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COUNTING CASUALTIES IN COMMUNITIES HIT HARDEST BY THE FORECLOSURE CRISIS

Matthew J. Rossman*

I. INTRODUCTION

It is well established that the fiscal and foreclosure crisis that gripped the global economy beginning in late 2006 had a devastating impact on American homeowners. The number of foreclosures quadrupled.[1] Eight million U.S. households (one of every six households with a mortgage) were involved in a foreclosure proceeding, and five million lost their homes to foreclosure.[2] Home prices plummeted an average of 33% between 2006 and 2011, far exceeding any other housing market decline in recorded American history.[3] This caused homeowners nationwide to lose an aggregate of seven trillion dollars in home equity,[4] nearly 50% of the total wealth tied up in homes in 2006.[5] Little wonder then

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1 *1.4 Million U.S. Properties with Foreclosure Filings in 2013 Down 26 Percent to Lowest Annual Total Since 2007*, REALTYTRAC (Jan. 13, 2014), http://www.realtytrac.com/content/foreclosure-market-report/2013-year-end-us-foreclosure-report-7963 [https://perma.cc/4YKS-LZYN] (showing total U.S. foreclosure filings in 2006 at approximately 717,000 increasing to approximately 2.9 million by 2010).

2 Annamaria Andriotis et al., *After Foreclosures, Home Buyers are Back*, WALL STREET J. (Apr. 8, 2015, 8:17 PM), http://www.wsj.com/articles/after-foreclosures-home-buyers-are-back-1428538655 (on file with the Utah Law Review); Ben Beachy, *A Financial Crisis Manual: Causes, Consequences, and Lessons of the Financial Crisis* 4, 14–15 (Glob. Dev. & Env't Inst., Working Paper No. 12-06, 2012), http://www.ase.tufts.edu/gdae/Pubs/wp/12-06BeachyFinancialCrisis.pdf [https://perma.cc/59GS-AMQM].

3 BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS 1 (2012) [hereinafter 2012 FEDERAL REPORT ON HOUSING MARKET], http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf [http://perma.cc/5MWJ-HBT7]; *see* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 13 fig.2.1 (2d ed. 2005) (displaying U.S. home prices, building costs, population, and interest rates from 1890 to 2004).

4 Home equity means "[t]he value of ownership built up in a home or property that represents the current market value of the house less any remaining mortgage payments." *Home Equity*, INVESTOPEDIA, http://www.investopedia.com/terms/h/home_equity.asp [https://perma.cc/ZQB5-YSKQ] (last visited Jan. 24, 2016).

5 *See* Beachy, *supra* note 2, at 37.

that the Foreclosure Crisis and the larger and broader economic downturn it put into motion draw comparisons to the Great Depression.[6]

Most recent reports on the U.S. housing market indicate that the country has largely recovered from the damage wrought by the Crisis. Average national home prices have rebounded (in some places to at or above pre-2006 levels),[7] housing inventories have shrunk,[8] and foreclosures continue to decrease steadily.[9] These trends have contributed to a recapture of more than two-thirds of the aggregate homeowner equity lost by the peak of the Crisis.[10]

Wide-lens statistics like these obscure a critical part of the story, however. A closer look reveals that the country is not composed of one or even fifty real estate markets, but rather thousands of smaller markets experiencing dramatically uneven levels of recovery.[11] Home values in some markets have recovered little or none of their pre-Crisis peak, and in some cases are even still losing value.[12] When examined

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[6] *See, e.g.*, U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO CONGRESS ON THE ROOT CAUSES OF THE FORECLOSURE CRISIS, at vi (2010) [hereinafter HUD REPORT ON FORECLOSURE CRISIS], http://www.huduser.org/portal/publications/Foreclosure_09.pdf [http://perma.cc/QXP2-XMY4]; FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, at xv (2011) [hereinafter FINANCIAL CRISIS INQUIRY COMMISSION REPORT], http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [http://perma.cc/X544-2ZX8].

[7] *See S&P/Case-Shiller 20-City Composite Home Price Index*, S&P DOW JONES INDICES (Oct. 27, 2015), http://us.spindices.com/indices/real-estate/sp-case-shiller-20-city-composite-home-price-index [http://perma.cc/UME2-2L4C] (showing home prices have risen steadily since the 2011 low point).

[8] DANIEL HARTLEY & KYLE FEE, FED. RESERVE BANK OF CLEVELAND, HOUSING RECOVERY: HOW FAR HAVE WE COME?, ECON. COMMENT. (2013) (citing to data from the National Association of Realtors showing recent declines in for-sale home inventory).

[9] *See* CORELOGIC, NATIONAL FORECLOSURE REPORT 2–4 (2015), http://www.corelogic.com/research/foreclosure-report/national-foreclosure-report-august-2015-v2.pdf [http://perma.cc/T4B4-DDRH] (showing forty-six consecutive months of declining foreclosure inventory on a year-over-year basis and a national foreclosure rate that, while still more than double pre-crisis rate, has dropped steadily and returned to January 2008 levels); *see also 1.1 Million U.S. Properties with Foreclosure Filings in 2014, Down 18 Percent from 2013 to Lowest Level Since 2006*, REALTYTRAC (Jan. 14, 2015), http://www.realtytrac.com/news/foreclosure-trends/1-1-million-u-s-properties-with-foreclosure-filings-in-2014-down-18-percent-from-2013-to-lowest-level-since-2006/ [http://perma.cc/T97K-8SB6] (announcing that foreclosure filings in 2014 were at their lowest level since 2006).

[10] *See generally* HOUS. FIN. POLICY CTR., HOUSING FINANCE AT A GLANCE: A MONTHLY CHARTBOOK 6 (2015), http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000194-Housing-Finance-Chartbook-April-2015.pdf [https://perma.cc/ME8Z-ZQTM] (showing that approximately $2.2 trillion in lost equity still remains).

[11] *See infra* Part II.

[12] SARAH BURD-SHARPS & REBECCA RASCH, SOC. SCI. RESEARCH COUNCIL, IMPACT OF THE US HOUSING CRISIS ON THE RACIAL WEALTH GAP ACROSS GENERATIONS 2 (2015), https://www.aclu.org/files/field_document/discrimlend_final.pdf [https://perma.cc/9PH4-H5QW].

carefully, it appears that these markets have suffered serious structural damage due to a downward spiral of rampant foreclosures, vacancies, and physical deterioration spurred or accelerated by the Crisis.[13] Even more troubling is that these most heavily impacted housing markets are in communities (what this Article will refer to as the "Hardest Hit Communities") that are typically composed predominantly of low- and middle-income residents, and are also disproportionately communities of color.[14] Because the home is much more likely to be the principal or only asset in these households,[15] the Foreclosure Crisis has had a more severe, as well as a more enduring, impact on overall household wealth on those least able to afford it. There is little evidence to suggest that housing markets in most of the Hardest Hit Communities will recover more than marginally at any point in the near future.[16]

Most efforts to ease the blow to U.S. homeowners caused by the Foreclosure Crisis have proposed fixes to what may be its most prominent and nefarious symbol—the "underwater mortgage." An underwater mortgage is one in which the homeowner owes more on the mortgage than the home is worth,[17] and it is both a cause and vestige of the Crisis that continues to afflict many American homeowners.[18] The most dramatic and potentially impactful proposals have called for governmental involvement in reducing principal loan amounts on those

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[13] *See infra* Part II.

[14] *See id.*

[15] *See, e.g.*, Mauricio Soto, *Family Net Worth Before the Recession*, URBAN INST. (Mar. 2010), http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412078-Family-Net-Worth-before-the-Recession.PDF [https://perma.cc/MUE6-P74V] (using Survey of Consumer Finances Data to show that home equity constitutes approximately 60% of net worth for families in the bottom quintile of U.S. income, approximately 47% for families in the middle quintile, and 22% for families in the highest quintile). Home ownership constitutes 92% of the net worth for African Americans and 67% for Latinos, compared with 58% for whites. REBECCA TIPPETT ET AL., CTR. FOR GLOB. POLICY SOLS., BEYOND BROKE: WHY CLOSING THE RACIAL WEALTH GAP IS A PRIORITY FOR NATIONAL ECONOMIC SECURITY 4 (2014), http://globalpolicysolutions.org/wp-content/uploads/2014/04/Beyond_Broke_FINAL.pdf [http://perma.cc/MHF6-738Z].

[16] There is even some concern that home prices in these communities will fall further as a wave of interest rate increases on home mortgages and equity lines kick in during 2015. *See* David Dayen, *You Thought the Mortgage Crisis Was Over? It's About to Flare Up Again*, NEW REPUBLIC (Aug. 24, 2014), http://www.newrepublic.com/article/119187/mortgage-foreclosures-2015-why-crisis-will-flare-again [http://perma.cc/4CJD-T3LB]; Dina ElBoghdady, *The Foreclosure Crisis Is Still Burning Years After the Housing Crisis Ended*, WASH. POST (Mar. 11, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/03/11/the-foreclosure-crisis-is-still-burning-years-after-the-housing-crisis-ended/ [http://perma.cc/Y93Q-PH69].

[17] *See* 2012 FEDERAL REPORT ON HOUSING MARKET, *supra* note 3, at 4.

[18] *See* Svenja Gudell, *Negative Equity Continues to Fall, Concentrated in Bottom Tier*, ZILLOW (May 19, 2014), http://www.zillow.com/research/2014-q1-negative-equity-report-6937/ [http://perma.cc/H5V4-L2ZF] (showing that as of the first quarter of 2014, 18.8% of U.S. homeowners with a mortgage had negative equity).

mortgages most at risk of default.[19] Realigning the loan-to-value ratio on mortgages that are deeply underwater would, according to advocates, reduce the incidence of default, and thereby keep more homeowners in their homes, lessen the number of distressed foreclosure sales, and help "stuck" housing markets rebound.[20]

Principal reduction strategies have, however, typically encountered strenuous public-policy objections centered primarily on the perception that they inappropriately bail out the types of irresponsible consumer borrowing and other behaviors that helped fuel the Foreclosure Crisis and interfere with market forces.[21] As a result, meaningful principal reduction has usually been a political and practical nonstarter. Government's other, more modest, attempts to aid at risk borrowers have been tepid, piecemeal, and ineffective.[22] More recently, the popular perception is that the Foreclosure Crisis is simply over, which has sapped any remaining political momentum to intervene.[23]

Without disputing the merits of any further efforts to reverse the fortunes of distressed borrowers, this Article takes a decidedly different approach. Nearly a decade removed from the onset of the Crisis, it calls for taking stock of the permanent damage the Crisis caused. As this Article will illustrate, the evidence is clear that what homeowners in the Hardest Hit Communities have experienced is not a temporary downturn in home prices, but rather a permanent transition to a

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[19] *See, e.g.*, Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, CURRENT ISSUES ECON. & FIN., no. 5, 2013, at 1, 4 (suggesting that governments use their eminent domain power to purchase underwater mortgages); Jann Swanson, *How a "Bad Bank" Could Help Clear the Mortgage and Housing Markets*, MORTGAGE NEWS DAILY (July 16, 2012, 2:51 PM), http://www.mortgagenewsdaily.com/07162012_principal_reduction.asp [https://perma.cc/QYF5-4MLX] (reporting on Adam J. Levitin's proposal to create a "bad bank . . . specifically for acquiring and restructuring troubled assets").

[20] *Id.*

[21] Dan Immergluck, *Too Little, Too Late, and Too Timid: The Federal Response to the Foreclosure Crisis at the Five-Year Mark*, 23 HOUSING POL'Y DEBATE 199, 218 (2013). Often these strategies are criticized for creating the moral hazard of incentivizing borrowers to fall behind on their mortgages in order to qualify for principal reduction. *See* Hockett, *supra* note 19, at 8. Others defer to the idea that the market is the most appropriate arbiter and that government-mandated principal reduction would interfere with the market resetting home values. *See, e.g.*, Tim Cavanaugh, *The 'Foreclosure Crisis' Has Ended*, NAT'L REV. (Apr. 16, 2014, 7:01 PM), http://www.nationalreview.com/article/375931/foreclosure-crisis-has-ended-tim-cavanaugh [http://perma.cc/5QXC-J46U]; *The Sanctification of Irresponsible Borrowers*, REAL CLEAR MARKETS (Oct. 30, 2008), http://www.realclearmarkets.com/articles/2008/10/the_sanctification_of_irrespon.html [http://perma.cc/39WR-P8E9].

[22] *See infra* Part III.

[23] *See, e.g.*, *Ohio Blight-fighting Money Is in Jeopardy as Congress Eyes it for Highway Use Instead* http://www.cleveland.com/open/index.ssf/2015/07/ohio_blight-fighting_money_is.html [https://perma.cc/NPL4-F9RV] (reporting effort by Senate committee to re-direct Foreclosure Crisis Hardest Hit Funds to highway repair by contending that foreclosures have slowed and home prices have sufficiently rebounded).

lower value plateau.[24] Moreover, this transition represents something other than just a healthy readjustment to real value in the wake of pre-Crisis home price run-ups, and instead reflects damage to the fundamentals of these housing markets brought on by rampant foreclosures. Given that this damage will be very difficult to overcome during the average tenure of a U.S. homeowner,[25] the bottom line for homeowners in the Hardest Hit Communities is that they have incurred "permanent" losses in the values of their homes and, by extension, in their household wealth.[26] The time is right to consider whether the law provides any remedy.

Adjusting the focus in this way also brings to light that the Foreclosure Crisis wreaked financial havoc on many more than just those whose homes went into foreclosure. Across the country, a large majority of homeowners with underwater mortgages stayed current on their payments.[27] Many others owned their homes outright[28] or had already paid enough into their mortgages that declining home prices did not cause their homes to go underwater, making foreclosure a much less likely outcome. Within localized housing markets, home-value declines did not discriminate among those who defaulted on their mortgages and those who did not. Homeowners in the Hardest Hit Communities who did not go into foreclosure suffered substantial collateral damage as repeated waves of foreclosures battered

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[24] *See infra* Part II.

[25] A recent study by the National Association of Home Builders, using data from the U.S. Census Bureau's American Housing Bureau, estimates the average buyer of a single-family home can be expected to stay in the home approximately thirteen years before moving out and that this has stayed roughly consistent over the past twenty-five years. *See* Paul Emrath, *Latest Study Shows Average Buyer Expected to Stay in a Home 13 Years*, NAHB® (Jan. 3, 2013), http://eyeonhousing.org/2013/01/latest-study-shows-average-buyer-expected-to-stay-in-a-home-13-years/ [http://perma.cc/QBM2-8UCD]. However, median tenure is lower, with several recent studies showing nine years as the median tenure of a U.S. homeowner. *See* NAT'L ASS'N OF REALTORS®, 2014 NATIONAL ASSOCIATION OF REALTORS® HOME BUYER AND SELLER GENERATIONAL TRENDS exhibit 6-16 (2014), http://www.realtor.org/sites/default/files/reports/2014/2014-home-buyer-and-seller-generational-trends-report-full.pdf [http://perma.cc/D8MC-9MST]; *see also* PETER MATEYKA & MATTHEW MARLAY, U.S. CENSUS BUREAU, THE DURATION AND TENURE OF RESIDENCE, 1996 TO 2009 (2012), https://www.census.gov/hhes/migration/files/2008-Duration-WP.pdf [https://perma.cc/385G-Y6ZT].

[26] As explained in Part II, "permanent" corresponds roughly to the length of time homeowners typically remain in their homes. This is not to say home prices in the Hardest Hit Communities will not recover in future years. But if a community's home prices are impaired to the point that they show little prospect of meaningful recovery over a ten- to fifteen-year horizon, then this equates to a permanent loss of value for homeowners in this community.

[27] According to one study, 90% of homeowners with underwater mortgages stay current on their mortgages. Gudell, *supra* note 18.

[28] According to census data, more than one-third of homeowners do not have a mortgage. U.S. CENSUS BUREAU, 2013 HOUSING PROFILE: UNITED STATES 2 tbl.2 (2015), http://www2.census.gov/programs-surveys/ahs/2013/factsheets/ahs13-1_UnitedStates.pdf [http://perma.cc/H3YS-KVVL].

their communities and destroyed the equity in their homes.[29] To the extent that it matters, most of the public-policy objections raised to aiding distressed borrowers should not apply to this largely sympathetic and, to date, overlooked group of homeowners who stuck by their obligations, held fast in their communities, and simply had the misfortune of being in the wrong place at the wrong time.

Although comprehensive strategies aimed at repairing damage to home values in the Hardest Hit Communities certainly exist, the political climate for implementing them is daunting and they would, even if adopted, take years to make a substantial impact. So this Article turns instead to a mechanism that already exists under the Internal Revenue Code[30] ("IRC") that would simply allow homeowners in the Hardest Hit Communities to recognize their losses. Since its inception, the IRC has allowed taxpayers a deduction from taxable income for uninsured damages to their homes and other personal property due to a "fire, storm, shipwreck, or other casualty."[31] Known as the casualty-loss deduction, it is typically claimed by those whose property is damaged by natural calamities like hurricanes, earthquakes, and floods as well as others who incur similar losses as a result of a "sudden, unusual and unexpected force."

As this Article will explain, the Foreclosure Crisis stripped home values in the Hardest Hit Communities in a manner that was sudden, unexpected, and crippling. It was set into motion by a complex web of activity unknown to and uncontrollable by most of those homeowners who suffered the greatest losses from it. In these respects, the resemblance to casualty losses is striking. Accordingly, this Article argues that the Internal Revenue Service ("IRS") and, by extension, the U.S. Treasury Department should recognize the permanent damage to home values in the Hardest Hit Communities as casualty losses.[32]

This Article contends that this should be the case notwithstanding the historic stance taken by the IRS and most courts that limits the deduction to only those taxpayers whose property has incurred physical damage. A careful reading of the law reveals that this distinction is not required; a careful consideration of the normative rationales justifying the deduction reveals that the distinction is arbitrary and inequitable.[33] Moreover, as this Article will explain, Congress has already extended conceptually similar tax relief to those homeowners who agreed to mortgage principal reductions with their lenders or defaulted on their mortgages during the Foreclosure Crisis and had some of their mortgage debt released upon

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[29] *See, e.g.*, *Foreclosures Continue: What Needs to Change in the Administration's Response: Hearing before the Subcomm. on Domestic Policy of the H. Comm. on Oversight & Gov't Reform*, 111th Cong. 191 (2010) (statement of Julia Gordon, Center for Responsible Lending) ("Tens of millions of households where the owners have paid their mortgages on time every month are suffering a decrease in their property values that amounts to hundreds of billions of dollars in lost wealth just because they are located near property in foreclosure.").

[30] 26 U.S.C. §§ 1–9834 (2012).

[31] *Id.* § 165(c)(3).

[32] *See infra* Part V.

[33] *See infra* Part V.

reconveyance.[34] Allowing these taxpayers to reduce their tax base by amounts equatable to their damaged home values, but not those who incurred similar damage but did not receive any break on their mortgage obligations, is likewise inequitable.

Notwithstanding its conceptual fit, the casualty-loss deduction poses challenging valuation, timing, and qualification issues in its application to the Foreclosure Crisis which could make it difficult to administer and almost certainly fuel IRS resistance to recognizing it. Moreover, as currently written, the deduction's value is largely muted for low- and middle-income taxpayers, in part due to the floors Congress has imposed on it over time. This Article examines each of these challenges in turn and explains their implications for an effective and equitable implementation of the deduction in this instance.[35] The Article then proposes modifications to the deduction that the federal government could consider making to address these concerns.[36] The starting point is to recognize the conceptual and equitable justifications for considering the type of damage to home values that occurred in the Hardest Hit Communities as properly deductible casualty losses and to proceed from there in fashioning potential modifications.

This Article will proceed as follows. Part II explains briefly how the Foreclosure Crisis unfolded, its disparate impact among localized housing markets, and how in the Hardest Hit Communities the result was severe and entrenched reductions in home values tantamount to permanent damage. Part III summarizes the federal government's various responses to the Crisis, demonstrating that by and large these efforts have done little to address this damage. Part IV explains how the IRC treats a taxpayer's personal losses and why it typically does not allow a taxpayer whose primary residence has declined in value to deduct this from her taxable income. Part V explores the primary exception to this rule—the casualty-loss deduction—and makes the case for why it ought to apply to homeowners in the Hardest Hit Communities. Parts VI and VII identify the administrative and distributional challenges to utilizing the deduction in this context. Part VIII sets forth two possible modifications to the deduction to address these challenges and the merits of adopting one or both of these proposals.

