow states to veto unnecessary relief. Similarly, the duration of the relief should be left to the discretion of state housing authorities, subject to a statutory one-year cap to ensure relief truly remains "temporary."

XI. TAX CREDITS TO PROMOTE MITIGATION

Another way to address the temporary housing issue is to have fewer displaced individuals to begin with. More resistant structures actually help both individuals as well as businesses. Much of the damage from Hurricane Andrew resulted from buildings being inadequately constructed.[446] The State of Florida and the insurance industry began a massive program to tighten building code compliance.[447] In the aftermath of the hurricanes striking Florida in 2004, the insurance industry noted that the most severely damaged structures were those built before Hurricane Andrew.[448]

In trying to restore solvency to the National Flood Insurance Program, Congress is looking for ways to better mitigate future flood risks.[449] Along similar lines, the SBA proposed increasing the amount of lending assistance the SBA could provide for hurricane mitigation measures, such as storm shutters or construction of seawalls.[450]

Hardening structures to a wide variety of perils would reduce federal exposure should Congress decide to expand federal insurance programs to all major catastrophes. Even if Congress does not broaden the federal insurance programs, the entire nation benefits from avoiding the costs of casualty losses through lower insurance premiums, less risk to the insurance industry, smaller losses, and quicker recovery for affected individuals. Congress should consider tax credits to stimulate mitigation measures.

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445 *See, e.g.*, I.R.S. Notice 2004-76, *supra* note 147; I.R.S. Notices 2004-74, *supra* note 150; I.R.S. Notice 2004-75, *supra* note 150.

446 *Catastrophes: Insurance Issues*, *supra* note 25.

447 *Id.*

448 *Id.*

449 *See* H.R. 4973, 109th Cong. § 2(b) (2006).

450 Barreto statement, *supra* note 342, at 4.

A window (perhaps three to five years) of tax credits to homeowners and businesses would incentivize taxpayers to invest now rather than later. Congress could offer a credit to match a proportionate share of amounts invested in approved mitigation techniques. The proportionate share could vary based upon income. (For example, a dollar for dollar match up to a predetermined limit for taxpayers earning less than $20,000, ramping down to a ten or twenty percent match for taxpayers earning over $200,000 (up to the same limited credit amount).)

This matching formula serves as a substantial incentive by making mitigation more affordable, especially for the poor. It is in the government's interest to match these costs now to prevent far greater potential costs down the road. After all, "an ounce of prevention is worth a pound of cure."[451] The government may save considerably on disaster assistance in the future if precautions are taken now.

XII. CONCLUSION

The first and foremost lesson from Hurricane Katrina was "[n]o matter how prepared we think we are, we must work every day to improve."[452] The 2006 message from the National Hurricane Center was equally clear: "[P]repare, prepare, prepare."[453] Will Congress be prepared for future disasters? Will those affected by the next disasters enjoy the same tax relief as the victims of the 2005 hurricanes?

For individuals, being prepared can mean the difference between life and death. Financial preparedness is equally crucial to an individual's financial well-being. "For small business owners, being prepared can mean staying in business following a disaster."[454] A sound disaster plan can make the difference between being shut down for a few days and losing the business.[455] Just as each individual and business must be prepared, Congress must prepare appropriate tax measures now, instead of responding once the next emergency is underway.

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451 Benjamin Franklin, PA. GAZETTE, Jan. 28-Feb. 4, 1735, at 1. While the maxim was used in the context of fire prevention, it holds equally true for other emergencies.

452 LESSONS LEARNED, *supra* note 4, at 4.

453 NOAA, *supra* note 1.

454 Runyan, *supra* note 158.

455 SBA, FAQs (Disaster Preparedness), *supra* note 407.

Standardizing and simplifying the Internal Revenue Code should benefit all victims, but particularly small businesses and low to middle-income households.[456] Taxes should not discriminate based on the name of the tragedy. After all, "One hurricane hitting where you live is enough to make it a bad season."[457]

While the location of the next tragedy, the scope of the damages, who will be affected, how many will be affected, and how badly they will be affected may not be predictable, the tax consequences of the disaster should be both predictable and transparent. Taxpayers need to prepare financially; they must know about tax consequences ahead of time to effectively plan.

For example, tax incentives might motivate individuals and businesses to secure flood insurance or prompt them to invest in precautionary measures. If tax-advantaged catastrophe savings accounts are codified, they can serve as a repository for "self-insuring" a portion of prospective losses. By motivating the insurance community, through tax incentives, to set aside funds dedicated exclusively to national disasters, the government could help take some of the sting out of the next major catastrophe.

Although it is too late to redress past inequitable tax treatment (favoring victims of some tragedies over others),[458] if there is to be any equity for future victims, Congress must act now to standardize and optimize treatment of disaster victims in the tax code. The tax relief proposed in this article satisfies the need for both horizontal and vertical equity among taxpayers and reflects America's historic compassion to help those in need. Preserving the most cost-effective and beneficial measures and trimming expensive and unrefined aid will benefit all Americans.

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[456] For a discussion of the benefits of simplification, see *Testimony Before the Subcomm on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (April 6, 2006) (prepared statement of Dennis B. Drapkin, Chairman, American Bar Ass'n, Section on Taxation), http://waysandmeans.house.gov/hearings.asp?formmode=printfriendly&id=4836 (last visited Jan. 9, 2007).

[457] NOAA, *supra* note 1.

[458] *Cf.* GRAVELLE, *supra* note 36, at 1 (arguing that tax subsidies for lower Manhattan after 2001 terrorist attacks may be desirable means of compensating victims for catastrophic losses).