II. THE FORECLOSURE CRISIS AND ITS DISPARATE IMPACT ON HOME VALUES

A. The Foreclosure Crisis

The circumstances leading to the Foreclosure Crisis can best be likened to a brewing storm that escaped attention while it gathered strength, but once it rolled in was too furious to escape. Several years of increasingly risky mortgage lending and borrowing practices were fueled by a volatile and complex mix of rising home prices, low interest rates, lax governmental regulation of the mortgage finance industry, a corresponding loosening of underwriting requirements, a huge influx of

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[34] *See infra* Part III.
[35] *See infra* Parts VI, VII.
[36] *See infra* Part VIII.

additional lending capital due to the growth of the international mortgage-backed securities market, inaccurate risk assessments of these securities by credit-rating agencies, and, to some extent, fraud.[37] Lenders driven by the quest for profits and borrowers lured by previously unavailable avenues for financing home purchases and other expenses (by leveraging existing equity in their homes) cooperated to flood the market with large numbers of subprime mortgages that carried a high risk of default.[38] Meanwhile, the home construction industry matched homebuyers' enthusiasm for newly built homes with waves of new construction.[39] Inflated home prices, easy capital, and oversupply finally came to a head in late 2006, ending the growth in home prices and reversing course. As home prices began to fall, subprime borrowers could no longer sell or refinance their homes to pay off unaffordable mortgages, and they began to default in increasing numbers.[40] As defaults mounted, banks heavily invested in subprime mortgages began to fail, causing huge losses on the securities markets, which had invested trillions of dollars into these mortgages.[41] Mortgage industry exuberance built on the unrealistic expectation that home prices would continue to appreciate at a record pace turned quickly to despair as the storm clouds rolled in.[42]

But it gets worse. The collapse of the U.S. mortgage market quickly spurred similar collapses in other parts of the world and together put into motion a global financial crisis. Financial institutions failed, credit markets seized up, the stock market plummeted, companies shut down or laid off workers, and the economy plunged into a deep recession.[43]

Exacerbated by the larger economic freefall that it sparked, the Foreclosure Crisis dealt a sudden and severe blow to the U.S. housing market. Mortgage defaults quickly led to foreclosures.[44] The resulting flood of "distressed" property sales (i.e., sales made in the course of or in anticipation of foreclosure) further depressed prices.[45] As more properties went underwater (ensuring most potential home sellers

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[37] FINANCIAL CRISIS INQUIRY COMMISSION REPORT, *supra* note 6, at xv–xxviii.

[38] *Id.*

[39] Dean Baker, *The Housing Bubble and the Financial Crisis*, 46 REAL-WORLD ECON. REV. 73, 74 (2008).

[40] *Id.* at 79.

[41] FINANCIAL CRISIS INQUIRY COMMISSION REPORT, *supra* note 6, at xvi, 27.

[42] HUD REPORT ON FORECLOSURE CRISIS, *supra* note 6, at 38.

[43] FINANCIAL CRISIS INQUIRY COMMISSION REPORT, *supra* note 6, at xvi.

[44] HUD REPORT ON FORECLOSURE CRISIS, *supra* note 6, at 2–3; *see* HOUS. FIN. POLICY CTR., *supra* note 10, at 18.

[45] *See* Stephan Whitaker & Thomas J. Fitzpatrick, IV, *The Impact of Vacant, Tax-Delinquent, and Foreclosed Property on Sales Prices of Neighboring Homes* 35–36 (Fed. Reserve Bank of Cleveland, Working Paper No. 11-23R, 2012) (concluding that distressed properties lower the sales prices of neighboring properties). In some places, distressed sales went from a minuscule percentage of overall property sales to a majority of sales within a matter of months. Mark M. Fleming, Chief Economist, CoreLogic, Statement before the Financial Crisis Inquiry Commission 5 (Sept. 23, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0923-Fleming.pdf [http://perma.cc/GG7F-6HXK].

would sell at a loss) and the national unemployment rate doubled,[46] demand for real estate dried up and inventories of unsold homes doubled.[47] Average national home prices fell by 33%, causing a 50% loss in aggregate homeowner equity.[48] The housing market was in full-fledged crisis.

B. Disparate Onset, Disparate Recovery

Although national statistics are useful in grasping the aggregate impact of the Foreclosure Crisis, they obscure a critical reality. That is, the Crisis did not affect all areas of the country uniformly. To the contrary, certain areas fared much worse than others and much worse than the national statistics suggest.

This disparity can be seen first in the onset of the Crisis. For example, the "sand states" (Arizona, California, Florida, and Nevada) experienced much larger than average run-ups in home prices leading up to the Crisis, an average foreclosure rate during the acute phase of the Crisis of more than twice the national rate,[49] and a nearly 50% freefall in average home prices by the end of 2008.[50] In sharp contrast, the Foreclosure Crisis largely bypassed the less populated Upper Plain states (North and South Dakota, Montana, and Wyoming) and Alaska. These states did experience relatively large pre-Crisis home price increases.[51] However, foreclosure rates in the Upper Plains never exceeded the historic norm, and housing markets did not experience home price declines.[52] Industrial Midwestern states saw relatively modest, pre-Crisis home price increases, but these were followed by relatively high foreclosure rates and significant price declines.[53]

Finer-grained examinations that distinguish the impact of the Crisis on different cities within the same state and on different zip codes within the same metropolitan area often show similar variations within these much smaller geographic areas.[54] It was not uncommon for adjoining and nearby communities to experience radically different rates of home-value declines. For example, in Cleveland's Slavic Village,

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[46] The national unemployment rate was 5% in April 2008 and doubled to 10% by October 2009. *Labor Force Statistics from the Current Population Survey*, U.S. DEP'T OF LABOR, http://data.bls.gov/timeseries/LNS14000000 [http://perma.cc/MQV2-E2CU] (last visited Nov. 12, 2015).

[47] HARTLEY & FEE, *supra* note 8.

[48] *See supra* notes 3–5 and accompanying text.

[49] HUD REPORT ON FORECLOSURE CRISIS, *supra* note 6, at 10.

[50] *Id.* at 14.

[51] *Id.* at 12, 14.

[52] *Id.* at 13–14.

[53] *Id.*

[54] LAURA CHOI, FED. RESERVE BANK OF S.F., HOUSING MARKET RECOVERY IN THE 12TH DISTRICT: IMPLICATIONS FOR LOW- AND MODERATE-INCOME COMMUNITIES 2–4 (2013) (showing significant variation in foreclosure rates, home price declines, and negative equity rates as a result of the Foreclosure Crisis between various metropolitan regions within California); Fleming, *supra* note 45, at 13 (detailing dramatic differences in home price declines by zip code within the Sacramento, California metropolitan area).

the neighborhood originally deemed the epicenter of the Foreclosure Crisis, home values declined 54%;[55] but just two zip codes away in the affluent Cleveland suburb of Chagrin Falls, home values barely fell.[56]

By most indicators, the acute phase of the Foreclosure Crisis concluded toward the end of 2011, as housing markets bottomed out and then began to trend upward.[57] National price indices reflect a fairly steady recovery that has brought home prices to just under 10% of their pre-Crisis peak,[58] restored more than two-thirds of lost homeowner equity,[59] and significantly reduced the percentage of homeowners with underwater mortgages nationally to somewhere in the low teens.[60] However, a closer look reveals that the pace and degree of recovery also varies significantly among more localized housing markets.[61] Average home prices in eight states have fully recovered and actually increased, in some cases robustly, above their pre-Foreclosure Crisis peak.[62] Meanwhile, in Nevada and Florida home values remain at or close to one-third below their peak (the national average during the worst days of the Crisis).[63]

As with the onset data, finer-grained recovery data often reveals dramatic differences within much smaller geographic areas. Home values in Slavic Village remain stuck at their Foreclosure Crisis low point (54% below peak), while in Chagrin Falls homes have recovered their modest losses and gained nearly 10% on

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[55] *44105 Home Prices & Values*, ZILLOW (on file with the Utah Law Review), http://www.zillow.com/cleveland-oh-44105/home-values (last visited Nov. 12, 2015).

[56] *Chagrin Falls Home Prices & Values*, ZILLOW (on file with the Utah Law Review), http://www.zillow.com/chagrin-falls-oh/home-values (last visited Nov. 12, 2015) (showing a pattern of relatively quick decreases and increases to home values, the median home value never dropped below 7% of the pre-Crisis peak, and the median home value sometimes exceeded the pre-Crisis peak).

[57] HARTLEY & FEE, *supra* note 8.

[58] CORELOGIC, HOME PRICE INDEX REPORT 3 (2015), https://www.corelogic.com/research/hpi/corelogic_hpi_april_2015.pdf [https://perma.cc/28UG-4XYJ]; *S&P/Case-Shiller 20-City Composite Home Price Index*, *supra* note 7.

[59] *See* HOUS. FIN. POLICY CTR., *supra* note 10, at 6–9.

[60] *Id.* at 18 (showing residential properties in negative equity as a share of all residential properties with a mortgage at 10.8% in the last quarter of 2014). *But see* Svenja Gudell, *Q1 2015 Negative Equity Report: After Three Long Years, the Hard Work Begins Now*, ZILLOW (June 11, 2015), http://www.zillow.com/research/negative-equity-2015-q1-9905/ [http://perma.cc/J2D9-Z4WF] (showing the negative equity rate for the first quarter of 2015 at 15.4%).

[61] CORELOGIC, *supra* note 58, at 7. A comparison of the country's largest greater metropolitan areas shows a similar level of disparity. *See S&P/Case-Shiller 20-City Composite Home Price Index*, *supra* note 7 (examining individual city indices shows full recovery and robust subsequent appreciation of prices in Dallas and Denver, as contrasted with only modest recapture of Foreclosure Crisis price declines in, for example, Chicago, Cleveland, and New York).

[62] CORELOGIC, *supra* note 58, at 7.

[63] *Id.*

their pre-Crisis peak.[64] A *Wall Street Journal* map published in July 2015 demonstrates that this is not a local phenomenon.[65] The map reveals pockets of very high rates of negative equity, a direct outgrowth of depressed home prices, that are much higher than those in nearby zip codes (sometimes three or four times higher) within many major metropolitan areas.[66] In a similar vein, a 2014 report published by the Haas Institute at the University of California, Berkeley found 395 zip codes spread across the United States in which the percentage of homes still underwater ranged from 43% to 76% and in which home price appreciation since the low point of the Foreclosure Crisis was either negligible or where prices had fallen even further.[67] The bottom line is that not only has the recovery from the Foreclosure Crisis not been uniformly felt, but that there are certain neighborhoods and cities where there has been essentially no recovery at all.

The trajectories of three adjacent housing markets in one metropolitan region—Hartford, Connecticut—demonstrate this point in particularly dramatic fashion and provide some indication of why this happened. As was common throughout the United States, the entire greater Hartford region experienced healthy home price gains in the lead-up to the Foreclosure Crisis.[68] Starting in early 2008, home prices in the city of Hartford dropped dramatically, with the median home value declining approximately 33% from $134,000 to $91,000 by the time the national housing market began to recover.[69] Contrary to national housing market trends, however, median value in Hartford has, subject to some minor and temporary fluctuations, remained stuck at its post-Crisis low point.[70] Someone who bought the median value Hartford home in 2008 and sold it today at market value would receive approximately $43,000 less than what she paid for it.

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[64] *See supra* notes 55–56 and accompanying text. *See also* Frank Ford, *Is the Cuyahoga County Foreclosure Crisis Over? It Depends on Where You're Standing,* http://www.wrlandconservancy.org/articles/2016/03/18/is-the-cuyahoga-county-foreclosure-crisis-over/ [https://perma.cc/MD2A-5V2X].

[65] Martin Burch et al., *Housing Prices Still Falling for Working-Class Families*, WALL STREET J. (June 23, 2015), http://graphics.wsj.com/underwater-homes/ [http://perma.cc/NM6R-B6KC].

[66] *Id.*

[67] PETER DREIER ET AL., HAAS INST. FOR A FAIR & INCLUSIVE SOC'Y, UNDERWATER AMERICA: HOW THE SO-CALLED HOUSING "RECOVERY" IS BYPASSING MANY AMERICAN COMMUNITIES 6 (2014) [hereinafter HAAS REPORT], http://diversity.berkeley.edu/sites/default/files/HaasInsitute_UnderwaterAmerica_PUBLISH_0.pdf [http://perma.cc/8U6J-7KMH]. Of the 395 zip codes identified as the hardest hit, average home price declines since 2006 were greater or equal to 33% in 82% of the zip codes for which data was available. *Id.*

[68] *See, e.g.*, Kenneth R. Gosselin, *Home Building Remains Sturdy in State*, HARTFORD COURANT (June 26, 2004), http://articles.courant.com/2004-06-26/business/0406260172_1_new-home-sales-home-buyer-interest-permits [http://perma.cc/5QEJ-JFX9] (indicating that Hartford County was among the state's leaders in new building permits and linking demand for new housing with continuing home price increases).

[69] *Hartford Home Prices & Values*, ZILLOW (on file with the Utah Law Review), http://www.zillow.com/hartford-ct/home-values/ (last visited Nov. 12, 2015).

[70] *Id.*

A similar pattern occurred in one of Hartford's immediately adjacent inner-ring suburbs, East Hartford. The median home value in East Hartford also fell dramatically from a pre-Crisis peak of $194,000 in 2007 to $142,000 in December 2014 (approximately 26%), where it has essentially flatlined.[71]

Immediately to the west of Hartford is another inner-ring suburb, West Hartford. Its median home value fell approximately the same dollar amount as the city of Hartford's during the Crisis, although this decline represented only a 10% reduction due to West Hartford's considerably higher home values.[72] Moreover, West Hartford's housing market rebounded strongly starting in 2012 and its median home value is within approximately 4% of its pre-Crisis peak.[73] Drilling one level deeper, in West Hartford's westernmost zip code, the housing market has fully recovered, meaning that homeowners will at least break even upon resale and might even walk away with a profit.[74]

So what explains the differences? It is worth noting that, although these cities are adjoining, they are worlds apart in demographics. Median household income is $28,931 in Hartford,[75] $48,438 in East Hartford,[76] and $81,588 in West Hartford.[77] In other words, one city is poor, one is middle income, and one is affluent. The cities are also quite different in racial composition: Hartford is predominantly African American and Hispanic, East Hartford is racially mixed, and West Hartford is predominantly white.[78] These facts are noteworthy because, in many cases, a community's median income and racial composition are useful indicators of how acutely it was impacted by the Foreclosure Crisis and how well it is recovering.[79]

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[71] *East Hartford Home Prices & Values*, ZILLOW (on file with the Utah Law Review), http://www.zillow.com/east-hartford-ct/home-values/ (last visited Nov. 12, 2015) (showing the value of a median home at $143,900 as of November 2015).

[72] *West Hartford Home Prices & Values*, ZILLOW (on file with the Utah Law Review), http://www.zillow.com/west-hartford-ct/home-values/ (last visited Nov. 12, 2015).

[73] *Id.*

[74] *06107 Home Prices & Values*, ZILLOW (on file with the Utah Law Review), http://www.zillow.com/west-hartford-ct-06107/home-values/ (last visited Nov. 12, 2015).

[75] CERC, HARTFORD, CONNECTICUT: CERC TOWN PROFILE 2014, at 1 (2014) [hereinafter HARTFORD PROFILE], https://www.cerc.com/TownProfiles/Customer-Images/hartford.pdf [https://perma.cc/UK9M-NEWZ].

[76] CERC, EAST HARTFORD, CONNECTICUT: CERC TOWN PROFILE 2014, at 1 (2014) [hereinafter EAST HARTFORD PROFILE], https://www.cerc.com/TownProfiles/Customer-Images/easthartford.pdf [https://perma.cc/JA2N-67PQ].

[77] CERC, WEST HARTFORD, CONNECTICUT: CERC TOWN PROFILE 2014, at 1 (2014) [hereinafter WEST HARTFORD PROFILE], https://www.cerc.com/TownProfiles/Customer-Images/westhartford.pdf [https://perma.cc/5VE2-536L].

[78] HARTFORD PROFILE, *supra* note 75, at 1; EAST HARTFORD PROFILE, *supra* note 76, at 1; WEST HARTFORD PROFILE, *supra* note 77, at 1.

[79] These factors are less determinative in explaining which areas in the sand states experienced home-value declines, as the Foreclosure Crisis affected these states more uniformly. However, recovery of home values, as reflected by zip code negative equity rates, has generally speaking been more robust in higher-median-income zip codes in the sand states than in lower-median-income zip codes. *See* Burch et al., *supra* note 65.

Communities that are not recovering from the Crisis are much more likely to be middle to low income[80] and racially mixed or communities of color.[81]

Why is this? Like the answers to most questions relating to the Foreclosure Crisis, the answer here is multifaceted and a bit complex. An important piece is the impact of subprime lending. Home price declines tended to be worst among those communities most heavily targeted by subprime lenders in the years preceding the Crisis.[82] Subprime lending proliferated in low- and middle-income communities between 2002 and 2005. Mortgage lenders, flush with additional lending capital supplied by the asset securitization markets, sought out new waves of untapped borrowers but utilized subprime mortgages with higher interest rates to cover the higher risk of default associated with borrowers with weaker credit histories, lower income, and smaller down payments.[83] This type of lending also proliferated in certain fast-growing areas with considerable new construction (in particular, in the sand states).[84]

The more aggressive subprime terms proved to be a self-fulfilling prophecy in that they left these borrowers more vulnerable to mortgage default when economic circumstances worsened.[85] Communities with larger shares of subprime borrowers

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[80] Eighty-eight percent of cities with more than 100,000 residents and listed in the Haas Report as the one hundred cities hit hardest by the Foreclosure Crisis have a poverty rate greater than the national poverty rate of 14.5%. HAAS REPORT, *supra* note 67, at 6. The negative equity rate among "low value" homes (those in the bottom one-third tier) remains three times that among "high value" homes (those in the top one-third tier). Gudell, *supra* note 60.

[81] The Haas Report notes that "[i]n 64% of the 395 hardest-hit ZIP codes, African Americans and Latinos accounted for at least half of the population," HAAS REPORT, *supra* note 67, at 4, while they represent just 28.9% of the national population, according to 2010 Census data. *Quick Facts*, U.S. CENSUS BUREAU, http://www.census.gov/quickfacts/table/PST045215/00 [https://perma.cc/HP96-569F] (last visited Jan. 28, 2016); *see also* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 31–32 (2014) (asserting that price drops as a result of the Foreclosure Crisis were three times greater in minority neighborhoods than in white neighborhoods).

[82] Atif Mian & Amir Sufi, The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis 1–2 (Dec. 12, 2008) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1072304 [http://perma.cc/Z927-WZ9F]; *see* Beachy, *supra* note 2, at 19–20 (citing favorably to the Mian and Sufi study in concluding that subprime lending played an important role in causing the Foreclosure Crisis and subprime defaults emanated from zip codes with a higher proportion of subprime borrowing); *see also* HUD REPORT ON FORECLOSURE CRISIS, *supra* note 6, at 12 (stating that two factors stood out in differentiating states hit hardest by the Foreclosure Crisis—higher shares of high-cost loans and larger home price increases in the years preceding the Foreclosure Crisis).

[83] Beachy, *supra* note 2, at 20; *see* Paul S. Calem et al., *The Neighborhood Distribution of Subprime Mortgage Lending*, 29 J. REAL EST. FIN. & ECON. 393, 404–07 (2004).

[84] Chris Mayer & Karen Pence, *Subprime Mortgages: What, Where, and to Whom?* 11 (Fed. Reserve Bd., Working Paper No. 2008-29, 2008), http://www.federalreserve.gov/pubs/feds/2008/200829/200829pap.pdf [https://perma.cc/2YTY-YRAT].

[85] Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the*

had mortgage default rates more than three times larger than those in "prime" zip codes in the same metropolitan areas during the first two years of the Foreclosure Crisis.[86] Numerous studies have demonstrated that each foreclosure has a negative spillover effect on the property values of neighboring properties,[87] and that this effect can be heightened when foreclosures are highly concentrated[88] and occur during housing downturns.[89] Thus it stands to reason that those cities and zip codes pounded early by subprime defaults and foreclosures experienced large home price declines, pushing more mortgages underwater and creating the environment for additional waves of foreclosures and greater price instability.

This phenomenon also has a racial component. Studies of lending-industry data show that African American and Latino borrowers were much more likely than white borrowers of the same risk profile (i.e., credit score, income level, etc.) to be approved for and steered toward a subprime mortgage instead of a more affordable traditional mortgage.[90] Moreover, among mortgages that went into default, lenders foreclosed on the homes of African American and Latino borrowers at a rate nearly double that for white borrowers at the same income level.[91] Recognizing, as the previous paragraph does, that subprime mortgages are more likely to lead to

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Subprime Mortgage Market, 88 FED. RES. BANK OF ST. LOUIS REV. 31, 32 (2006) (citing evidence that as a general matter the propensity of borrowers of subprime loans to default is much higher than for borrowers of prime loans).

[86] Mian & Sufi, *supra* note 82, at 1.

[87] DEBBIE GRUENSTEIN BOCIAN, PETER SMITH, & WEI LI, CTR. FOR RESPONSIBLE LENDING, COLLATERAL DAMAGE: THE SPILLOVER COSTS OF FORECLOSURES 2 (2012) [hereinafter THE SPILLOVER COSTS OF FORECLOSURES], http://www.responsiblelending.org/mortgage-lending/research-analysis/collateral-damage.pdf [https://perma.cc/XCR8-CE7Y] (estimating that residents who lived in close proximity to foreclosures lost $1.95 trillion in property value during the first four years of the Foreclosure Crisis due to the "spillover" cost of a foreclosed property); *see also* Elliot Anenberg & Edward Kung, *Estimates of the Size and Source of Price Declines Due to Nearby Foreclosures*, 104 AM. ECON. REV. 2527, 2527 (2014) (providing "new evidence that foreclosures have a causal effect on nearby house prices"); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 58 (2006) (suggesting that foreclosures "can have implications for surrounding neighborhoods and for larger communities").

[88] John P. Harding, Eric Rosenblatt, & Vincent W. Yao, *The Contagion Effect of Foreclosed Properties*, 66 J. URB. ECON. 164, 164 (2009).

[89] Zhenguo Lin, Eric Rosenblatt, & Vincent W. Yao, *Spillover Effects of Foreclosures on Neighborhood Property Values*, 38 J. REAL EST. FIN. & ECON. 387, 388–89 (2009).

[90] DEBBIE GRUENSTEIN BOCIAN, WEI LI, & KEITH S. ERNST, CTR. FOR RESPONSIBLE LENDING, FORECLOSURES BY RACE AND ETHNICITY: THE DEMOGRAPHICS OF A CRISIS 6 (2010), http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf [https://perma.cc/D4NV-P3T6]; *see also* MONIQUE W. MORRIS, DISCRIMINATION AND MORTGAGE LENDING IN AMERICA: A SUMMARY OF THE DISPARATE IMPACT OF SUBPRIME MORTGAGE LENDING ON AFRICAN AMERICANS, NAACP (2009), http://action.naacp.org/page/-/resources/Lending_Discrimination.pdf [https://perma.cc/C9BU-35RZ]; Mayer & Pence, *supra* note 84, at 12–14; Calem et al., *supra* note 83, at 407.

[91] BOCIAN, LI, & ERNST, *supra* note 90, at 2.

foreclosures than traditional mortgages and that foreclosures force down a community's home prices, these discriminatory lending practices help to explain why price drops in predominantly minority neighborhoods during the Foreclosure Crisis were significantly greater than price drops in predominantly white neighborhoods.[92]

Another part of the answer involves the differences in vulnerability among localized housing markets to a sudden and massive price shock. Using fundamental principles of supply and demand, one might posit that communities in which home values decreased the most during the Foreclosure Crisis would be best poised for recovery as demand for housing recovers. Indeed this bears out in some areas of the country.[93]

Other, lower growth markets, however, have proven to be highly inelastic and much less resilient to the severe blow dealt to them by the Foreclosure Crisis. Unanticipated waves of foreclosures swept through these communities, creating large inventories of vacant and abandoned properties, sucking the vitality out of them, and making it difficult to attract new residents and businesses.[94] Especially in less affluent areas, where local governments were poorer and banks less motivated to invest in protecting properties in foreclosure, property vacancy accelerated rates of tax delinquency, deterioration, vandalism, and crime, which placed further downward pressure on neighboring home values.[95] Large volumes of foreclosure-induced, distressed home sales led to an oversupply on the housing market and the creation of shadow inventories of homes ready to flood markets whenever prices showed signs of recovery.[96] In turn, entrenched lower home values further reduced

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[92] JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 81, at 31–32 (asserting that price drops as a result of the Foreclosure Crisis were three times greater in minority neighborhoods than in white neighborhoods); Michael Fletcher, *A Shattered Foundation: African Americans Who Bought Homes in Prince George's Have Watched Their Wealth Vanish*, WASH. POST (Jan. 24, 2015), http://www.washingtonpost.com/sf/investigative/2015/01/24/the-american-dream-shatters-in-prince-georges-county/ [http://perma.cc/99S5-YGHF] (comparing "housing values in two suburban Washington Zip codes" and finding that in the predominantly black community housing prices have not recovered any of the nearly 50% in lost value, while in the predominantly white community housing prices have recouped two-thirds of lost value).

[93] *See* CHOI, *supra* note 54, at 6 ("Low prices and increased demand for rental properties drew investors to purchase single family homes in markets across the country, particularly in areas with high concentrations of distressed properties," in turn leading to rising home prices and a rapidly shrinking supply of distressed properties "particularly in hot markets around the country.").

[94] *See, e.g.*, Alex Kotlowitz, *All Boarded Up*, N.Y. TIMES MAG. (Mar. 4, 2009), http://www.nytimes.com/2009/03/08/magazine/08Foreclosure-t.html?_r=0 [https://perma.cc/GH7D-SKTG] (describing the toll of these foreclosures on Cleveland, Ohio).

[95] Whitaker & Fitzpatrick, *supra* note 45, at 3; Press Release, Nat'l Fair Hous. All., U.S. Bank Accused of Racial Discrimination in Five More Cities (Nov. 18, 2014), http://www.nationalfairhousing.org/Portals/33/2014-11-18%20US%20Bank%20news%20release.PDF [http://perma.cc/M48R-BC4B].

[96] STEPHAN WHITAKER, FED. RESERVE BANK OF CLEVELAND, FORECLOSURE RELATED

the local property tax base necessary to fund community services,[97] caused banks to stop lending to potential buyers in these neighborhoods, and made current homeowners skittish about investing in improvements to their homes. These conditions acted in concert with such speed and force that they crippled home prices in these communities, causing their housing markets to break rather than bend. In this way, the Foreclosure Crisis acted as much more than a market correction, as some have contended, in which hyperinflated home prices simply reset to reflect their true pre-Crisis value.[98] The Crisis inflicted its own casualties manifested in actual physical damage to homes and neighborhoods beset by foreclosures, as well as underlying harm to the fundamental functioning of certain housing markets.

Nearly a decade removed from the onset of the Foreclosure Crisis, localized housing market statistics speak loud and clear. Some communities were not impacted by the Crisis; many others were impacted but have recovered or are recovering. This Article is concerned with housing markets that have not recovered and in which there appear to be no prospects for a meaningful recovery in the foreseeable future.

Home values in these communities may decline further or flatline. Or they may begin to improve marginally. It is also possible that, with the right combination of sound redevelopment policies, infusions of public or private sector investment, and beneficial external market forces, a more significant increase in values may occur at some point down the road. But all indicators suggest that whatever increases or decreases in home values occur will take place from a new, dramatically lower, normal. It is this transition to a lower value plateau that is the hallmark of the Hardest Hit Communities.

Moreover, at this point, the transition should be considered "permanent." Admittedly, this is a difficult term to apply when it comes to property values. But if the objective is an assessment of homeowner losses, then it is useful to look through the eyes of a homeowner. The tenure of a typical U.S. homeowner historically and at present is somewhere between nine and thirteen years.[99] With the ten-year mark of the onset of the Foreclosure Crisis looming, it is increasingly certain that homeowners in the Hardest Hit Communities who purchased in the years prior to the Crisis or before it fully manifested will not recoup declines in the values of their homes in any meaningful way within that period of time when they might reasonably

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VACANCY RATES, ECON. COMMENT. (2011).

[97] *See, e.g.*, James Alm, Robert D. Buschman, & David L. Sjoquist, *How Do Foreclosures Affect Property Values and Property Taxes?*, LAND LINES, Jan. 2014, at 22, 27–28 (describing this process in Georgia).

[98] *See, e.g.*, Nicole Gelinas, Opinion, *A Free-Market Fix to the Nation's Housing Hangover*, L.A. TIMES (July 31, 2011), http://articles.latimes.com/2011/jul/31/opinion/la-oe-gelinas-foreclosure-california-20110731 [http://perma.cc/9MRZ-4LNQ] (expressing that the market itself will fix housing prices in California); *The Sanctification of Irresponsible Borrowers*, *supra* note 21 (offering several reasons why the federal government should not intervene to save the housing market).

[99] Emrath, *supra* note 25.

be expected to own them. It is in this sense the damage to their home values is rightly considered permanent.

III. AMELIORATIVE RESPONSES TO THE FORECLOSURE CRISIS

Given the scale and scope of the Foreclosure Crisis and the federal government's oversight of the banking and housing sectors, most of the comprehensive responses to the Crisis aimed at easing the blow to U.S. homeowners and communities have come from the federal government. Although successful in tackling certain aspects of the Crisis, a brief look at these efforts shows they have largely overlooked the problem of permanent damage to home values in the Hardest Hit Communities.

A. Types of Responses

The primary ameliorative responses to date can be grouped into four categories based on their objectives: (i) market stabilization, (ii) foreclosure prevention (including principal reduction), (iii) community stabilization, and (iv) tax relief. The first category is *market stabilization*. In the darkest days of the Crisis, the Bush and Obama administrations, working together with Congress, intervened aggressively with several large-scale maneuvers meant to stabilize the country's financial and housing sectors and prevent a total economic collapse.[100] With congressional authorization, the U.S. Treasury Department spent hundreds of billions of federal dollars shoring up government-sponsored mortgage giants Fannie Mae and Freddie Mac.[101] It also made equity purchases in several of the country's largest banks, which were heavily invested in subprime mortgages but deemed too big to fail.[102] The Federal Reserve Board spent another $1.25 trillion to purchase faltering mortgage-backed securities in order to keep interest rates low and housing capital flowing.[103] In 2007, Congress approved homebuyer tax credits, which stayed in place in modified forms through 2010, with the objective of providing a spark to the frozen national housing market.[104] Taken together, these measures helped quell the chaos

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[100] U.S. DEP'T OF THE TREASURY, THE FINANCIAL CRISIS FIVE YEARS LATER: RESPONSE, REFORM, AND PROGRESS 1 (2013), https://www.treasury.gov/connect/blog/Documents/FinancialCrisis5Yr_vFINAL.pdf [https://perma.cc/K6BD-JQ9J].

[101] *FHFA as Conservator of Fannie Mae and Freddie Mac*, FED. HOUSING FIN. AGENCY, http://www.fhfa.gov/Conservatorship/Pages/History-of-Fannie-Mae--Freddie-Conservatorships.aspx [http://perma.cc/L96D-SELC] (last visited Nov. 12, 2015); *see* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1117, 122 Stat. 2654, 2683–88 (codified as amended in scattered sections of the U.S.C.) (authorizing the U.S. Treasury to purchase obligations held by Fannie Mae and Freddie Mac).

[102] *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765, §§ 101–125, 122 Stat. 3765, 3767–93 (codified as amended in scattered sections of 12 and 26 U.S.C.) (implementing the Troubled Asset Relief Program).

[103] Immergluck, *supra* note 21, at 205.

[104] The first-time homebuyer credit was implemented under the Housing and Economic

in the financial sector and kept the national housing market from total collapse. This had a positive spillover effect on everyone involved—investors, lenders, mortgage servicers, and homeowners.

The second category is *foreclosure prevention (including principal reduction)*. Congress authorized the Treasury Department to implement several programs aimed at stemming the tide of foreclosures, grouped under the Department's Making Home Affordable ("MHA") initiatives.[105] Taken together, the MHA initiatives (i) provided inducements to lenders and loan servicers to ease mortgage loan terms, reduce mortgage principals, and sign off on short sales for at risk borrowers, (ii) allowed underwater borrowers to refinance their mortgages at lower interest rates, and (iii) in certain cases, gave short-term financial assistance to borrowers behind on their mortgages due to unemployment or other financial duress.[106] For the most part, lenders balked at the notion of taking the more dramatic and impactful step of reducing what a borrower owed under his or her mortgage. Instead, a large majority of those helped under MHA programs merely refinanced their mortgages at lower interest rates or spread out mortgage payments over a longer horizon.[107]

To some extent, the government learned from MHA's design flaw of expecting lenders to voluntarily agree to lower principals. In its more recent settlements of several consumer and securities fraud lawsuits against the country's largest banks and mortgage servicers arising out of the Foreclosure Crisis, the federal government has required that a portion of the settlement amounts go toward principal reduction.[108] Still, critics have pointed to the flexibility banks have in complying

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Recovery Act of 2008. § 3011, 122 Stat. at 2888–92 (codified as amended at 26 U.S.C. § 36 (2012)). It was later amended and extended by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1006, 123 Stat. 115, 316–17, and the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 11, 123 Stat. 2984, 2989–91.

[105] *See generally* Cong. Oversight Panel, March Oversight Report, The Final Report of the Congressional Oversight Panel (2011).

[106] *Id.*

[107] *See* HOUS. FIN. POLICY CTR., *supra* note 10, at 27 (showing quarterly statistics on MHA loan modification activity, evidencing that on a quarter-by-quarter basis interest rate reductions, interest capitalizations, and term extensions make up the strong majority of modifications).

[108] PHILIP A. LEHMAN, N.C. DEP'T OF JUSTICE, EXECUTIVE SUMMARY OF MULTISTATE/FEDERAL SETTLEMENT OF FORECLOSURE MISCONDUCT CLAIMS 2, https://d9klfgibkcquc.cloudfront.net/NMS_Executive_Summary-7-23-2012.pdf [https://perma.cc/239L-GKAN] (last visited Jan. 25, 2015) (providing that the country's five largest servicers provide up to $10.2 billion in mortgage principal reduction to borrowers who are in default or at risk of default). The U.S. Department of Justice took a similar tack when settling three cases against the nation's largest banks related to their marketing and selling of mortgage-based securities. In total, the settlements allocated approximately $13 billion for "consumer relief," including principal reduction on underwater mortgages. Press Release, Dep't of Justice, Justice Department, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013), http://www.justice.gov/opa/pr/justice-department-

with the settlement agreements and the risk that they will use this to avoid meaningful principal reduction.[109] Other commentators have proposed a variety of creative approaches for overcoming lenders' resistance to principal reduction, but none of these proposals has taken hold on a widespread basis.[110]

The third category is *community stabilization*. To a limited extent, the federal government has sought to address the negative spillover effects on cities and neighborhoods of abandoned and vacant properties left in the wake of the Foreclosure Crisis. Its principal effort in this regard was a temporary enhancement to the Federal Community Development Block Grant program called the Neighborhood Stabilization Program ("NSP"), targeted at neighborhoods most negatively impacted by the Crisis.[111] The NSP rolled out in three rounds of funding to selected state and local governments and nonprofit organizations for projects involving the strategic acquisition and redevelopment or demolition of foreclosed and abandoned properties.[112] Altogether, Congress authorized $7.3 billion in allocations for the NSP before the political will for continued funding waned in 2010.[113] Ultimately, this proved to be only a drop in the bucket given the massive damage caused by the Foreclosure Crisis.[114] As the design of the NSP anticipated,

federal-and-state-partners-secure-record-13-billion-global-settlement [http://perma.cc/5Z MV-RMRL]; Press Release, Dep't of Justice, Justice Department, Federal and State Partners Secure Record $7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014), http://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-7-billion-global-settlement [http://perma.cc/BQ75-64FM]; Press Release, Dep't of Justice, Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014), http://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading [http://perma.cc/GLY9-Q35P].

[109] Jacob Davidson, *Bank of America Is Paying Up for the Mortgage Mess, but Who Will Get the Money*, TIME (Aug. 29, 2014), http://time.com/money/3177343/bank-of-america-mortgage-settlement/ [http://perma.cc/5XJK-X3XT]; Alan Mallach, *Now You See the Money, Now You Don't*, ROOFLINES (Sept. 22, 2014), http://www.rooflines.org/3843/now_you_see_the_money_now_you_dont/ [http://perma.cc/4SSB-VA4T].

[110] *See, e.g.*, Hockett, *supra* note 19, at 1.

[111] COMMUNITY PLANNING AND DEVELOPMENT FUND, COMMUNITY DEVELOPMENT FUND, 2015 SUMMARY STATEMENT & INITIATIVES, at P-10, https://portal.hud.gov/hudportal/documents/huddoc?id=fy15cj_comm_dvlpt_fnd.pdf [https://perma.cc/L2S6-XC6G] (last visited Jan. 29, 2016).

[112] *NSP Eligibility Requirements*, U.S. DEP'T HOUSING & URB. DEV., https://www.hudexchange.info/nsp/nsp-eligibility-requirements [http://perma.cc/8D7A-VKRZ] (last visited Nov. 12, 2015).

[113] *Id.*

[114] Some states ultimately succeeded in convincing the U.S. Treasury Department to redirect a small portion of the funds allocated for foreclosure prevention efforts to fund vacant property demolition costs. *See* Alan Mallach, *Hardest Hit Funds Demolition Policy Change on Track to Become a Boon for Distressed Communities*, CTR. FOR COMMUNITY PROGRESS (July 1, 2014), http://www.communityprogress.net/blog/federal-policy-change-leads-results-ground-hardest-hit-funds-demolish-derelict-houses [https://perma.cc/J48T-

most community stabilization efforts have instead taken place at the local level through initiatives like land banks, strategic demolition, vacant property registration ordinances, and public nuisance lawsuits.[115] Often, however, these initiatives have proceeded without the support of and sometimes even with resistance from the federal government.[116]

The final category is *tax relief*. Congress has provided income-tax relief to many homeowners who struggled with their mortgages as a result of the Foreclosure Crisis and (a) obtained principal reductions from their lenders, (b) sold or transferred their homes to avoid foreclosure, or (c) lost their homes to foreclosure. These transactions often involve the mortgage lender's forgiveness of a portion of the homeowner's debt in an amount roughly equatable to the home's lost value. Congress passed the Mortgage Forgiveness Debt Relief Act of 2007 ("MFDRA"), which as a general matter excluded a homeowner's canceled or reduced mortgage debt from the income tax that would normally apply to it.[117] Approximately 6.9 million mortgage "liquidations" (i.e., foreclosures, short sales,[118] and deeds in lieu of foreclosures[119]) and another 545,000 mortgage principal reductions occurred between 2007 and the end of 2013 alone, and the MFDRA spared many of these homeowners from tax on what the legislation's drafters termed "phantom income."[120] Although the MFDRA originally expired at the end of 2013, Congress has since twice extended it to include mortgage debt forgiven through the end of 2016.[121]

3NYS]. Again, however, the funds approved for redirection were small relative to the task of helping housing markets in the Hardest Hit Communities recover.

[115] David P. Weber, *Zombie Mortgages, Real Estate, and the Fallout for the Survivors*, 45 N.M. L. REV. 37, 50–57 (2014).

[116] *See, e.g.*, Fed. Hous. Fin. Agency v. City of Chi., 962 F. Supp. 2d 1044, 1044 (N.D. Ill. 2013).

[117] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 2, 121 Stat. 1803, 1803–04 (codified at 26 U.S.C. § 108 (2012)).

[118] *See* INVESTOPEDIA, DEFINITION OF REAL ESTATE SHORT SALE. A real estate short sale is a sale of real estate that generates proceeds that are less than what the owner/borrower owes on the property and typically occurs when the lender and borrower decide that selling the property and absorbing a moderate loss is preferable to having the borrower default on the loan. http://www.investopedia.com/terms/r/real-estate-short-sale.asp?layout=orig [https://perma.cc/Z4JL-VP6T].

[119] *See* INVESTOPEDIA, DEFINITION OF DEED IN LIEU OF FORECLOSURE. A deed in lieu of foreclosure is a transaction in which a borrower on a mortgage loan deeds the collateral property to the lender in exchange for the release of all obligations under the mortgage. http://www.investopedia.com/terms/d/deed_in_lieu_of_foreclosure.asp#ixzz4366wHYKT [https://perma.cc/Y5YM-7377].

[120] Laurie Goodman & Ellen Seidman, *The Mortgage Forgiveness Debt Relief Act Has Expired—Renewal Could Benefit Millions*, HOUSING FIN. POL'Y CTR. COMMENT., Feb. 17, 2014, at 1, 2–3. The term "phantom income" was used frequently on the House and Senate floors during discussion of this legislation. *See, e.g.*, 153 CONG. REC. 26,626–27 (2007) (statement of Rep. Cardoza).

[121] Congress most recently extended the provisions of the MFRDA through the end of

B. Critiquing the Responses from the Perspective of the Hardest Hit Communities

The responses to the Foreclosure Crisis detailed above have been, to varying degrees, too limited, too sanguine, and too narrow to adequately address the problem of permanently damaged home values in the Hardest Hit Communities. The market stabilization, community stabilization, and, to a large extent, foreclosure prevention strategies have primarily functioned as efforts to stop the bleeding caused by the Crisis. By aiming to create conditions that theoretically stabilize housing markets and then exiting the stage, each of these strategies assumed that home prices would ultimately rebound on their own and restore most, if not all, of homeowners' lost equity. However, the political will to fund these initiatives began to evaporate as the national housing market ended its freefall, but well before many communities had shown signs of recovering home values.[122] Moreover, as Part II of this Article demonstrated, housing markets in the Hardest Hit Communities suffered such significant structural damage that meaningful home price recovery is at best a longer-term proposition.

The principal reduction and tax relief strategies, on the other hand, address the issue of damage to home values more squarely. Principal reduction accomplishes this by eliminating a portion of the debt that a homeowner owes on her home mortgage to better reflect the home's reduction in market value. For example, consider a homeowner who purchased a home for $200,000 in 2007, took out a mortgage for the entire amount, and has made only interest payments to this point. If the home is now worth $150,000, she has suffered a $50,000 reduction in her net worth. But, if the bank reduces her mortgage principal to $150,000, it completely eradicates her reduction in net worth and effectively resets her purchase price to match the home's reduced value. Furthermore, the MFRDA eliminates the tax that the homeowner would have had to pay on the $50,000 in canceled debt.[123] Assuming she has a marginal income-tax rate of 25%, she has avoided a $12,500 tax bill. As this Article will later explain, the MFRDA allows the taxpayer to avoid tax on a portion of her original purchase price equatable to the home's reduction in value.

While potentially effective at dealing with the problem of permanently damaged home values, banks and mortgage servicers have largely resisted principal reduction. Furthermore, the MHA initiatives incentivized principal reduction for only those homeowners who were in default or at serious risk of default on their mortgages. As a result, they have reached only a small percentage of those whose home values suffered significant damage. The strong majority of homeowners with underwater mortgages have made their regular mortgage payments on time.[124] Others have paid enough on their mortgages that they are not underwater and thus,

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2016 in the Consolidated Appropriations Act. Pub. L. 114-113, 129 Stat. 2242 (2016).

[122] *See generally* Immergluck, *supra* note 21, at 218 (discussing the congressional climate regarding financial crisis legislation from 2009 to 2012).

[123] 26 U.S.C. § 108(a)(1)(E) (2012).

[124] Gudell, *supra* note 18.

are even more likely to be making payments on time. Plus, about one-third of all homeowners do not have a mortgage.[125] In the Hardest Hit Communities, the Foreclosure Crisis caused significant and permanent home-value damage for all homeowners, but most have not been and are not candidates for principal reduction nor, more importantly for purposes of this Article, for the exclusion from tax of their homes' damaged values that the MFRDA essentially provides. Taken as a whole, the responses to the Crisis have, to date, largely overlooked these homeowners.

IV. TAX CODE TREATMENT OF PERSONAL LOSSES

This Part summarizes how the IRC treats personal losses and why, as preparation for proposing how permanent damage to home values in the Hardest Hit Communities ought to be treated. It is helpful to also include here some discussion of the IRC's treatment of personal expenses, as there is a close correlation between the two.

A. The General Rule

As a general rule, a taxpayer's personal expenses and losses, including a decline in the value of her home or other property she uses for personal purposes, are not deductible from taxable income.[126] Put another way, a taxpayer must pay for personal-use goods and services (a.k.a. consumption) with dollars that are taxed. This is in contrast to a taxpayer's expenses and losses that arise from operating a business or pursuing other profit-seeking activities, which are, as a general matter, deductible[127] because they are viewed as outlays necessary to generate income.[128] In short, the cost of earning a living is deductible, but the cost of living is not.[129]

This is consistent with the widely acknowledged Haig-Simons definition of income,[130] paraphrased as the change in a person's wealth plus her consumption

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[125] *Id.*

[126] 26 U.S.C. §§ 165, 262.

[127] *Id.* §§ 162, 165.

[128] MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 117 (13th ed. 2015).

[129] Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 952 (1967).

[130] The Haig-Simons definition is the refinement by Henry C. Simons of a definition of income set forth by Robert M. Haig. Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 7 (Robert Murray Haig ed., 1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). It is the most commonly accepted definition of income among economists, and it provides a baseline for evaluating the equity of an income tax. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 84 (7th ed. 2013); David G. Duff, Rethinking the Concept of Income in Tax Law and Policy 2 (unpublished manuscript) (on file with the Utah Law Review), http://taxprof.typepad.com/taxprof_blog/files/Duff.pdf [https://perma.cc/R873-CEJY] (last visited Feb. 7, 2016).

during a taxable period.[131] The use of an income tax to allocate society's tax burden is premised on the notion that a taxpayer's accessions to wealth (i.e., income) are a fair measure of her ability to pay taxes.[132] As a general matter, personal income is either saved or consumed.[133] So consumption must be included in a taxpayer's income-tax base in order to accurately calculate the taxpayer's income and to avoid unfairly preferencing those who spend more of their income rather than save it.[134]

While elegant in its simplicity, the rule against the deductibility of personal losses is imprecise.[135] First, it makes an asset's purpose an all-or-nothing classification.[136] Even if a taxpayer acquires an asset for both personal use and with the expectation that it will appreciate and be sold for a profit, the asset is classified as used for one or the other purpose based on the taxpayer's primary motive.[137] For example, the IRC assumes that a taxpayer's primary residence is a personal-use asset.[138] The reality of course is that most homeowners purchase their home with an eye toward more than just using it as a place to live. It is also an investment that they expect over time will appreciate in value.[139]

Second, once an asset has been classified as for personal use, all of its loss in value will be attributed to personal consumption.[140] This is an inexact assumption. A car may lose value due to wear and tear from its anticipated use. Or it may lose value for reasons wholly unrelated to the taxpayer's use and enjoyment of it (e.g., market demand for that particular type of car decreases sharply because the public becomes aware that its air bags don't properly deploy). In the first scenario, the car's lost value clearly reflects consumption; in the second scenario, the lost value does

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[131] SAMUEL A. DONALDSON & DONALD B. TOBIN, FEDERAL INCOME TAX: A CONTEMPORARY APPROACH 58 (2012); Gilbert E. Metcalf, *Consumption Taxation*, TAX POL'Y CTR., http://www.taxpolicycenter.org/taxtopics/encyclopedia/Consumption-Taxation.cfm [http://perma.cc/7VCQ-XV4Z] (last visited Nov. 12, 2015).

[132] Julio Escolano, *Taxing Consumption/Expenditure Versus Taxing Income*, *in* TAX POLICY HANDBOOK 50, 51 (Parthasarathi Shome ed., 1995).

[133] *See, e.g.*, PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 408 (19th ed. 2010).

[134] *See, e.g.*, Joel S. Newman, *Of Taxes and Other Casualties*, 34 HASTINGS L.J. 941, 949 (1983).

[135] *See* Boris I. Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 203–04 (1973); Daniel I. Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unresolved Problem*, 122 U. PA. L. REV. 859, 859–62 (1974).

[136] *See* Helvering v. Nat'l Grocery Co., 304 U.S. 282, 289 n.5 (1938); Austin v. Comm'r, 298 F.2d 583, 584 (2d Cir. 1962).

[137] *Austin*, 298 F.2d at 584.

[138] CHIRELSTEIN & ZELENAK, *supra* note 128, at 400.

[139] *See, e.g.*, Eric S. Belsky, *The Dream Lives On: The Future of Homeownership in America* 4–6 (Joint Ctr. of Hous. Studies, Harvard Univ., Working Paper No. W13-1, 2013) (citing several surveys gauging American attitudes toward home ownership and finding that the belief that home ownership is a good long-term investment continues to be widely held even after the Foreclosure Crisis).

[140] CHIRELSTEIN & ZELENAK, *supra* note 128, at 117.

not arrive from any meaningful use by its owner and so its connection to consumption is debatable.[141] Nevertheless, the IRC treats these scenarios identically by not allowing a deduction for either.[142]

B. The Casualty-Loss and Theft Exceptions

As with many general rules in the tax code, there are exceptions. The IRC permits deductions for personal losses in some circumstances. The principal exceptions are the deductions provided under IRC § 165(c)(3) for uninsured damages to a taxpayer's personal property arising from disasters and other casualties like storms, fires, and floods, and from theft.[143] For casualty losses, the amount deductible is the property's reduction in fair market value caused by the casualty (or, alternatively, the cost of restoring the property to its precasualty condition), subject to certain statutory and basis limitations.[144] The net effect is that a portion of the dollars the taxpayer spent on personal consumption (i.e., to purchase the property) equatable to the damage incurred is removed from the tax base via a deduction.

Some assert that the casualty-loss and theft deductions are examples of "tax expenditures."[145] In essence, tax expenditures are special exceptions to how the income tax is normally assessed meant to provide tax benefits to particular taxpayers.[146] Seen in this light, § 165(c)(3) is a tax subsidy aimed at aiding those

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[141] There is some debate among theorists over whether consumption is understood to mean the opportunity to consume or actual consumption. Some argue for viewing losses to personal assets using an ex ante approach in which consumption is measured at the moment the taxpayer makes a consumption expenditure and before the asset experiences losses in value. *See, e.g.*, Daniel Halperin, *Valuing Personal Consumption: Cost Versus Value and the Impact of Insurance*, 1 FLA. TAX REV. 1, 12–28 (1992). A more conventional view and one that I subscribe to in this Article is that consumption should be measured based on the taxpayer's use and enjoyment of the goods and services at issue. *See, e.g.*, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 313 (1972); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* READINGS IN THE ECONOMICS OF TAXATION 54, 55 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

[142] 26 U.S.C. § 165(a), (c) (2012).

[143] Technically it is 26 U.S.C. § 165(a) that provides for the deduction for individual losses, but since it is § 165(c)(3) that describes casualty losses, this Article will refer to the latter in discussing the casualty-loss deduction.

[144] *Id.*; Treas. Reg. §§ 1.165-7, 1.165-8 (2014) (setting forth the amount deductible). For statutory limitations, see 26 U.S.C. § 165(h)(1), (2) and *infra* Part VII. Furthermore, the amount deductible cannot exceed the property's "adjusted basis prescribed in § 1.1011-1 for determining the loss from the sale or other disposition of the property involved." Treas. Reg. § 1.165-7(b)(1)(ii); *see infra* note 306 and accompanying text.

[145] *See, e.g.*, STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 21–23, 193 (1973) (asserting that personal-tax deductions are not refinements to the concept of income, but rather tax subsidies).

[146] GRAETZ & SCHENK, *supra* note 130, at 39–45 (including an excerpt from STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 (Comm. Print 2013)). Tax expenditures also included tax credits,

who have suffered damage to or theft of their property by partially offsetting their losses. Proponents of this line of thinking might call for eliminating these deductions if, on review, they are determined to be inefficient ways of delivering relief to those harmed by a casualty or theft or not of sufficient value to taxpayers relative to the loss in tax revenue that they cause.[147]

Others justify these deductions as necessary to accurately measure a taxpayer's income.[148] One rationale proffered for viewing the casualty-loss and theft deductions as "normative" tax provisions is that losses caused by these events do not arise from the taxpayer's consumption of the property.[149] Consider a taxpayer who is robbed of $2,000 in cash in a burglary and is not insured for this loss. Clearly the money has been removed from the taxpayer's store of wealth, but not due to any meaningful act of consumption by the taxpayer.[150] Applying the Haig-Simons definition of income, a reduction in wealth not attributable to consumption should be deducted from the taxpayer's income-tax base.[151]

This rationale applies identically to an errant shot from a BB gun that breaks an antique window on a taxpayer's house worth $2,000. If uninsured, the taxpayer incurs a reduction in her wealth, and, if it is not attributable to her personal consumption, then under Haig-Simons it is deductible.[152] Of course, the same might be argued for other market value declines not directly attributable to personal consumption (like changes in consumer preferences), but the IRC does not as a general matter allow for their deduction. So the deductions allowable under § 165(c)(3) could be explained as instances of Congress recognizing the IRC's imprecision in its general treatment of all declines in value in personal-use assets as consumption (referred to in this Article as the "nonconsumption rationale").

A closely related, though not entirely identical, normative rationale is premised on the taxpayer's ability to pay tax on the amount taken via casualty or theft.[153] As noted earlier, an assumption underlying the adoption of an income tax in the IRC is that it provides the best measurement of a taxpayer's ability to pay taxes and that ability to pay considerations should guide Congress in determining how the IRC defines taxable income.[154] Returning to the example of the taxpayer robbed of

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preferred tax rates, and tax deferrals. *Id.* at 39.

[147] *See* SURREY, *supra* note 145, at 179–203.

[148] *See generally* BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 24.01 (3d ed. 2002) (discussing rationales for casualty deductions).

[149] *See, e.g.*, Bittker, *supra* note 135, at 196–99; Richard A. Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code*, 23 STAN. L. REV. 454, 471–72 (1971).

[150] GRAETZ & SCHENK, *supra* note 130, at 362.

[151] Bittker, *supra* note 135, at 196–99; John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203, 244–45 (2011).

[152] Bittker, *supra* note 135, at 196–99.

[153] BITTKER ET AL., *supra* note 148, at ¶ 24.01; GRAETZ & SCHENK, *supra* note 130, at 361; Newman, *supra* note 134, at 942–45.

[154] *See supra* note 132 and accompanying text.

$2,000, because she no longer possesses the $2,000, she theoretically has no money with which to pay the taxes on it. Stolen property (or property damaged by a casualty) is a sudden, unexpected and unusual subtraction from the taxpayer's net worth and likewise a reduction in her ability to pay taxes that she could not have anticipated. Accordingly, it should be removable from her taxable income (referred to in this Article as the "ability to pay rationale"). In its limited mentions of the justification for the casualty-loss and theft deductions, Congress refers to § 165(c)(3) as motivated by ability to pay concerns.[155]

C. Ad Hoc Interventions

Congress has also made temporary and ad hoc modifications to the IRC in other cases to allow taxpayers experiencing significant, personal, financial harm caused by sudden, unexpected and unusual forces to remove otherwise taxable personal consumption dollars from their income-tax bases. It is worth pausing at this point to note that the IRC provides two closely related mechanisms for removing dollars from taxable income—exclusions from income and deductions.[156] The difference between them is principally a matter of timing. An exclusion prevents specified dollars from entering the pool of gross income in the first place, while a deduction subtracts specified dollars from gross income in the course of computing taxable income.[157] But the objective is the same: the removal of certain dollars from the tax base that Congress has determined should not be taxed.

That said, a good example of this type of *ad hoc* intervention is when Congress has excluded certain discharged consumer debt from income tax. Normally, a taxpayer must pay tax on all dollars that she borrows to pay for personal consumption (e.g., a mortgage on a home) because they are treated like any other dollar spent on consumption.[158] Via the IRC, the borrower pays this tax not when she receives the loan, but as she repays it with after-tax dollars.[159] When a lender

[155] S. REP. NO. 97-494, at 115–16 (1982) (invoking "ability to pay" multiple times as the rationale for the deductions); S. REP. NO. 88-830, at 57 (1964) (stating "casualty and theft losses will continue to be deductible (over the $100 [threshold]) in those cases where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes").

[156] GRAETZ & SCHENK, *supra* note 130, at 211.

[157] *Id.* Because they arise at different points in the process, some deductions are subject to floors and limits that prevent removal of the full amount and thus an exclusion from income is often more advantageous to a taxpayer than a deduction. *Id.*

[158] 26 U.S.C. § 108(a)(1)(E), (a)(2)(C), (h) (2012).

[159] CHIRELSTEIN & ZELENAK, *supra* note 128, at 61; *The Housing Decline: Extent of the Problem and Potential Remedies: Hearing Before the S. Comm. on Fin.,* 110th Cong. 7, at 38–39 (2007) [hereinafter *Hearing: The Housing Decline*] (statement of Deborah A. Geier, Professor of Law, Cleveland-Marshall College of Law, Cleveland State University).

cancels some or all of this debt, the IRC still taxes the borrower on the amount discharged, recognizing that otherwise dollars the borrower received and presumably spent on personal consumption would be removed from the tax base.[160]

In the wake of Hurricane Katrina in 2005 and several catastrophic weather events that plagued the Midwest in 2008, Congress excluded from tax, subject to certain limitations, cancelled personal consumption debt (including home mortgages) for those taxpayers with primary residences in areas heavily damaged by these events who either did or were assumed to have suffered "economic loss" as a result.[161] Pursuant to the MFRDA (discussed in Part III), Congress did likewise for certain homeowners whose lenders cancelled a portion of their home-mortgage debt during and in the wake of the Foreclosure Crisis.[162] Both of these measures allowed borrowers to remove what would otherwise be considered personal-consumption dollars from their tax base.

Congressional testimony in support of the MFRDA made clear the normative income-tax links between the need for this remedy and the decrease in home values due to the Foreclosure Crisis. The testimony of a tax expert explained that in many cases home values fell during the Foreclosure Crisis not due to personal consumption, but instead due to unusual market forces.[163] Accordingly, the cancelled debt that corresponded to this unusual drop in value and would normally represent taxable consumption should not be taxed as a normative matter.[164] Several members of Congress identified the hardship to and inequity of taxpayers having to pay tax on debt discharge income that emanated from their homes' sudden and unexpected losses in value (what many termed "phantom income").[165] This testimony reflects the same nonconsumption and ability to pay rationales I identified earlier as backstopping the casualty-loss deduction.

D. Summary

So the answer to how the tax code treats personal losses is somewhat complex. As a general rule, a taxpayer cannot deduct personal losses because they represent consumption.[166] For this reason, a taxpayer cannot normally deduct reductions in her

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[160] CHIRELSTEIN & ZELENAK, *supra* note 128, at 61.

[161] Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, § 401, 119 Stat. 2016, 2026–27; Heartland Disaster Tax Relief Act of 2008, Pub. L. No. 110-343, § 702(e)(4), 122 Stat. 3765, 3918.

[162] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. 110-142, § 2, 122 Stat. 1803, 1803–04 (codified at 26 U.S.C. § 108(a)(1)(E)(h) (2012)).

[163] *Hearing: The Housing Decline*, *supra* note 159, at 45.

[164] *Id.*

[165] *See, e.g.*, 153 CONG. REC. 35,952 (2007) (statement of Rep. Jones) ("Under current law, if your [h]ouse is under foreclosure and the bank discharges your debt, you receive a tax bill. . . . The resolution we consider today rectifies that disconnect so that if a person's principal residence lost value, that loss won't give rise to a tax liability.").

[166] *See supra* Part IV.A.

home's value upon the sale of her home or at any other time.[167] As noted earlier, attributing all declines in the value of personal-use assets to personal consumption is overbroad and fails to account for losses in value attributable to other factors.[168] There is a long-standing exception to the general rule for losses in the value of personal-use property damaged or taken due to casualties, disasters, and thefts.[169] Also, Congress has stepped in on other occasions to allow taxpayers who have suffered personal financial harm due to particular sudden, unexpected and unusual events to exclude other amounts from their tax base that would normally represent personal consumption.[170]

One plausible interpretation of these exceptions and interventions is that they are each independent tax expenditures enacted by an occasionally benevolent Congress as a public subsidy to those afflicted by certain calamities. The stronger position is that they reflect an overarching recognition, however inconsistent and sometimes inexact,[171] that significant personal losses brought about by sudden, unexpected and unusual forces should, as a normative matter, be deducted from taxable income. The casualty-loss deduction is a long-standing and permanent component of the country's income tax.[172] Moreover, the exclusion of casualty losses from income squares comfortably with the Haig-Simons definition of income and the ability to pay concept that is intrinsic to the IRC.[173] In its rare statements on the matter, congressional legislative history uses a normative explanation.[174] The more recent ad hoc interventions are conceptually similar adjustments to taxable income justified by the same normative rationales as casualty losses and thus, can be thought of as sporadic offshoots of the IRC's approach to casualty losses.

Ultimately, it is not critical to the argument that follows that the normative interpretation carry the day. A quest for horizontal equity drives this Article's argument that homeowners in the Hardest Hit Communities should be able to deduct the permanent damage to their home values and horizontal equity considerations would apply under either interpretation. Recognizing the normative basis for the

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[167] Treas. Reg. § 1.165-9 (2014).

[168] *See supra* Part IV.A.

[169] *See supra* Part IV.B.

[170] *See supra* Part IV.C.

[171] *See, e.g.*, AM. INST. OF CPAS, NATURAL DISASTERS: THE CASE FOR PERMANENT TAX RELIEF 3 (2015), https://www.aicpa.org/advocacy/tax/downloadabledocuments/automatic-tax-relief-for-natural-disaster-victims-brochure.pdf [https://perma.cc/GL6A-7PEN] (providing commentary on the inequity of Congress providing tax relief via exclusion of debt discharge income and enhanced casualty-loss deductions, among other provisions for some catastrophic weather events but not others).

[172] Inclusion of a casualty-loss and theft deduction dates to the first iterations of the modern Internal Revenue Code. *See* Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167 (providing a deduction for losses to personal property from fire, shipwreck and storm).

[173] *See, e.g.*, Janet Stotsky, *The Base of the Personal Income Tax*, *in* TAX POLICY HANDBOOK, *supra* note 132, at 121, 123; William J. Turnier, *Evaluating Personal Deductions in an Income Tax—The Ideal*, 66 CORNELL L. REV. 262, 272 (1981).

[174] *See supra* note 155 and accompanying text.

IRC's approach to casualty losses does, however, arguably make this Article's central proposal more compelling. Read through this lens, the proposal is about more than simply achieving consistency with recent Congressional interventions; it is also about correctly measuring taxable income.

V. THE CASE FOR TREATING DAMAGE TO HOME VALUES IN HARDEST HIT COMMUNITIES AS PERSONAL CASUALTY LOSSES

Permanent damage to home values in the Hardest Hit Communities merit treatment as deductible casualty losses under the IRC. As explained below, the Foreclosure Crisis satisfies the principal qualitative jurisprudential standards for what constitutes a casualty. And yet, most relevant IRS rulings and judicial precedent indicate that a casualty-loss claim in this context would be rejected because the resulting damage is not physical. This Part will call into question the explanations for this distinction.

Furthermore, allowing a deduction for homeowners in the Hardest Hit Communities is wholly consistent with the normative rationales that justify the deduction of casualty losses under an income tax. Accordingly, horizontal equity considerations prescribe that these homeowners be put on equal tax footing with others whose home values are damaged by a sudden, unexpected and unusual force. This Part also sets forth this argument.

A. *Prologue: The Foreclosure Crisis as Catastrophe*

As the Foreclosure Crisis reached its apex, commentators, pundits, and politicians seemingly passed on no opportunity to liken the Crisis to a physical disaster. In 2007, CNN first identified an "epicenter" of the Crisis in Cleveland, Ohio.[175] The national commission charged by Congress with investigating the causes of the Crisis published a report of its findings rife with apocalyptic imagery like "seismic proportions," "the flame of contagion," "human disaster," and "catastrophe" to describe the immediate impact of the Crisis.[176] Since then, studies have measured the "collateral damage" of the Crisis,[177] cataloged "hot spots,"[178] and contended that the Crisis is "still burning."[179] But perhaps no term has been more ubiquitous in association with the Crisis than "underwater."[180] In describing the loan-to-value condition of nearly one-third of American mortgages at the worst of the Crisis, the word is also apt imagery for the manner in which the Crisis suddenly and indiscriminately overwhelmed household finances when home prices fell and

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[175] Les Christie, *Where Cleveland Went Wrong*, CNN MONEY (Nov. 14, 2007, 3:44 PM), http://money.cnn.com/2007/11/12/real_estate/Cleveland_foreclosure_factors [http://perma.cc/6TUD-P6F4].

[176] *See* FINANCIAL CRISIS INQUIRY COMMISSION REPORT, *supra* note 6, at xv.

[177] *See* THE SPILLOVER COSTS OF FORECLOSURES, *supra* note 87, at 2.

[178] *See* HAAS REPORT, *supra* note 67, at 11.

[179] ElBoghdady, *supra* note 16.

[180] *See, e.g.*, HAAS REPORT, *supra* note 67, at 5.

the wreckage left behind in many communities as the acute phase of the Crisis began to recede.

It is more than just a penchant for analogy that has caused the Foreclosure Crisis to be described in such dramatic fashion. The fact that natural disasters usually carry with them a loss of life makes a full comparison with a financial crisis hard to make. But there is little arguing that the physical and financial impact on many of the Hardest Hit Communities has resembled that of a disaster scene. For sake of comparison, Hurricane Katrina, which by most accounts was the worst natural disaster in United States history, caused $100 billion in property damage and $250 billion in total economic loss, displaced 770,000 people from their homes and destroyed or made uninhabitable 300,000 homes.[181] The Foreclosure Crisis has caused trillions of dollars in lost homeowner equity and household wealth, resulted in 5 million U.S. households losing their homes and accelerated home vacancy and abandonment in certain cities and neighborhoods at record rates.[182] Of course, one might contend that the Foreclosure Crisis affected the entire United States, which might dilute its impact on any one area. But as Part II documented, the Crisis impacted some areas far worse than others, causing depopulation and physical deterioration on par with areas afflicted by a natural calamity. Accordingly, one would be hard-pressed to argue that the impact of the Crisis on the Hardest Hit Communities was anything less than catastrophic.

B. The Scope of the Personal Casualty-Loss Deduction

Section 165(c)(3) of the IRC provides some balm for those who suffer property loss or damage due to an unexpected and damaging outside force. As noted earlier, it allows a taxpayer a deduction from taxable income, subject to certain statutory and basis limits, for unreimbursed losses on personal-use property caused by "fire, storm, shipwreck, or other casualty."[183] Little controversy has arisen from claims for the deduction arising out of major motion picture style natural events like hurricanes, tornados, earthquakes, and ice storms, all of which clearly fall within the statute's scope. By contrast, significant debate (and litigation) has resulted from alleged casualties that are slower acting,[184] man-made,[185] and mundane.[186] In almost every such debate, the IRS has initially taken the stingiest position on what qualifies as a casualty loss and put the onus on the courts to expand the definition.[187]

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[181] Kimberly Amadeo, *Hurricane Katrina Facts: Damage and Economic Effects*, ABOUT NEWS, http://useconomy.about.com/od/grossdomesticproduct/f/katrina_damage.htm [http://perma.cc/Z4UB-FW2C] (last updated Oct. 21, 2015).

[182] *See supra* Part II.

[183] 26 U.S.C. § 165(c)(3) (2012).

[184] *E.g.*, Rev. Rul. 90-61, 1990-2 C.B. 39; Weyerhaeuser Corp. v. United States, 32 Fed. Cl. 80, 97–99 (1994) (addressing damage to timber by southern pine beetles).

[185] *E.g.*, Shearer v. Anderson, 16 F.2d 995, 996 (2d Cir. 1927) (addressing damage to claimant's automobile alledgedly due to another's faulty driving).

[186] *E.g.*, White v. Comm'r, 48 T.C. 430, 434 (1967) (addressing a lost wedding ring).

[187] *See supra* notes 184–186.

Disagreement over the scope of the deduction typically stems from the fact that neither the IRC nor any of its clarifying regulations define what is meant by "or other casualty." With nowhere else to turn but the plain meaning of the term "casualty," courts frequently invoke the interpretive principle of *ejusdem generis* ("of the same kind")[188] in interpreting the phrase to mean other events that share the common characteristics of fires, storms, and shipwreck.[189] Drawing from case law, the IRS has identified broadly what these characteristics are. Revenue Ruling 72-592 sets forth the agency's position that a "casualty" is an identifiable event that causes damage and is "sudden, unexpected and unusual."[190] Also relevant, but certainly no more definitive, is the very limited legislative history explaining the purpose of the deduction as for "those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living."[191]

The absence of an explicit definition and the wide range of events that cause some form of damage to property has resulted in case law that is, in the words of one court, "difficult to reconcile with others either in result, theory, or language."[192] Just a few highlights of the head-scratching distinctions include conclusions that overheated home boilers cause casualty losses,[193] but overheated car engines do not;[194] a husband who accidentally slammed a car door on his wife's finger, jarring loose the diamond from her wedding ring, caused a deductible casualty loss,[195] while another who accidentally flushed his wife's ring down the toilet was merely careless and could not claim a deduction;[196] and the disappearance of a U.S. citizen's household possessions while in transport in Iran in 1979 resulted in a casualty loss likely attributable to civil unrest and violence,[197] while the East German government's seizure of a U.S. citizen's newly purchased Volkswagen was a despotic act but not a casualty.[198] In other instances, judicial and administrative interpretations of whether a particular force qualifies as a casualty have evolved, reversed course, or received different treatment among jurisdictions.[199] One

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[188] "A canon of construction holding that when a general word or phrase follows a list of specifics, the general word or phrase will be interpreted to include only items of the same class as those listed." *Ejusdem Generis*, BLACK'S LAW DICTIONARY (10th ed. 2014).

[189] United States v. Rogers, 122 F.2d 485, 485 (9th Cir. 1941); Keenan v. Bowers, 91 F. Supp. 771, 774–75 (E.D.S.C. 1950).

[190] Rev. Rul. 72-592, 1972-2 C.B. 101; *see also* Matheson v. Comm'r, 54 F.2d 537, 539 (2d Cir. 1931) (stating that casualty "is an event due to some sudden, unexpected, or unusual cause").

[191] S. REP. NO. 88-830, at 57 (1964).

[192] Heyn v. Comm'r, 46 T.C. 302, 309 (1966).

[193] *Keenan*, 91 F. Supp. at 774.

[194] Newton v. Comm'r, 57 T.C. 245, 248 (1971).

[195] White v. Comm'r, 48 T.C. 430, 433–34, 438 (1967).

[196] *Keenan*, 91 F. Supp. at 775.

[197] Clem v. Comm'r, 62 T.C.M. (CCH) 586, 589 (1991).

[198] Powers v. Comm'r, 36 T.C. 1191, 1192–93 (1961).

[199] *See, e.g.*, Rev. Rul. 63-232, 1963-2 C.B. 97 (cataloguing cases and rulings showing the IRS reversing its position and splits among courts on termite damage).

commentator has attributed this inconsistency to a central flaw in the statute—namely, that it seeks to make a form of economic loss deductible from the tax base by utilizing an incomplete list of forces that cause the loss, rather than by more carefully describing the nature of the loss itself.[200] In any case, the concept of "casualty loss" is hardly airtight, but instead subject to interpretation in accordance with IRC §165(c)(3)'s inexact language and the broad principles underlying its adoption.

C. *"Sudden, Unexpected and Unusual"*

The definition in IRS Revenue Ruling 72-592 is the starting point for most assessments of whether an event is a casualty. It provides in pertinent part that a casualty must result from an event that is "sudden, unexpected and unusual" and that:

> To be 'sudden' the event must be one that is swift and precipitous and not gradual or progressive.
>
> To be 'unexpected' the event must be one that is ordinarily unanticipated that occurs without the intent of the one who suffers the loss.
>
> To be 'unusual' the event must be one that is extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred, and one that does not commonly occur in the ordinary course of day-to-day living of the taxpayer.[201]

The Foreclosure Crisis easily satisfies two out of the three components of this definition. First, it was unexpected. The likelihood of a total collapse of the housing market certainly eluded the attention of most mortgage and housing industry experts, government regulators, and investors at large.[202] Thus, it would be hard to argue that the average homeowner could or should have expected the Crisis. Furthermore, the decline in home values spurred by the Crisis was of a magnitude that far exceeded any other in recorded U.S. history and reversed a long-running trend of price appreciation in the housing market.[203] So, it was also clearly unusual.

Open to some debate, on the other hand, is the question of whether the Crisis was sudden enough to qualify as a casualty. The IRS defines "sudden" in this context

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[200] *Federal Income Tax: The Dilemma of the Casualty Loss Deduction*, 1961 DUKE L.J. 440, 444–45 (1961).

[201] Rev. Rul. 72-592, 1972-2 C.B. 101.

[202] *See, e.g.*, FINANCIAL CRISIS INQUIRY COMMISSION REPORT, *supra* note 6, at 3 (noting that several banking industry experts and regulators referred to the collapse in home prices as completely unanticipated).

[203] *See* SHILLER, *supra* note 3, at 13 fig.2.1.

as "swift and precipitous, and not gradual or progressive."[204] The IRS often gauges suddenness in terms of hours and days.[205] Courts have drawn a similar line, refusing to classify as casualties events that cause progressive deterioration through a "steadily operating cause," including rust, corrosion, and decay.[206]

The Foreclosure Crisis presents a dilemma in this regard. Its full impact was not experienced in a matter of moments, as are most accidents, or in a matter of hours or days, as is true of most natural calamities. There was no singular moment at which the Crisis began. Rather, it developed through a series of events that unfolded over several months, impacted different regions of the country at different points in time, and caused damage over a period of years.[207] The IRS would almost certainly challenge classification of the Crisis as a casualty on these grounds.

Three considerations should weigh heavily in supporting the argument that the Foreclosure Crisis was in fact a sudden event. The first is that courts have not interpreted "suddenness" according to any fixed period of time, but instead addressed the issue on a case-by-case basis. The case law concedes that casualty losses "may exist in a variety of backgrounds in respect of which the rapidity and detection of the damage may vary considerably . . . ."[208] Droughts, pests, and diseases are all examples of more prolonged events that have caused substantial litigation and divergent results over whether they qualify as casualties.[209] Often determinative in these cases is whether the damaging event in question occurred in a manner that is sudden relative to how similar events typically unfold.[210] As noted earlier, when viewed relative to prior economic downturns and variations in home price values over the long-term, the onset of the Foreclosure Crisis was incredibly rapid and its impact unusually sharp.

The second consideration is the unresolved position of the jurisprudence on how quickly damage resulting from a casualty must manifest in order for it to be considered part of a casualty loss. The current formal stance of the IRS is that not only the precipitating event, but also the damage, must occur suddenly (the so-called "elapsed time theory").[211] It has used the elapsed time theory to disregard casualty-loss claims for damages that invasive pests have caused to trees and structures that

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[204] Rev. Rul. 72-592, 1972-2 C.B. 101.

[205] *See, e.g.*, Marx v. Comm'r, 62 T.C.M. (CCH) 1370, 1373 (1991) (overruling IRS determination that faulty roof repair and resulting damage from rainfall a few weeks later was not sudden enough to qualify as a casualty); Nelson v. Comm'r, 27 T.C.M. (CCH) 158, 162 (1968) (overruling IRS determination that a mass attack of beetles that killed trees in five to ten days was not sudden enough to qualify as a casualty).

[206] Fay v. Helvering, 120 F.2d 253, 253 (2d Cir. 1941) (per curiam).

[207] *See supra* Part II.

[208] Kilroe v. Comm'r, 32 T.C. 1304, 1306 (1959).

[209] *See* BITTKER ET AL., *supra* note 148, at ¶ 24.02 n.11.

[210] Rosenberg v. Comm'r, 198 F.2d 46, 47 (8th Cir. 1952); Hoppe v. Comm'r, 42 T.C. 820, 823–24 (1964); *Kilroe*, 32 T.C. at 1306.

[211] Dale Lee Berg, III & Robert A. Swiech, *Identifying the Correct Kind of Loss Resulting from Mountain Pine Beetle Damage*, 114 J. TAX'N 244, 247–48 (2011).

did not occur immediately after the invasion.[212] However, the IRS only arrived at this stance after several reversals of position, including a period of time when it subscribed to the contrary theory. Known as the "onset theory," it focuses only on the suddenness of the precipitating event and allows casualty-loss deductions in subsequent years when residual damage manifests.[213] Courts have not uniformly adopted the elapsed time theory and the most recent court to consider the issue adhered to the onset theory in recognizing casualty losses claimed in a year subsequent to the one in which a pine beetle attack ravaged a taxpayer's timber inventory.[214] The Foreclosure Crisis resembles casualties in case law that subscribes to the onset theory in that the shock to the mortgage industry that instigated the Crisis occurred relatively quickly, setting into motion damage that manifested over a longer period of time.

Finally, and perhaps of greatest consequence, is the demonstrated willingness of the IRS to deviate from its own stance on suddenness. In 2010, the IRS, acting by administrative fiat and in cooperation with the Department of Treasury, issued a Revenue Procedure recognizing the casualty-loss claims of homeowners who, over an eight-year period, installed defective imported drywall.[215] The drywall had a corrosive effect on the electrical wiring and copper components of household appliances in the homes in which it was used.[216] These types of damages manifested gradually and so would have presumably precluded a claim of a casualty loss according to the official IRS position on suddenness.[217] In using the Revenue Procedure to create a safe harbor for these types of claims, the IRS explicitly recognized corrosion as a force causing a casualty loss under IRC § 165(c)(3) in "view of the unique circumstances."[218] Just like the Foreclosure Crisis, the use of defective imported drywall did not commence at a singular moment in time, did not cause its damage within hours, days, months or even a few years, and affected different homeowners at different points in time. Revenue Procedure 2010-36 stands either for the proposition that the IRS subscribes to a more expansive definition of "suddenness" than it usually articulates or that suddenness is not actually an absolute necessity for a casualty-loss claim. Bearing all of these considerations in mind, the Foreclosure Crisis should actually fit quite comfortably within the jurisprudential bounds of suddenness and meet the principal qualitative standards for classification as a casualty.

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[212] *Id.*

[213] *Id.* at 246–47.

[214] Weyerhaeuser Corp. v. United States, 32 Fed. Cl. 80, 98, 140 (1994).

[215] Rev. Proc. 2010-36, 2010-42 I.R.B. 439.

[216] *Id.*

[217] *See* Matheson v. Comm'r, 54 F.2d 537, 540 (2d Cir. 1931) (disallowing casualty-loss claim based on damage caused by corrosion because the damage was not sudden).

[218] Rev. Proc. 2010-36, 2010-42 I.R.B. 439.

D. Questioning the Physical Damage "Requirement"

Notwithstanding the often shifting boundaries of the meaning of "other casualty," the case law appears to be fairly well settled in one respect that would be quite problematic for anyone seeking to claim that damage to their home's value caused by the Foreclosure Crisis is a casualty loss. According to the IRS and most courts, only physical damage counts.[219]

One or both of two explanations are typically used in supporting this position. The first is ejusdem generis.[220] Since fires, storms, and shipwrecks all cause physical damage, so must other casualties, the reasoning goes.[221] On these grounds, home-value declines allegedly attributable to neighbors' harassment[222] and snooping tourists ("looky-loos")[223] have failed to qualify.

The second explanation is rooted in the IRC's longheld administrative rule that a taxpayer can only claim a loss that has been fully "realized." In order to be deductible, "a loss must be evidenced by closed and completed transactions, fixed by identifiable events."[224] This rule serves, as a general matter, to ensure that taxpayers only deduct losses they have genuinely suffered and will not later recoup. Although a casualty is considered a realization event, courts and the IRS have pointed to the realization rule in distinguishing between physical damage, considered irreversible and thus deductible, and a decrease in a property's value due to a market fluctuation, which may ultimately rebound.[225]

Courts find support for this explanation in one of the regulations that amplifies § 165(c)(3). Regulation 1.165–7 provides that a claim for a casualty-loss deduction must "recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property."[226] In cases involving a casualty like an earthquake, which causes both physical damage to a home and a drop in the home's value due to a concern that the casualty may reoccur (a so-called "buyer resistance" claim), buyer resistance is typically chalked up to "general market decline."[227] These cases,

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[219] Kamanski v. Comm'r, 477 F.2d 452, 452 (9th Cir. 1973); Caan v. United States, No. CV 98-4833-GHK SHX, 1999 WL 250753, at *2 (C.D. Cal. Feb. 26, 1999); Chamales v. Comm'r, 79 T.C.M. (CCH) 1428, 1431–33 (2000).

[220] *See supra* note 188 and accompanying text.

[221] *See, e.g.*, Pulvers v. Comm'r, 407 F.2d 838, 839 (9th Cir. 1969).

[222] Torre v. Comm'r, 82 T.C.M. (CCH) 429, 431–32 (2001).

[223] *See Chamales*, 79 T.C.M. at 1431.

[224] Treas. Reg. § 1.165-1(b) (2014).

[225] *See, e.g.*, Citizens Bank of Weston v. Comm'r, 252 F.2d 425, 427 (4th Cir. 1958); Rev. Rul. 66-242, 1966-2 C.B. 56.

[226] Treas. Reg. § 1.165-7(a)(2)(i).

[227] Kamanski v. Comm'r, 477 F.2d 452, 452 (9th Cir. 1973); Pulvers v. Comm'r, 407 F.2d 838, 839 (9th Cir. 1969); Gordon v. United States, No. C-94-4210 MHP, 1995 WL 429248, at *3 (N.D. Cal. July 3, 1995).

many of which are from the Ninth Circuit, where natural calamities occur more frequently, have come to stand for the proposition that only physical damage is deductible.[228]

While compelling in their straightforwardness, the explanations for the physical-damage requirement have serious gaps in reasoning. One, of course, is that neither § 165(c)(3) nor Regulation 1.165-7 requires physical damage. In fact, the phrase "physical damage" does not appear anywhere in these provisions. The terms used are "losses" and "damage";[229] "physical damage" is arrived at only by inference. It bears repeating that the limited legislative history regarding the impetus for the casualty-loss deduction describes these losses as those that are "extraordinary," "recurring," and "beyond the average or usual expenses incurred . . . in day-to-day living."[230] The IRS in identifying the essential features of a casualty settled on "sudden, unexpected and unusual," but did not include the word "physical."[231] Nothing within these criteria compels excluding nonphysical damage.

Furthermore, when examined closely, Regulation 1.165-7 seems focused on the need to establish a causal relationship between the casualty and the damage, rather than on distinguishing between physical and nonphysical damage.[232] It requires that an appraisal recognize any simultaneously occurring "general market decline" affecting taxpayer's damaged and undamaged property so that the loss claimed is limited to "actual loss resulting from damage to the property."[233] Interpreted literally it provides that only that portion of the property that the casualty has actually damaged is deductible. In the case at hand, the Foreclosure Crisis caused damage to home values and so this is what would be deductible.

This interpretation is bolstered when taking into account the Regulation's choice of the phrase "simultaneously occurring" to modify a "general market decline" that should not be included in the claimed loss.[234] "Simultaneous" suggests an event occurring at the same time but independent of the casualty (as opposed to "corresponding" or "resulting"). For example, a hurricane could strike a town that is already experiencing a decline in home values due to the departure of a major employer. The Regulation would prevent a fair market appraisal from taking this simultaneous and independent market force into account in assessing the casualty loss due to the hurricane. But the same rule should not apply to a decline in fair market value that is a direct result of the damage imposed by the hurricane since the event and the decline in value are inextricably related.

At its root, judicial and IRS adherence to a physical-damage requirement likely results more from a concern over recognizing unrealized losses than from an interest

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[228] *See, e.g.*, Lund v. U.S., No. 2-97-CV-0078-S, 2000 WL 300394, at *2 (D. Utah Jan. 20, 2000); Caan v. United States, No. CV 98-4833-GHK SHX, 1999 WL 250753, at *1 (C.D. Cal. Feb. 26, 1999); Pang v. Comm'r, 101 T.C.M. (CCH) 1252 (2011).

[229] *See* 26 U.S.C. § 165 (2012); Treas. Reg. § 1.165–7.

[230] S. REP. NO. 88-830, at 57 (1964).

[231] Rev. Rul. 72-592, 1972-2 C.B. 101.

[232] Treas. Reg. § 1.165–7(a)(2)(i).

[233] *Id.*

[234] *Id.*

in precise statutory interpretation. In order to qualify as a casualty loss, a home-value decline would have to represent more than a temporary or specious dip in value. Otherwise, how would the IRS (and taxpayers) deal with market value declines, no matter how sympathetic the circumstances, that later recover? Would taxpayers have to refund previous deductions? And how could such a deduction be justified to other taxpayers whose personal property fluctuates in value due to circumstances beyond their control?

E. Permanent Transition to a Lower Value Plateau

The answer is that the damage to a taxpayer's home value would have to comply with the realization rule and constitute a permanent loss. Of course, physical damage is easier to identify as such; it is objectively observable and nonrecoverable absent some human intervention to fix it. A drop in market value can potentially reverse course at a moment's notice and is based purely on a change in buyers' whims.

A critical concept for addressing this concern and crystallizing the concept of permanent nonphysical losses in market value is found in a case decided by the Eleventh Circuit in 1986, *Finkbohner v. United States*,[235] which is the principal outlier on the question of whether physical damage is required for a casualty loss. The case involved a casualty-loss deduction claimed by homeowners in Mobile, Alabama whose home was largely bypassed by a flood severe enough that several of their neighbors' homes had to be demolished.[236] The city later concluded that because of future flood risks the demolished homes should not be replaced, but instead maintained as permanent open space.[237] The bulk of the homeowners' claim consisted of the 20% drop in value of their home after the flood, attributable to decreased market demand rather than to physical damage to the home.[238]

Unsurprisingly, the IRS rejected the claim, characterizing it as buyer resistance.[239] In siding with the homeowners and the district court, the Eleventh Circuit made a distinction between temporary buyer resistance and a transition to a "lower value plateau" caused by permanent changes in the character of the neighborhood.[240] In getting to that point, the court first recognized that buyers' immediate unwillingness to pay as much for property in the neighborhood due to the recent flooding was a short-term response and not sufficient to justify a casualty loss.[241] However, the permanent removal of seven out of twelve homes on a residential cul-de-sac so changed the amenities and attractiveness of the claimants' home, "placing it in a lonesome neighborhood, more exposed to crime, and with much diminished privacy" that it caused a permanent and realized loss in value that

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[235] Finkbohner v. United States, 788 F.2d 723, 727 (11th Cir. 1986).
[236] *Id.* at 724.
[237] *Id.*
[238] *Id.*
[239] *Id.* at 724–25.
[240] *Id.* at 727.
[241] *Id.*

could be claimed.[242] Over time, the home's value would inevitably change. But the court asserted that any subsequent appreciations or depreciations in value should be measured from this reduced figure.[243] Thus, the court recognized the home's reduction in value as a realized and deductible casualty loss.

The U.S. Tax Court made a similar holding in its 1994 decision *Beams v. Commissioner*.[244] A married couple owned multiple adjoining properties. After fire destroyed most of the forest cover on one of the undeveloped properties, the couple sought a casualty-loss deduction on the diminished value of one of the other parcels, on which their home stood.[245] The IRS sought to classify this decline in value as a simultaneously occurring "general market decline," but the court upheld a deduction based on the reduction in the home's aesthetic value, separate and apart from any physical damage.[246] In so doing, the Tax Court supported the homeowners' contention that the home had experienced a permanent change in character and value because it now stood in "a field, rather than a forest."[247]

In its last official guidance on the issue of nonphysical damage, the IRS rejected the casualty-loss claim of a taxpayer whose property had lost market value due to a flood, attributing it to buyer resistance.[248] In so doing, the agency expressed its position that the problem with the claim was that a decrease in value due to a "psychological resistance to inundated properties" is "short lived" and a "mere 'fluctuation' in value," and thus not "sustained."[249] This ruling is actually consistent with the holdings in *Finkbohner* and *Beams*. Short-term fluctuations in value are distinguishable from a permanent transition in value and thus not deductible.[250]

Assessing the permanence of a property's damage is a better conceptual barometer of its qualification as a casualty loss than simply treating all reductions in value due to nonphysical damage as unrealized. The latter approach, while administratively straightforward, unfairly preferences one permanent loss in value over another.[251] For this reason, those that might contend that the nonphysical damage in *Finkbohner* and *Beams* at least had an event causing physical damage as a starting point place too much importance on the event causing the damage rather than the nature of the taxpayer's loss. Insisting that only those nonphysical losses in value that arise from a "sudden, unusual and unexpected" event and that result from a change in the home's value so substantial and entrenched that it locks in a lower plateau provides a meaningful threshold.

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[242] *Id.* at 724.
[243] *Id.*
[244] 67 T.C.M. (CCH) 3152 (1994).
[245] *Id.* at 3153.
[246] *Id.* at 3154.
[247] *Id.*
[248] Rev. Rul. 66-242, 1966-2 C.B. 56.
[249] *Id.* at 57.
[250] *See* Finkbohner v. United States, 788 F.2d 723, 727 (11th Cir. 1986); *Beams*, 67 T.C.M. at 3154.
[251] *See infra* Part V.F.

The Foreclosure Crisis provides dramatic examples of communities that have transitioned to a lower value plateau. Not unlike the facts in *Finkbohner* and *Beams*, occupied homes in the Hardest Hit Communities have been permanently impacted by the condition of the properties around them. In many of these communities, vacancy, deterioration, and demolition have left long-lasting scars on the physical and financial landscape of the neighborhoods that the remaining occupants inhabit. The fact that nearly a decade removed from the onset of the Crisis, homes in these communities have recovered little or none of their lost value is evidence of a completed transition that is difficult to contest.

F. Normative Arguments and the Quest for Horizontal Equity

Having established a textual basis for questioning the interpretive soundness of the physical-damage requirement, it is worthwhile to compare on normative grounds those in the Hardest Hit Communities who suffered permanent damage to their home values to others whom the IRC allows to reduce their taxable income by declines in their home values attributable to sudden, unexpected and unusual outside forces. Doing so introduces the fundamental tax-law principle of "horizontal equity" to the discussion.

Horizontal equity provides that "taxes should bear similarly upon all people in similar circumstances."[252] It is widely regarded as a basic yardstick in gauging the fairness of any tax system and was also explicitly heralded as one of the central organizing principles behind the last comprehensive revision of the IRC undertaken pursuant to the Tax Reform Act of 1986.[253] Accordingly, when it comes to any provision establishing gain or loss, one can expect that the IRC aims to treat similarly-situated taxpayers in similar ways and call into question those instances in which it does not.

Part IV.B of this Article explained that the casualty-loss deduction is best understood as a normative provision meant to recognize that a taxpayer's losses to personal property that are caused by a sudden, unusual, and unexpected outside force should be subtracted from the taxpayer's income-tax base because they (i) impair her ability to pay taxes with respect to the amount lost and (ii) do not represent consumption by the taxpayer. Part IV.C. pointed out that Congress enacted the MFRDA on identical grounds. Accordingly, this section will compare damage to home values incurred by homeowners in the Hardest Hit Communities with (i) those who conventionally claim the casualty-loss deduction based on physical damage to their property and (ii) those who qualify for conceptually similar tax relief under the MFRDA according to these normative principles and contend that there is no principled reason for distinguishing among them.

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[252] Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113 (1990) (quoting HENRY C. SIMONS, FEDERAL TAX REFORM 8 (1950)).

[253] JOSEPH J. CORDES ET AL., *Horizontal Equity*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 164–66 (1999).

1. Comparison with Homeowners Incurring Physical Damage Due to Natural Calamity

Consider two homeowners: A and B. In 2005, A bought a home in an area that is at a relatively low risk for flooding. A's standard home insurance policy does not cover floods, and A did not seek out additional coverage.[254] In the same year, B bought a home of equal value in an area that eventually became one of the Hardest Hit Communities. In 2007, a hurricane took an unusual course and caused severe flooding on A's property. The resulting physical damage to the home and surrounding property, which insurance did not cover, reduced its value by $40,000. At the same time, the Foreclosure Crisis caused an identical reduction in the value of B's home. B's local housing market has, to date, experienced no recovery.

A and B have suffered equal losses to the values of their homes. Both losses were due to sudden, unexpected and unusual outside forces. Assuming A and B are in identical financial circumstances, both suffered immediate impairment to their net worth of an equal amount and significance that neither anticipated.

Accordingly, A and B are equally impaired with respect to their ability to pay income taxes. Furthermore, if we recognize that a drop in home value due to a sudden, unexpected and unusual force is not attributable to consumption, then neither A's nor B's home value reductions reflect consumption. By these standards, it is difficult to justify making A's loss deductible, but not B's, merely because B's loss did not result from physical damage.[255]

2. Comparison with Homeowners Qualifying for MFRDA

Via the MFRDA, Congress has forgiven income tax on canceled debt for certain homeowners who have struggled with their mortgages due to the Foreclosure Crisis.[256] The MFRDA applies to homeowners who, since 2007, have: (a) agreed on a mortgage principal reduction with their lender, (b) sold their homes to third parties

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[254] *Residents of Moderate-to-Low Risk Areas*, FLOODSMART.GOV, https://www.floodsmart.gov/floodsmart/pages/about/when_insurance_is_required.jsp [https://perma.cc/9N8W-U9G2] (last visited Feb. 4, 2016) ("Homes and businesses located in moderate-to-low risk areas that have mortgages from federally regulated or insured lenders are typically not required to have flood insurance.").

[255] An argument might actually be made that B's claim for a casualty loss is more defensible because A bought a home in an area that is at some risk of flooding (so the event was not completely "unexpected") and had an insurance option available through the National Flood Insurance Program to cover this risk. In contrast, given the state of the market when B purchased his home, a dramatic collapse in home prices was almost certainly unanticipated and not readily insurable by the average home buyer at the time of the Foreclosure Crisis. However, the jurisprudence has not held homeowners like A accountable in this respect.

[256] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 2, 121 Stat. 1803, 1803–04 (codified at 26 U.S.C. § 108 (2012)); Consolidated Appropriations Act. Pub. L. 114-113, 129 Stat. 2242 (2016).

in lender-approved short sales to avoid a foreclosure, (c) transferred their homes to their lenders in lieu of a foreclosure, or (d) lost their homes in a foreclosure, *and* whose lenders have cancelled a portion of their (the homeowners') mortgage debt.[257] It is important to recognize that each of the transactions just described results from an underlying recognition by homeowner and lender that the home's value has declined. But for a decline in value, most homeowners behind on a mortgage could instead sell their home and use the proceeds to pay off what remained on the mortgage. The cancelled mortgage debt corresponds roughly to that reduction in value. Congress passed the MFRDA in recognition of the fact that the Foreclosure Crisis caused these home-value declines.[258]

With this in mind, consider two more homeowners: C and D. They both utilized mortgages to purchase identical homes in 2005 in the same Hardest Hit Community and for the same price of $200,000. By 2011, the values of both homes declined by $40,000 and neither has recovered any value. C fell behind on her mortgage payments and reached an agreement with her lender to reduce her principal in an amount equal to the $40,000 loss in value. So even though she spent $200,000 to purchase her home, she will only have to repay $160,000 in principal. D has stayed current on her mortgage and will ultimately have to repay the entire $200,000. So, D will pay $40,000 more for the same home.

In normal times, C would have to pay income tax on the $40,000 in principal reduction to ensure that none of the dollars she spent in consumption escape income tax. For the same reason, neither C nor D could deduct their $40,000 in lost home value. Via the MFRDA, C does not need to pay income tax on the $40,000 reduction in principal that corresponds to her home's lost value because, according to the testimony supporting the MFRDA, it does not reflect consumption and represents $40,000 in home value that no longer exists.[259] Absent an allowance for a casualty-loss deduction, D must still pay taxes on her full purchase price even though she has incurred the exact same loss in value. The only significant difference between C and D is that D has abided by the original terms of her mortgage.

When viewed in terms of the normative income-tax principles referenced throughout this section, A, B, C, and D are all in the same boat. B and D should be able to deduct the permanent damage to their home values as casualty losses to put them on equal tax footing with A and C and to accurately measure their income.

VI. ADMINISTRATIVE CHALLENGES IN UTILIZING THE CASUALTY-LOSS DEDUCTION

The Foreclosure Crisis was complex in its onset, progression and aftermath. As a result, even though the casualty-loss deduction is a conceptual and normative fit for homeowners in the Hardest Hit Communities, actually utilizing the deduction for this purpose poses several significant administrative challenges. While equity in tax

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[257] *Id.*
[258] *See infra* notes 163–165 and accompanying text.
[259] *Id.*

treatment is a fundamental principle on which tax provisions should be evaluated, so is the ease (or difficulty) of administration of the provision.[260] There are many examples of provisions that might serve as normative improvements to the IRC that Congress has chosen to omit due to their administrative complexity.[261]

This Part will identify and explain each of the principle administrative challenges, associated with utilizing the casualty-loss deduction in this context, and, where applicable, identify possible solutions. The challenges include (A) defining Hardest Hit Communities, (B) measuring casualty loss, (C) determining causation, (D) establishing the timeliness of claims, and (E) clarifying the class of eligible claimants.

A. Defining Hardest Hit Communities

Perhaps most fundamental is the question of who actually qualifies to make a casualty-loss claim. With home prices nationally still 9% below the pre-Foreclosure Crisis peak,[262] a very significant number of American homeowners can accurately claim that their home has lost value as a result of the Crisis. But many of these homeowners live in communities where home values are steadily recovering value.[263] To allow them to claim a loss runs afoul of the realization rule discussed earlier.[264]

Assessing which housing markets have permanently transitioned to a lower value plateau and thus, where homeowners have actually realized a loss is, admittedly, easier said than done and would require careful scrutiny of highly localized market data, conditions, and trends. Moreover, the Foreclosure Crisis impacted different geographic and demographic areas of the country in different ways and at different paces, so it is difficult to devise a standard measuring stick.[265] Some local housing markets would provide clear indicators of permanent damage, while those on the margins would be harder to call and highly contestable.

A related issue is how broadly to draw the geographic boundaries of the Hardest Hit Communities. Casting the net too widely would allow some of those whose home values are recovering to ride the coattails of homeowners in more distressed neighboring communities; casting it too narrowly would exclude those who are rightly entitled to the deduction. As Part II explained, state and metropolitan boundaries tend to encompass multiple regions, communities, and neighborhoods

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[260] *See, e.g.*, GRAETZ & SCHENCK, *supra* note 130, at 32 (identifying "simplicity" as an overarching norm of an equitable and efficient tax code).

[261] *Id.* at 135–38. Some commonly acknowledged examples of significant scope include the omission of "imputed income" from the definition of income and of periodic taxation of accrued gains and losses. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 82–83, 86 (1977), https://www.treasury.gov/resource-center/tax-policy/Documents/full.pdf [https://perma.cc/263Q-FAFD].

[262] CORELOGIC, *supra* note 58, at 3.

[263] *See supra* Part II.

[264] *See supra* Part V.D.

[265] *See supra* Part II.

that are faring in dramatically varying ways with the aftermath of the Foreclosure Crisis.[266] Data based on zip codes is more granular and better equipped to distinguish the most distressed areas, although even some zip codes encompass adjacent neighborhoods with radically different housing markets. Census tract[267] and census block[268] data are even more granular and thus potentially useful in isolating damage, but not every unit of this size produces enough data to accurately reflect home prices.

Resolving these eligibility issues on a case-by-case basis, as homeowners make their claims, would likely overwhelm the IRS and lead to contradictory outcomes and protracted, expensive appeals. It would also create an uneven playing ground for claimants, as those with greater means and sophistication could hire more qualified advocates and craft stronger arguments in favor of their eligibility. A better approach would be for the IRS, in cooperation with the Treasury Department, to issue administrative guidance reflecting its position on which areas are Hardest Hit Communities. In selecting and drawing appropriate boundaries, the IRS and Treasury could consult with other federal agencies, like the U.S. Department of Housing and Urban Development ("HUD"), with expertise in evaluating the impact of the Foreclosure Crisis on communities throughout the country.

The IRS and Treasury provided similar guidance for the homeowners who used defective imported, corrosive drywall in their homes between 2001 and 2009. Acknowledging homeowners' numerous inquiries regarding their eligibility for the casualty-loss deduction, and what appeared to be case law and previous IRS rulings that would categorically prevent their claims, the IRS (citing the Treasury Department's approval) issued Revenue Procedure 2010-36, which recognized categories of eligible claimants.[269] In so doing, the IRS relied on studies conducted by the Federal Consumer Product Safety Commission and HUD.[270] Although Revenue Procedure 2010-36 did not exclude other homeowners from attempting to demonstrate their eligibility for a claim, by creating a "safe harbor" for those who they believed merited the deduction, it greatly reduced the costs of eligible claimants in proving their claims and the agency's own administrative burden in ruling on them.[271] It also served notice to those outside of the safe harbor of the significant hurdles they would face in making their cases, probably in the interest of dissuading

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[266] *See id.*

[267] *Geographic Terms and Concepts—Census Tract*, U.S. CENSUS BUREAU, https://www.census.gov/geo/reference/gtc/gtc_ct.html [https://perma.cc/NVF5-MZYD] (last visited Feb. 5, 2016) (describing a census tract as a "small, relatively permanent statistical subdivisions of a county[,] . . . with an optimum size of 4,000 people").

[268] *Geographic Terms and Concepts—Block*, U.S. CENSUS BUREAU, https://www.census.gov/geo/reference/gtc/gtc_block.html [https://perma.cc/Y243-Y3VE] (last visited Feb. 5, 2016) (Census blocks are "statistical areas bounded by visible features, such as streets, roads, streams, and railroad tracks, and by nonvisible boundaries. . . . Generally, census blocks are small in area; for example, a block in a city bounded on all sides by streets.").

[269] Rev. Proc. 2010-36, 2010-42 I.R.B. 439.

[270] *Id.*

[271] *Id.*

them from trying to do so.[272] Responding similarly to the Foreclosure Crisis could likewise smooth the channels for those in the Hardest Hit Communities, while discouraging others and providing courts with something to point to in supporting the IRS stance in litigation that might emerge.[273]

B. Measuring Casualty Loss

Once the Hardest Hit Communities are identified, the next, perhaps most daunting, challenge is determining how to measure loss. The conventional approach for measuring a casualty loss set forth in the Treasury Regulations is for the taxpayer claiming the deduction to obtain and present a competent appraisal of the property that assesses and substantiates its decline in value.[274] The deductible casualty loss is the difference in the property's fair market value immediately before and immediately after the casualty.[275] In this era, many private firms are generating sophisticated housing market data that tracks property value changes within specific zip codes, neighborhoods, and, in some cases, property-by-property on a continuous basis,[276] which suggests that this information is readily ascertainable by any taxpayer with access to the Internet. On the other hand, there is not uniformity in how sources

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[272] *Id.* at 440.

[273] See *infra* Part VIII for a brief discussion of whether a Revenue Procedure is the appropriate mechanism for Treasury Department and IRS action in this instance.

[274] Treas. Reg. § 1.165-7(a)(2)(i) (2014) (requiring an assessment of a property's fair market value be determined by a "competent appraisal"). One approach for doing so that is clearly endorsed by courts and the IRS is for the taxpayer to hire an appraiser knowledgeable about the market in which the taxpayer is located. *FAQs for Disaster Victims—Casualty Loss*, IRS (June 1, 2007), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/FAQs-for-Disaster-Victims-Casualty-Loss-Valuations-and-Sections-165-i [http://perma.cc/7WXM-X7WA]. Case law also supports, in certain circumstances, testimony of the property owner as to a property's decline in value, sale and asking prices, and relevant industry publications (e.g., bluebook prices on cars). *See* Fed. Tax Coordinator 2d (RIA) ¶¶ M–1818, M-1823.

[275] Treas. Reg. § 1.165-7(b)(1)(i). The regulations provide for an alternative approach for determining the amount deductible: the cost to repair the property in order to restore it to its precasualty condition. *Id.* § 1.165-7(a)(2)(ii). This method would presumably be difficult to utilize in the circumstances at hand.

[276] *See, e.g.*, CORELOGIC, www.corelogic.com [http://perma.cc/6DCQ-FQT7] (last visited Nov. 12, 2015) (providing property and financial data, analytics, and services); REALTYTRAC, www.realtytrac.com [http://perma.cc/EQV6-BRRU] (last visited Nov, 12 2015) (providing a resource for foreclosure properties); ZILLOW, www.zillow.com [http://perma.cc/YSA9-9SPV] (last visited Nov. 12, 2015) (providing consumers with real estate and rental marketplace data and connecting consumers with local professionals). Most homeowners also receive periodic assessments of their property value from local taxing authorities, and they must obtain a property appraisal upon securing or refinancing a mortgage or could obtain one in the course of preparing their tax return.

that provide property values assess them, which could lead to IRS challenges to taxpayer assertions of property value declines.[277]

A harder question is where to draw the before and after lines. A familiar method for assessing the impact of the Foreclosure Crisis is to show the decline in a particular market's home values from its pre-Crisis high point to its subsequent low point ("peak to trough").[278] Measuring casualty loss in this way would provide a claimant with the maximum possible loss, capturing the entire pre-Crisis run-up in prices as well as the entire subsequent drop off as part of the deduction. But when assessing loss, is it accurate to limit the Crisis only to that period when prices were in free fall? A counterargument is that the premarket crash price run-up reflected overvaluation fed by market frenzy that was a critical component of the Crisis, that the subsequent bottom point reflected undervaluation caused by the crash, and that neither accurately reflected property values.[279] By this reasoning, casualty losses are smaller (perhaps considerably so) than a peak-to-trough valuation would indicate, and instead should be measured by designating the "before point" sometime before the market frenzy began and the "after point" at the place where prices ultimately stabilized after the acute phase of the Crisis ended. Complicating matters further is the fact that different housing markets experienced appreciation, depreciation, and recovery at different rates and intensities.[280]

The timing of a homeowner's home purchase is also potentially relevant in measuring loss and another complicating factor. Substantial numbers of homeowners bought at or near peak value in the years leading up to the Crisis and thus using price data from that period seems like the right starting point for measuring loss, no matter how short-lived or overexuberant that level of price appreciation might have been. A homeowner who bought a home for $200,000 in 2005 that is now worth $150,000 is $50,000 poorer whether she paid too much for her house or not—a reality that will become clear when she sells her home. Her neighbor with an identical home who bought it for $150,000 in 2000 has experienced the same $50,000 loss in home value since 2005, but he will break even at a sale. A peak-to-trough measurement of casualty loss would net the neighbors the same deduction. But is this the right result?

A related problem is accounting for homeowners who made substantial improvements to their homes after the Foreclosure Crisis began. The homeowner from the previous paragraph may have made an addition to her home in 2009 that

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[277] *See, e.g.*, Andrew Bruce, *Zillow Home Value Forecast: Methodology*, ZILLOW (Jan. 24, 2013), http://www.zillow.com/research/zillow-home-value-forecast-methodology-2-3740/ [http://perma.cc/5ZJT-FXS9] (explaining unique features of Zillow's home value index).

[278] *See, e.g.*, STAN HUMPHRIES, REAL ESTATE MARKET OVERVIEW 2 (2014), http://cdn1.blog-media.zillowstatic.com/3/HousingRenPanel2-a27e1f.pdf [http://perma.cc/MV54-T584].

[279] *See, e.g.*, KATALINA M. BIANCO, THE SUBPRIME LENDING CRISIS: CAUSES AND EFFECTS OF THE MORTGAGE MELTDOWN 3–5 (2008), http://business.cch.com/images/banner/subprime.pdf [http://perma.cc/D6XM-69TP].

[280] See *supra* Part II.

raised its fair market value to $175,000. So a peak-to-trough measurement would net her a loss of $25,000. $50,000 is probably a more accurate measurement of the damage to her home value caused by the Foreclosure Crisis. But a literal application of the conventional formula for measuring damage takes into account only the home's overall decline in fair market value between the before and after points.

These questions of loss valuation would be difficult to resolve and could cause severe headaches for the IRS in evaluating claims and litigation from homeowners unsatisfied with their recoveries. This is another instance in which administrative guidance from the Treasury Department and the IRS could be of some use. Anticipating a massive number of casualty-loss claims in the aftermath of three hurricanes that rocked the Gulf Coast in 2004 and 2005 and complicated valuation issues attendant to the damage they caused, the IRS and the Treasury Department issued Revenue Procedure 2006-32.[281] The document provided several different methods that taxpayers could use to value their property's damage, reflective of the unique circumstances.[282] One of these methods introduced a completely novel method of computing damage—a cost index simply multiplying a home's square footage by a pre-established factor that varied depending on whether the home was small, medium, or large.[283] An approach like this could serve as a useful model for the Hardest Hit Communities. For example, administrative guidance could provide a formula that multiplies a home's pre-Crisis value by a designated figure that reflects a particular community's overall percentage loss in property values due to the Crisis rather than putting the onus on each homeowner to determine how to accurately value her damage.

Revenue Procedure 2006-32 designated the various valuation methods as "safe harbors," but did not exclude the traditional approach of a taxpayer obtaining, presenting, and, if necessary, defending an independent appraisal of the property's decline in value, which would invite the valuation debate discussed in the previous paragraph.[284] One could certainly project, however, that many potential claimants would opt for a predetermined valuation if it seemed reasonably fair, thereby avoiding the cost, effort, and uncertainty of utilizing their own appraisals.[285]

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[281] Rev. Proc. 2006-32, 2006-28 I.R.B. 61. It is not uncommon for the Treasury Department to work with the IRS to issue guidance to reduce controversies regarding asset valuation under the tax law. *See* Letter from Eric Solomon, Assistant Sec'y, Dep't of Treasury, to Senator Charles E. Schumer, United States Senate, at *3 (Dec. 11, 2008), 2008 WL 5381799 (citing Rev. Proc. 2006-32 as an example of the Treasury Department providing administrative guidance regarding valuation complexity); *see also* Rev. Proc. 2010-36, 2010-42 I.R.B. 439 (creating a safe harbor for valuing damage of corrosive drywall).

[282] *See* Rev. Proc. 2006-32, 2006-28 I.R.B. 61, 63–68.

[283] *Id.* at 65.

[284] *See id.* at 61–71 (establishing "safe harbor" valuation methods without prohibiting a traditional appraisal approach).

[285] *See infra* Part VIII for a brief discussion of whether a Revenue Procedure is the appropriate mechanism for Treasury Department action in this instance.

A higher level approach would be for the Treasury Department to amend the regulations amplifying § 165 or for Congress to amend IRC § 165 to provide a different approach for measuring casualty losses arising from the Foreclosure Crisis. The Treasury Department could clarify how the measurement already set forth in § 1.165-7 applies. Alternatively, the Department or Congress could provide a different measurement tailored to fit the unique valuation issues associated with the Foreclosure Crisis.

C. Determining Causation

Assessing the damage to home values in the Hardest Hit Communities during the Foreclosure Crisis would undoubtedly raise the question of whether this damage was attributable solely to the Crisis or whether other simultaneous and more gradual market forces affecting those communities, like job loss, depopulation, and changing housing preferences should be taken into account. The applicable Treasury Regulations require that the casualty-loss appraisal consider the impact of other market forces and calculate the loss based only on the damage caused by the casualty.[286] This potentially complicates matters in the case at hand (assuming that either the IRS has not published valuation safe harbors as proposed above or the taxpayer has opted not to use them), since it could be difficult to accurately disaggregate these types of historic trends.

Ultimately, however, the facts support placing the blame for housing-price collapses exclusively on the Foreclosure Crisis. Home prices nationwide, even in the weakest markets, were on the rise before the Foreclosure Crisis and had been for decades, notwithstanding the presence of these other forces.[287] Prices suddenly nosedived beginning in late 2006 in most markets, even those that previously had strong economies, robust demand for housing, and growing populations.[288] Thus, it seems clear that an independent actor entered the stage in 2006 and caused the free fall.

Where other market forces have played a greater role is in hindering the capacity of the Hardest Hit Communities to recover home values. The Hardest Hit Communities are located disproportionately in low- and middle-income areas, which are considerably more prone to weaker local job markets and declining demand for housing.[289] Lenders targeted homeowners in these types of communities for subprime lending and the Foreclosure Crisis swept many of them away resulting in exactly the type of permanent change in neighborhood character described in *Finkbohner* that irreparably damaged home values.[290] Other market forces mean that there are not ranks of new residents ready to enter and revitalize these communities. But this should not make a difference for purposes of measuring casualty losses. If

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[286] Treas. Reg. § 1.165–7(a)(2)(i) (2014).

[287] *See, e.g.*, *S&P/Case-Shiller 20-City Composite Home Price Index*, *supra* note 7.

[288] *Id.*

[289] *See supra* Part II.B.

[290] Finkbohner v. United States, 788 F.2d 723, 727 (11th Cir. 1986).

the purpose of the casualty-loss deduction is to allow deduction of the actual loss suffered by a taxpayer that results from the casualty, then the focus should be on whether the Foreclosure Crisis acted as the precipitating cause of the damage. The deduction does not discount recovery for a house more heavily damaged by a hurricane because it was built on sand rather than stone; neither should it discount the recovery of those who lived in communities less able to withstand the financial shock delivered by the Foreclosure Crisis.

D. Establishing Timeliness of Claims

As a general rule, the Treasury Regulations provide that a casualty-loss deduction must be claimed in the year in which the loss is sustained.[291] This is typically the year in which the casualty occurs.[292] When exactly did homeowners in the Hardest Hit Communities "sustain" home equity losses? The Crisis began in late 2006, home prices dropped in most places until late 2011, and some communities are still wrestling with the aftermath. The IRS could contend that the Crisis ended at the latest when prices bottomed out in 2011 and that the three-year statute of limitations has already tolled on any potential claims for losses.[293]

Case law provides an important exception to this general rule in circumstances in which the full extent of the loss is not immediately known.[294] For example, the Fifth Circuit allowed a taxpayer to claim, over the objection of the IRS, a casualty loss on trees on his property damaged in an ice storm three years after the storm occurred.[295] The court reasoned that the passage of time was necessary for the taxpayer to determine that the damage he suffered was permanent.[296] In a similar vein, the Treasury Regulations provide that if a casualty damages a taxpayer's property and she has filed a claim for reimbursement of the loss for which there is a reasonable prospect of recovery, she does not sustain the loss until she knows with reasonable certainty whether she will be reimbursed.[297] A similar principle ought to apply with respect to Foreclosure Crisis claims. Which communities would recover home values and which had suffered permanent damages was not ascertainable to industry experts, much less the average homeowner, in the immediate aftermath of the Crisis. Only the passage of time could have revealed this. It is only now, several

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[291] Treas. Reg. § 1.165–7(a)(1).

[292] BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 34.5.1 (2015), 1997 WL 439671.

[293] 26 U.S.C. § 6511(a) (2012). Generally, for a credit or refund, a taxpayer must amend a tax return within three years (including extensions) after the date it was originally filed or within two years after the date a taxpayer paid the applicable tax, whichever is later. *Id.*

[294] United States v. Barret, 202 F.2d 804, 806 (5th Cir. 1953); Kunsman v. Comm'r, 49 T.C. 62, 72 (1967); Lewis v. Comm'r, 80 T.C.M. (CCH) 196, 198 (2000); Allen v. Comm'r, 49 T.C.M. (CCH) 238, 239–40 (1984).

[295] *Barret*, 202 F.2d at 806.

[296] *Id.* A theft loss is likewise deductible in the year the taxpayer discovers it. Treas. Reg. § 1.165-8(a)(2) (2014).

[297] Treas. Reg. § 1.165-1(d)(2)(i).

years after prices in some communities began to rebound, that the permanent damage is clear and thus claims for deductions are timely.

This is yet another instance when the Treasury Department and the IRS could intervene to clarify matters by designating a reasonable discovery date and alerting taxpayers to it. Interestingly, in Revenue Procedure 2010-36 (addressing the corrosive drywall claims) they took an even more permissive course than the case law exception provides.[298] Revenue Procedure 2010-36 recognizes a casualty-loss deduction for repair costs in whatever year the claimant pays for the repair.[299] Given that the directive applied to homeowners who had the corrosive drywall installed in their homes between 2001 and 2009 and placed no outer limit on when deductible repairs could be made, it is possible that claimants could deduct their casualty loss a decade or even longer after the event causing the casualty commenced and in a year other than when they discovered the damage.[300] The IRS and the Treasury Department justified this fairly significant deviation from its general rule simply by referring to the "unique circumstances surrounding [the] damage."[301] The unique circumstances related to the Foreclosure Crisis should likewise invite a specially tailored solution.[302]

E. Clarifying the Class of Eligible Claimants

To this point, this Article has usually referred to homeowners in the Hardest Hit Communities as though they are a uniform group for purposes of claiming a deduction. There are, in reality, differences among them that would affect their eligibility for a claim. Two of these are worth discussion here.

One important difference among homeowners is when they bought and sold their homes. Would those who owned homes in the Hardest Hit Communities during the Foreclosure Crisis, but no longer do, be eligible to claim a deduction? It is well established in tax law that only those who "sustain" a loss can deduct it, which with respect to property generally means the person who owns it when the loss occurs.[303] As discussed in the previous section, the jurisprudence supports the notion that a taxpayer sustains a casualty loss only when she becomes aware that the damage is permanent and will not be reimbursed. This could be interpreted to qualify the sizable number of taxpayers who owned homes at some point during the four-year period while home prices nosedived and then sold the home at a loss, which could arguably serve as the point of discovery. On the other hand, depending on when the homeowner sold, the permanence of the damage may not have yet been sufficiently

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[298] Rev. Proc. 2010-36, 2010-42 I.R.B. 439.

[299] *Id.*

[300] *Id.*

[301] *Id.*

[302] *See infra* Part VIII for a brief discussion of the appropriate mechanism for Treasury Department and IRS action in this instance.

[303] Fed. Tax Coordinator 2d (RIA) ¶ M–1200.

apparent. Furthermore, the IRC's statute of limitations on amending tax returns would, as a general matter and absent congressional intervention, prevent anyone who sold their home more than three years ago from claiming a deduction.[304]

A second difference is that some homeowners in the Hardest Hit Communities qualified for the exclusion from tax of cancelled mortgage debt under the MFRDA.[305] Because the MFRDA already allowed those who qualified to effectively subtract the portion of their home's lost value caused by the Foreclosure Crisis from the tax base, these homeowners should not also qualify for a casualty-loss deduction for the debt forgiven. The MFRDA already addresses this point by reducing the adjusted basis of a home by the amount of cancelled debt on which the homeowner did not have to pay tax.[306] This would not be an issue for the lion's share of those the MFRDA covered, as most homeowners that qualified for the MFRDA lost or transferred their home via the qualifying transaction and thus would probably have no subsequent loss in value to claim.[307] For that smaller portion of homeowners who agreed to principal reductions and stayed in their homes, the casualty loss would need to exceed the amount already excluded from tax via the principal reduction and only the excess should be deductible.

VII. DISTRIBUTIONAL CHALLENGES IN UTILIZING THE PERSONAL CASUALTY-LOSS DEDUCTION

An additional challenge looms. The casualty-loss deduction in its current form is an ineffective mechanism for providing meaningful financial relief to most low- and middle-income households.[308] To the extent that one objective in allowing homeowners in the Hardest Hit Communities to claim this deduction is to help ease the severe blow that the Foreclosure Crisis dealt to their home equity, this fact presents a significant problem. A brief explanation of how the deduction functions will bring this problem to light.

The casualty-loss deduction is an itemized deduction against taxable income,[309] and therein lies two challenges. First, a claimant must have taxable income to reduce. At present, only 56.7% of Americans actually pay the income tax.[310] This is due to a variety of circumstances, but the most relevant one to the discussion at hand is that

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[304] *See supra* note 293 and accompanying text.

[305] *See supra* Parts III, IV.C, V.F.

[306] 26 U.S.C. § 108(h)(1) (2012); *see infra* note 341 and accompanying text.

[307] *See* Goodman & Seidman, *supra* note 120, at 5 (showing that most transactions that qualified under the MFRDA through the end of 2013 have been liquidations).

[308] *See, e.g.*, Patrick E. Tolan, Jr., *The Flurry of Tax Law Changes Following the 2005 Hurricanes: A Strategy for More Predictable and Equitable Tax Treatment of Victims*, 72 BROOK. L. REV. 799, 852 ("[T]here is an overwhelmingly regressive aspect to Section 165 . . . .").

[309] 26 U.S.C. §§ 63(d), 165.

[310] *Tax Topics: Who Doesn't Pay Federal Taxes?*, TAX POL'Y CTR. http://taxpolicycenter.org/taxtopics/federal-taxes-households.cfm [http://perma.cc/V88K-N6PH] (last visited Feb. 6, 2016) (based on 2013 figures).

the current IRC tax structure essentially exempts a substantial portion of low-income households from paying income tax. U.S. households in the lowest quintile income bracket (i.e., the lowest 20%) rarely pay income tax.[311] Even among those in the second to lowest quintile bracket, the percentage paying taxes typically is lower than 50%.[312] For those who don't pay the income tax, the deduction is worthless. Now it is also true that rates of home ownership are much higher among middle- and high-income households than low-income households.[313] Accordingly, homes in the Hardest Hit Communities are more likely to be owned by its middle- and high-income residents (i.e., taxpayers) than by its lowest income residents (i.e., nontaxpayers). But this will not be true across the board and, thus, it is fair to assume that a sizable portion of homeowners in the Hardest Hit Communities will be unable to utilize the casualty-loss deduction simply because they do not owe any tax.

A second challenge arises from the fact that a casualty loss is an itemized deduction.[314] The IRC provides all taxpayers with the option of taking a predetermined standard deduction from their taxable income rather than itemizing.[315] As a result, itemized deductions are only of value to those for whom the sum of all of their itemized deductions exceed the standard deduction. Only approximately 30% of U.S. taxpayers itemize deductions each year, and higher-income households are more likely to itemize than lower-income households because high-income households are more likely to have enough itemized expenses to make itemizing worthwhile.[316] This statistic is actually a little misleading in indicating who would take advantage of a casualty-loss deduction if it were available for homeowners in the Hardest Hit Communities. If a lower- or middle-income

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[311] CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, U.S. CENSUS BUREAU, INCOME AND POVERTY IN THE UNITED STATES: 2013, at 30 (2014) (showing the lowest quintile income bracket for 2013 are those households making less than $20,900 per year); *Tax Topics: Who Doesn't Pay Federal Taxes?*, *supra* note 310 (presenting via video that 99.5% of those making less than $10,000 per year do not pay federal income tax and 86.2% of those making between $10,000 and $20,000 per year do not pay).

[312] *See* DENAVAS-WALT & PROCTOR, *supra* note 311, at 30 tbl.A-2 (showing the second to lowest quintile income bracket for 2013 are those households making more than $20,900 per year but less than $40,187); *Tax Topics: Who Doesn't Pay Federal Taxes?*, *supra* note 310 (illustrating that 66.7% of those making more than $20,000 but less than $30,000 per year do not pay federal income tax and 49.3% of those making between $30,000 and $40,000 per year do not pay).

[313] *See* Press Release, Robert R. Callis & Melissa Kresin, U.S. Census Bureau, Residential Vacancies and Homeownership in the Second Quarter 2014, at 10 tbl.8 (July 29, 2014) (charting the discrepancy between one-unit structures and two-unit structures); U.S. DEP'T OF HOUS. & URBAN DEV., AMERICAN HOUSING SURVEY FOR THE UNITED STATES: 2011, at 27 tbl.C-09-AO (2013) (providing data showing that the rates of home ownership are much higher among middle- and high-income households than low-income households).

[314] 26 U.S.C. §§ 63(d), 165.

[315] *Id.* § 63(e).

[316] *See* SEAN LOWRY, CONG. RESEARCH SERVS., R43012, ITEMIZED TAX DEDUCTIONS FOR INDIVIDUALS: DATA ANALYSIS 2 (2014) ("In 2011, 32% of all tax filers chose to itemize their deductions rather than claim the standard deduction.").

taxpayer had a significant casualty loss, there is a much greater likelihood that his or her itemized deductions would exceed the standard deduction that year and, therefore, make itemizing worthwhile. Still, the value of a casualty-loss deduction would, in the aggregate, be reduced or completely offset for some additional low- and middle-income taxpayers because it is itemized.[317]

There is also a floor on the casualty-loss deduction that further limits its value to all taxpayers. A taxpayer can deduct only that portion of a casualty loss that exceeds 10% of his or her adjusted gross income (the "AGI Adjustment").[318] So, for example, if a household in one of the Hardest Hit Communities has a combined adjusted gross income of $70,000 in a particular year and seeks to claim a casualty loss for $40,000, the AGI Adjustment would reduce this claim by $7,000 to $33,000.[319]

Finally, as a general matter, most tax-code deductions are significantly more valuable to higher-income taxpayers than they are to middle- and lower-income taxpayers. This is because a taxpayer's income is not taxed at a uniform rate; instead, different rates apply to different segments of a taxpayer's income with the rates increasing as income gets higher.[320] A deduction reduces a taxpayer's overall taxable income and, thus, its value depends on the rate at which the deducted income would have been taxed. Using 2014 tax brackets, a married couple with a combined annual taxable income of $70,000 and a casualty-loss deduction, after the AGI Adjustment, of $33,000, would realize a tax savings of approximately $4,950 because that portion of their income that exceeds $18,150 but is not greater than $73,800 is taxed at a 15% rate.[321] A married couple with a combined annual taxable income of $140,000 and the same $40,000 casualty loss would have their deduction reduced by the AGI adjustment to $26,000, but then realize a tax savings of approximately $6,500 on this loss, because that portion of their income greater than $73,800 but less than $148,800 is taxed at a 25% rate.[322] In fact, this paragraph has oversimplified the comparison for ease of discussion and the lower-income couple would probably receive even less of a tax benefit relative to the higher-income couple.[323]

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[317] *Id.* at 7 (discussing the implications of the value of itemized deductions).

[318] 26 U.S.C. § 165(h)(2).

[319] Section 165 also imposes a separate $100 de minimis floor, and thus the claimed loss would actually be further reduced to $32,900. *Id.* §165(h)(1). It is also possible, although fairly unlikely given the nature of home-value declines caused by the Foreclosure Crisis, that a casualty-loss deduction could be limited by the property's adjusted basis. Treas. Reg. § 1.165-7(b)(1)(ii) (2014). For further discussion of adjusted basis, see *infra* note 335 and accompanying text.

[320] *See generally* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 35–38 (3d ed. 1995) (discussing why progressive income tax rates are used).

[321] *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 538–42 (providing supporting data).

[322] *See id.*

[323] First, the de minimis reduction imposed by 26 U.S.C. § 165(h)(1) would reduce the amount the taxpayer could deduct by $100 to $32,900. *See supra* note 319 and accompanying text. Of greater consequence is the extent to which the sum of the taxpayer's other itemized

There is an extent to which this is an equitable outcome. Viewed through the nonconsumption rationale, the casualty-loss deduction is meant simply to remove unconsumed personal losses from the tax base.[324] Because this loss would otherwise be taxed at the highest marginal tax rate the taxpayer pays, taxpayers in higher tax brackets will necessarily stand to benefit more from a deduction. This logic also applies using the ability to pay taxes rationale if the deduction's purpose is merely meant to remove wealth that the taxpayer no longer possesses from her tax base. Where it is unsatisfactory from a normative (and policy) perspective is if the impact of the loss on the taxpayer's ability to pay taxes is considered relative to her other resources. Viewed this way, it is hard to ignore that a $33,000 loss in net worth will almost always have a more adverse impact on the financial outlook of a household with $70,000 in yearly taxable income than it does for one with $140,000 in income. Not only is the loss not of equal tax value for these two households, it is the wealthier household that benefits more.

VIII. MODIFYING THE PERSONAL CASUALTY-LOSS DEDUCTION FOR HOMEOWNERS IN THE HARDEST HIT COMMUNITIES

The previous two sections identified a variety of challenges to utilizing the casualty-loss deduction, as currently configured, to address the permanent damage to home values suffered by homeowners in the Hardest Hit Communities. This is not to say, however, that the deduction in its current form is completely untenable for these types of claims.

If the Treasury Department can be convinced of the merits of a claim to the deduction in this context, it could work with the IRS, as it has in the wake of other recent complex casualties, to issue agency guidance that addresses many of the administrative challenges.[325] As identified in Part VI, the Treasury Department has utilized IRS revenue procedures to create casualty-specific safe harbors that identify eligible claimants, alternative methods of damage valuation, and revised timelines for claiming the deduction, and could try to do so again in this instance.[326] This

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deductions falls short of the standard deduction. For 2014, the standard deduction for a married couple filing a joint tax return is $12,400. *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 541. If the couple's other itemized deductions only amount to $3,000, then the net value of the casualty-loss deduction is reduced from $32,900 to $23,900 (by subtracting the additional $9,400 in deductions that the standard deduction would have provided). At a 15% tax rate, the tax savings is $3,585, for approximately a 9% return on the home's lost value. By contrast, the wealthier household with $140,000 in adjusted gross income would likely already be an itemizer and thus recoup the full $6,500, or approximately 16% on the home's lost value.

[324] *See supra* Part IV.B.

[325] *See supra* Part VI.

[326] A revenue procedure is an "official statement of a procedure by the [IRS] that affects the rights or duties of taxpayers or other members of the public under the [IRC], related statutes, tax treaties, and regulations, or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge." INTERNAL

guidance would need to stay within the bounds of what § 165(c)(3) provides, and some might question whether recognizing nonphysical damage as a casualty loss exceeds those boundaries. But with *Finkbohner* representing a split among circuit courts on this issue and the recent use of revenue procedures to recognize and facilitate casualty-loss claims in other "unique circumstances,"[327] the Department would appear to have some room to maneuver in working with the IRS to issue agency guidance.[328] A more authoritative approach would be for the Department to issue interpretive regulations to implement these strategies.[329] The ease of adoption,[330] functional scope,[331] and degree of judicial deference[332] vary significantly among the different types of regulatory and rule-making devices the

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REVENUE SERV., INTERNAL REVENUE MANUAL § 32.2.2.3.2 (2004). Depending on the subject matter of the guidance, a revenue ruling, or a revenue ruling in combination with a revenue procedure, may be more appropriate. A revenue ruling is an "official interpretation by the [IRS] of the [IRC], related statutes, tax treaties, and regulations. It is the conclusion of the [IRS] on how the law is applied to a specific set of facts." *Id.* § 32.2.2.3.1.

[327] Revenue Procedure 2010-36 justified the recognition of damage caused by corrosion as a casualty loss "in view of the unique circumstances" and notwithstanding a seemingly contradictory Second Circuit opinion, Matheson v. Comm'r, 54 F.2d 537, 539–40 (2d Cir. 1931), and a seminal Revenue Ruling, 72-592, 1972-2 C.B. 101, on this issue. Rev. Proc. 2010-36, 2010-42 I.R.B. 439, 439; *see supra* notes 215–218 and accompanying text. Likewise, Revenue Procedure 2006-32 justified the creation of new methods for valuing fair market value decline associated with a casualty loss "in view of the unique circumstances" and congressional action lifting statutory floors on the deduction, which was unrelated to the question of valuing damage. Rev. Proc. 2006-32, 2006-28 I.R.B. 61, 61.

[328] The question of who possesses standing to challenge Treasury Department and IRS guidance expanding the availability of a deduction is an interesting one, but it is beyond the scope of this Article.

[329] The Treasury Department has the authority to issue interpretive regulations that implement and interpret the Internal Revenue Code. 26 U.S.C. § 7805(a) (2012).

[330] As a general matter, the process for adoption of a regulation is significantly more onerous and time-consuming than that for issuance of agency guidance, as it typically requires a public notice and comment period. *See generally* INTERNAL REVENUE SERV., *supra* note 326, at § 32.1 (providing an overview of the regulatory process).

[331] *See supra* notes 326 and 329.

[332] Treasury regulations require very expansive *Chevron* deference from courts and, if on a point not directly addressed in the statute, can only be overturned if "arbitrary or capricious in substance, or manifestly contrary to the statute." Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 53 (2011) (citations omitted). In addition, "[r]evenue rulings are entitled to great deference, but courts may disregard them if they conflict with the statute they purport to interpret or its legislative history, or if they are otherwise unreasonable." *In re* Kaplan, 104 F.3d 589, 599 (3d Cir. 1997). "While courts generally regard a revenue ruling as an official interpretation by the [IRS], a revenue procedure instead is seen as merely a statement of procedure" and not mandatory. 1 Casey Fed. Tax Prac. § 1:41 (2015). On the other hand, it is not uncommon for the Treasury Department to address significant issues related to loss valuation in revenue procedures and other less precedential documents. *See, e.g.*, Letter from Eric Solomon, *supra* note 281, at *3.

Department can utilize and so it would need to consider which combination of regulations and agency guidance represents the best and most appropriate option in this instance.

The distributional challenge, on the other hand, cannot be addressed without congressional intervention. No executive branch actor can unilaterally remove the ceilings and floors imposed on the casualty-loss deduction or change the basic mechanism by which it is delivered, all of which are established by § 165 of the IRC. The deduction in its current form would not be worthless. Middle- and upper-income homeowners in the Hardest Hit Communities could utilize it to recoup a portion of their damaged home values on par with recoveries due to more conventional casualty losses. Nevertheless, as Part VII detailed, those with the lowest incomes would receive either no deductions or the smallest ones relative to their damage suffered, which is to some extent an unsatisfactory outcome.[333]

More could be done to address the unresolved administrative and distributional challenges and in so doing better accomplish the normative objectives underlying the casualty-loss deduction. But this would involve more fundamental modifications to how the casualty-loss deduction functions in this instance. This Part will consider two such modifications: (A) changing the standard for measuring loss to one that is more reflective of the actual loss suffered by individual homeowners and (B) making the loss more fully deductible.

A. *Changing the Approach for Measuring the Casualty Loss of Homeowners in the Hardest Hit Communities*

As discussed in Part VI.B, a perplexing administrative challenge to recognizing any casualty-loss claims for damage to home values caused by the Foreclosure Crisis is how to value the loss. Casting this as purely an administrative issue camouflages the underlying equity issue of what constitutes an appropriate deduction in this context.

In its current form, § 1.165-7 of the Treasury Regulations provides that the casualty-loss deduction shall be limited to "the actual loss resulting from damage to the property," which is either "the fair market value of the property immediately before and immediately after the casualty . . . [as] ascertained by competent appraisal" or "the cost of repairs to the property damaged."[334] The former approach raises the difficulties, explained in Part VI, inherent in trying to value the impact of such a complex event that affected individual communities and homeowners in different ways. The latter approach simply does not apply in circumstances where there is not physical damage.

A logical alternative is the IRC's standard rules for measuring gain or loss upon a taxpayer's sale of a primary residence. In brief, upon sale a taxpayer calculates her "adjusted basis" in her home (i.e., her initial cost of acquiring the home plus or minus subsequent adjustments to the home's cost) and subtracts the adjusted basis from

[333] *See supra* note 308 and accompanying text.
[334] Treas. Reg. § 1.165-7(a)(2) (2014).

what she realizes upon sale.[335] If the difference is a positive number, she has taxable gain, which is often excluded from tax.[336] If it is a negative number, it is a loss that is nondeductible, as explained earlier, because it is assumed to reflect personal consumption.[337]

Congress could amend § 165(c)(3) or the Treasury Department could amend the interpretive regulations to create an exception in this instance and allow the homeowners in the Hardest Hit Communities to deduct their losses when they sell their homes.[338] Doing so makes the same assumption about the losses these homeowners would incur upon sale as has been generally made about reductions in home prices incurred in the aftermath of the Foreclosure Crisis throughout this Article: that they arose from unprecedented and unexpected financial turmoil, rather than personal consumption. This change would fix the point of discovery of the loss at sale rather than leaving it to the IRS and homeowners to determine when a particular community's transition to a lower value plateau became permanent.

This approach may be a better fit for measuring a casualty loss in this instance for several practical reasons. First, the rule can be uniformly applied by the IRS, no matter the Hardest Hit Community in which the claimant resides, and provides a relatively clear formula for measuring loss. Second, it is a calculation commonly made by accountants and homeowners and so well-established rules and standards for making the calculation exist. Third, the sale of a home is undeniably a realization event and, thus, avoids potential disagreement (and litigation) over when a particular community has completed its transition to a lower value plateau.

Furthermore, and perhaps most critically for normative purposes, it is probably more reflective of the actual loss suffered by individual homeowners due to the Foreclosure Crisis. It addresses squarely the problems identified earlier in this Article of how to accurately determine home-value declines that affected homeowners in the same community differently based on when they bought and made improvements to their homes. As discussed in Part VI, it would be unfair and inaccurate to disregard inflated, pre-Crisis price run-ups for those homeowners who had the misfortune of buying their homes right before the Foreclosure Crisis at or near price peaks. Using the home sale measurement model takes this into account because the purchase price is the starting point in determining adjusted basis and, ultimately, loss. On the other hand, a homeowner who purchased several years before prices began to run up would, theoretically, not take a greater loss than merited because she would also be starting with her purchase price. This approach also addresses homeowners who made substantial improvements to their home in the midst or aftermath of the Foreclosure Crisis.[339] "Adjusted basis" takes into account the cost a homeowner incurs in making those improvements, while a fair

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[335] *See* 26 U.S.C. §§ 1011, 1012, 1016 (2012).

[336] *See id.* § 121.

[337] Treas. Reg. § 1.165-9(a); *see supra* Part IV.A.

[338] Treasury Regulation §§ 1.165-7 and 1.165-9 would require amendments.

[339] *See supra* Part VI.B.

market value approach may perversely cause the improvements to reduce the homeowner's loss.[340]

Using the home sale loss measurement approach also disposes of the problem of allowing a homeowner to take a loss that the homeowner later recoups through unexpected market appreciation. Because the homeowner does not take the loss until the home is sold, any home value recoveries up to the point of sale would not be included in the loss. This probably would not have a great impact on losses in most Hardest Hit Communities because they are, by definition, housing markets that have not and are not expected to experience significant price recoveries anytime soon. But this would at least prevent pockets of these communities and individual homeowners whose homes have recovered significantly from deducting unmerited losses.

Ultimately, the home sale loss alternative, in its current form, is not a perfect solution. It assumes all reductions in home value in the Hardest Hit Communities are attributable to the Foreclosure Crisis. This would not be true for all homes, especially if a homeowner continues to own her home well into the future. A possible fix is to reflect depreciation of the home over time at an annual rate in adjusted basis.[341] It also risks understating loss for longtime, pre-Crisis homeowners whose homes had appreciated according to "normal" (i.e., pre-2000) home value rates, but now have fallen below that figure due to localized housing market damage caused by the Foreclosure Crisis. A possible remedy would be to allow this type of homeowner to substantiate the home's fair market value at a designated time (prior to the pre-Crisis price run-ups) and substitute it for adjusted basis in measuring loss upon resale.

B. Making the Loss More Fully Deductible

To address the distributional challenge, Congress could remove the limitations on recovery it normally imposes on the casualty-loss deduction for homeowners in the Hardest Hit Communities.[342] The principal limitations, discussed in detail earlier in the Article, are the AGI Adjustment and the requirement that the loss be claimed as an itemized deduction.[343] Removing these limits would make the deduction

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[340] *See* 26 U.S.C. §§ 1011, 1012, 1016.

[341] Real property held for business or investment purposes is assumed to depreciate. But this depreciation is deductible because the property is utilized in profit-seeking activity. *See supra* Part IV. The depreciation of a personal residence should theoretically not be deductible as it would be attributable to personal consumption. *See* Epstein, *supra* note 149, at 457–62.

[342] This Article does not call for removal of the limitation that the loss not exceed the property's adjusted basis. Treas. Reg. § 1.165-7(b)(2). This reflects the longstanding rule that a taxpayer's loss of property cannot exceed her investment in that property. In addition, it has not been removed in the other casualties in which Congress has intervened.

[343] As explained *supra* in note 319, Section 165 also imposes a separate $100 floor on the casualty-loss deduction. This limitation is not discussed separately here because it does not significantly reduce recovery and is typically removed in those instances when Congress

available to more low- and middle-income homeowners in the Hardest Hit Communities and increase the amount of their deductions.

These limitations are, for the most part, driven by non-normative objectives. Congress imposed the AGI Adjustment in 1984,[344] motivated in large part by concerns that taxpayers frequently claimed the casualty-loss deduction erroneously making it challenging for the IRS to regulate.[345] By screening out all claims not amounting to more than 10% of a taxpayer's income, Congress hoped to reduce the number of claimants and, thus, alleviate the agency's auditing burden.[346] The AGI Adjustment was also part of a broader package of amendments to the IRC specifically aimed at increasing federal revenue in anticipation of federal budget deficits.[347] So the AGI Adjustment reduced all casualty-loss recoveries by an amount equal to 10% of a taxpayer's adjusted gross income as a way of increasing tax revenue.[348] The designation of the casualty-loss deduction as an itemized deduction appears to owe more to the point in time at which it was adopted rather than to any consistently applied normative principle.[349] The bottom line in how the deduction currently operates is that taxpayers justified on normative grounds in taking a full deduction for casualty losses (because they do not reflect consumption or they affect the taxpayer's ability to pay taxes) are limited or prevented from doing so based on other factors.

Congress has selectively lifted these limitations for specific groups of casualty-loss claimants when it has perceived that they are obstructing getting sufficient aid to communities in crisis and no longer effectively serve the purpose for which they were adopted. For example, Congress removed the AGI Adjustment for residents in portions of the Gulf Coast states struck by Hurricanes Katrina, Rita, and Wilma in 2005.[350] It contemplated the same treatment for those who suffered damages as a result of the Gulf Oil Spill and Superstorm Sandy.[351] It went one step further for

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removes the AGI Adjustment. Furthermore, it is also possible, although fairly unlikely given the nature of home-value declines caused by the Foreclosure Crisis, that a casualty-loss deduction could be limited by the amount of the property's adjusted basis.

[344] 26 U.S.C. § 165(h)(2).

[345] S. REP. NO. 97-494(I), at 82–109 (1982).

[346] *Id.*

[347] Joint Committee on Taxation, "General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982," (December 31, 1982) at 13–14.

[348] 26 U.S.C. § 165(h)(2). Congress justified the structure of the AGI Adjustment as also reflective of ability to pay concerns; the imposition of the adjustment would reduce the claims of higher-income taxpayers more than lower-income ones. But ultimately this is best interpreted as a way of easing the impact on lower-income taxpayers of what was essentially a provision aimed at administrative ease and revenue.

[349] Brooks, *supra* note 151, at 214–15.

[350] *See* Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, § 402, 119 Stat. 2016, 2027; Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § 201, 119 Stat. 2577, 2596–2608 (codified at 26 U.S.C. § 1400S(b) (2012)).

[351] *See, e.g.*, MOLLY F. SHERLOCK ET AL., CONG. RESEARCH SERV., R41323, TAX ISSUES AND THE GULF OF MEXICO OIL SPILL: LEGAL ANALYSIS OF PAYMENTS AND TAX RELIEF POLICY OPTIONS 10 (2010); Investment Savings Access After Catastrophes Act of

residents of portions of several Midwestern states inundated by storms, floods, and tornadoes in 2008, by not only removing the AGI Adjustment, but also allowing residents to claim the loss on top of their standard deduction.[352]

All of these situations involved events that indisputably qualified as disasters or casualties that caused widespread and obvious damage. Given these circumstances, the AGI Adjustment ceased to act as an effective filter of inconsequential or unmerited claims. Moreover, they involved events for which the government already intended to provide direct financial assistance to those most seriously impacted, and thus, budgetary objectives were no longer paramount.

Homeowners in the Hardest Hit Communities merit similar treatment. As explained throughout this Article, the impact of the Foreclosure Crisis on these Communities was widespread, catastrophic, incontrovertible, and certainly on par with the financial damages suffered by those in other circumstances in which Congress has made the casualty-loss deduction more fully deductible.[353] Moreover, the federal government has already provided direct financial assistance to banks, mortgage guarantors, and certain subsets of homeowners affected by the Foreclosure Crisis.[354] Accordingly, the budgetary justifications for limiting the availability and value of the deduction can easily be overcome in this instance for those homeowners who have received virtually no assistance to this point.

It also worth pointing out that those taxpayers aided by the MFRDA are able to exclude all of their damaged home values, to the extent it was represented by discharged debt, from income tax. Because the MFRDA acts as an exclusion of gain from taxable income, rather than as a deduction, it is not subject to any of the floors and limits that apply to the casualty-loss deduction.[355] Because there is no meaningful distinction between the permanent home value losses suffered by those covered by the MFRDA and those suffered by homeowners in the Hardest Hit Communities, as a matter of horizontal equity, the latter should be deductible to the same extent as the former.

Taken together, the removal of the AGI Adjustment and allowing the casualty-loss deduction to be taken on top of the standard deduction for those who would not otherwise itemize, would certainly make casualty losses more fully deductible for homeowners in the Hardest Hit Communities. Not all of the distributional issues would be resolved, however. For those homeowners who do not pay income tax in the year in which the deduction would be claimed, the deduction would still be worthless. A sizable number of homeowners in the Hardest Hit Communities may fall into this category. In addition, the return on a home's lost value yielded by taking the deduction would still be relatively small for lower income individuals due to their lower marginal tax rates.[356] Because many homeowners in the Hardest Hit

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2012, H.R. 453, 113th Cong. (2013).

[352] Heartland Disaster Tax Relief Act of 2008, Pub. L. No. 110-343, § 706, 122 Stat. 3912, 3921–23 (codified at 26 U.S.C. 165 (2012)).

[353] *See supra* Parts II, V.A.

[354] *See supra* Part III.

[355] *See supra* note 157 and accompanying text.

[356] *See supra* Part VII.

Communities are low- and middle-income, a large number would recoup only 10% to 15% of their lost home value as tax savings.[357] Nevertheless, the deduction could be claimed by many more in the Hardest Hit Communities and in greater amounts than would otherwise be the case under existing rules.

IX. CONCLUSION

The Foreclosure Crisis wreaked havoc on the finances of American households in a manner and to a degree not seen in almost a century. While most areas of the country are well on the road to recovery, the Crisis caused fundamental damage to the housing markets of some communities resulting in home-value declines that bear little hope of a meaningful recovery in the near future. Homeowners in these Hardest Hit Communities have suffered a serious economic loss on what is likely their principal asset, due in most cases to circumstances completely beyond their own control.

The best long-term approach to remedying this situation may very well reside in a comprehensive package of carefully crafted policies aimed specifically at fixing housing markets in the Hardest Hit Communities—for example, geographically targeted home purchase tax credits along with public sector investments in housing rehabilitation, strategic demolition, and neighborhood stabilization programs. The federal government spends billions of dollars annually in tax incentives to bolster the American housing market, many of which are principally of value to high-income taxpayers who have relatively little need for them.[358] The redirection of these dollars to those in the Hardest Hit Communities in order to restore confidence in their housing markets would be a more effective and equitable approach to accomplish the government's stated objective of promoting home ownership. But the likelihood of generating the political will to marshal a comprehensive solution and oversee its implementation in a way that meaningfully impacts home values within the ownership tenure of most of those who bought homes in the Hardest Hit Communities prior to or in the midst of the Foreclosure Crisis is increasingly unlikely as time passes.

Given this, the proposal made in this Article is a fairly modest one. It simply proposes that the IRC permit these homeowners to deduct permanent damage to their home values from their taxable income on the same grounds as others who suffer a serious economic loss due to a sudden, unexpected, and unusual event. Once these homeowners are considered equally worthy of claiming a casualty loss, the question then shifts to how the IRS, the Treasury Department, and Congress can best address

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[357] Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[358] *See, e.g.*, Benjamin H. Harris et al., *New Perspectives on Homeownership Tax Incentives*, 2013 TAX NOTES 1315, 1315; Rebecca N. Morrow, *Billions of Tax Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 FORDHAM J. CORP. & FIN. L. 751, 753–54, 760 (2012); ANTHONY DOWNS, BROOKINGS INST., WHAT'S WRONG WITH AMERICAN HOUSING? 5, http://www.brookings.edu/~/media/research/files/papers/2011/12/28%20housing%20downs/1228_housing_downs.pdf [https://perma.cc/J5YL-P7Z8] (last visited Feb. 7, 2016).

the administrative and distributional challenges attendant to utilizing the casualty-loss deduction in this context. These challenges are not insurmountable barriers, but rather issues to be carefully considered and strategically addressed. This Article presents a template for how to do so, and, in so doing, restore a measure of lost equity, economic justice, and confidence in home ownership to homeowners in the housing markets most severely damaged by the Foreclosure Crisis.