



Hurricane Tax Relief¹

A memo from the National Society of Tax Professionals

Fall 2005

Hurricane Katrina disrupted the lives of hundreds of thousands of people and destroyed countless homes, businesses and investment properties. It will have an enormous financial impact not only on the disaster areas but on the entire country.

On September 15, 2005, the House passed H.R. 3768, the *Katrina Emergency Tax Relief Act of 2005* by voice vote. The Senate passed S. 1696, the *Hurricane Katrina Tax Relief Act of 2005*, by Unanimous Consent on the same day. Later in the day, the Senate called up H.R. 3768 and amended it with a modified version of S. 1696. The modifications helped to bring the House and Senate bills into conformity. The Senate amendment passed by Unanimous Consent. The House further amended H.R. 3768 to resolve the remaining differences between the House and Senate bills.

On September 21, Congress passed a \$6.1 billion package of tax breaks to help individuals and businesses affected by Hurricane Katrina. The legislation provides tax breaks for victims, volunteers and donors.

On September 23, 2005, President George W. Bush signed into law the *Katrina Emergency Tax Relief Act of 2005*².

This paper is intended to highlight the most significant provisions of the 2005 Act.

Analysis of the 2005 Legislation

Definitions:

The *Katrina Emergency Tax Relief Act of 2005* (herein the Act) defines (1) "Hurricane Katrina disaster area" as an area declared as a major disaster area by the President before September 14, 2005, by reason of Hurricane Katrina; and (2) "core disaster area" as that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance.

Significant Provisions of the Act

1. Additional Exemption for Housing Dislocated Persons

Section 302 of the Act allows individuals, in taxable years beginning in 2005 or 2006, to claim an additional tax exemption of \$500 to \$2,000 (up to 4 people) for providing free housing for a period of 60 consecutive days to an individual/s displaced by Hurricane Katrina.

The additional exemption is not available for any person already claimed on the taxpayer's return. The provision would not affect any deductions or exemptions due the dislocated person on his or her tax return.

2. Discharge of Debts

Gross income generally must include any amount realized from the discharge of indebtedness. The Act provides an exemption for indebtedness discharged by commercial lenders when the forgiveness is in response to damage suffered by Hurricane Katrina.

This special exception only applies to debt discharges during the period beginning on August 25, 2005 and ending on December 31, 2006.

¹ © 2005 Thomas Barry Cooke, Executive Director, The National Society of Tax Professionals; Editor, The Federal Tax Alert; Editor, The Tax Client Newsletter.

² The government has produced the Hurricane Katrina Helping Handbook. The Handbook is a work in progress. The Handbook may be viewed online at: <http://www.mofo.com/about/Katrina.html>. Section 5 of the Handbook is titled **Taxes**. The Handbook can be printed in its entirety or by specific sections.

3. Special Rules for Use of Retirement Funds for Relief

A. Post-Hurricane Katrina

Section 101 exempts from the 10% penalty for premature retirement plan distributions (Code section 72(t)) any qualified Hurricane Katrina distribution, up to \$100,000, made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, was located in the Hurricane Katrina disaster area and who has sustained an economic loss due to Hurricane Katrina. Note that while the taxpayer will not face a tax penalty, the taxpayer may have taxable income as a result of the distribution.

The Act allows repayment of a qualified Hurricane Katrina distribution to a tax-qualified retirement plan as a rollover if made within three years after an initial distribution.

The Act allows qualified Hurricane Katrina distributions to be spread in income ratably over a three-year period. This is an election.

Example: T, a resident of New Orleans, took a \$27,000 taxable qualified Hurricane Katrina distribution from his/her traditional IRA.

Under the Act, T does not face a 10% penalty.

Under the Act, T can elect to pay taxes on the \$27,000 distribution as follows: (2006) \$9,000; (2007) \$9,000 and (2008) \$9,000. T may elect to include the \$27,000 in his/her 2006 income. (If this sounds like the 1998 Roth IRA rollover rules - it is the same theory.)

Note: During a three year period starting on 1/16/06 and ending on 1/15/09, T can rollover all or any portion of the \$27,000 distribution to a traditional IRA. T may file an amended return.

B. Pre-Hurricane

Section 102 of the Act allows individuals to make rollover contributions to tax-qualified retirement plans of distributions from such plans received after February 28 and before August 29, 2005, to purchase or construct a principal residence in a Hurricane Katrina disaster area if the residence was not purchased or constructed due to Hurricane Katrina. This provision effectively extends the standard 60 day rollover and 120 day rollover for first time home buyers.

4. Loss of Tax Benefits Due to Relocation

Section 407 of the Act authorizes the Secretary of the Treasury, for taxable years beginning in 2005 or 2006, to apply the tax laws to ensure that taxpayers do not lose any tax deduction or credit or experience a change in filing status by reason of temporary relocations due to Hurricane Katrina.

For example, the Treasury may adjust the application of the residency requirements relating to dependency exemptions. However, any adjustments must ensure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit.

5. Personal Casualty Losses

The Act waives the limits on personal casualty losses. The \$100 exclusion and the 10% of AGI test are waived for casualty losses that arise in the designated areas on or after August 25, 2005.

Example: A taxpayer with a casualty loss of \$5,000 and AGI of \$20,000 may claim the full \$5,000 loss instead of the \$2,900 normally allowed.

6. Replacing Damaged Property

Under current law, businesses and individuals with damaged property must invest their insurance proceeds in replacement property within a certain period of time to avoid having the proceeds taxed. Under current law, businesses have two years to reinvest and homeowners have four years to replace/repair principal residences.

Section 405 of the Act extends the tax-free reinvestment period from two years to five years for apartments and other commercial properties as long as the replacement property is located within the disaster area. Individuals whose principal residence was damaged or destroyed by the hurricane will receive an extra year (up to 5 years) to replace the property.

Example: T's personal residence was destroyed in Hurricane Katrina. T's basis in the residence was \$50,000, and it had a fair market value of \$400,000 before Hurricane Katrina. On 12/15/05, T received an insurance reimbursement of \$380,000. T has a potential taxable gain of \$330,000. Under the current law, T would have until 12/15/09 to replace the residence. Under the 2005 Act, T has until 12/15/10 to replace the residence as long as the replacement property is located within the disaster area.

7. Cash Donations by Corporations

Section 301 of the Act suspends the limitations on corporate tax deductions for cash contributions to charitable organizations (normally 10%) made between August 28 and December 31, 2005. The Act increases the 10% to 100%.

8. Cash Donations by Individuals

Section 301 of the Act suspends the limitations on individual tax deductions for new cash contributions to charitable organizations made between August 28, 2005 and December 31, 2005.

Generally, individuals are limited to deducting 50% of AGI to charity. Under the Act, cash contributions made to a qualified charity from August 28 to December 31 may be deducted up to 100% of their AGI.

9. Donations of Educational Books

Section 306 of the Act allows an increased tax deduction for charitable contributions of book inventories made to public schools between August 28 and December 31, 2005.

Under current law, taxpayers may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (e.g., basis plus one half of fair market value in excess of basis) or (2) two times basis for donations of book inventory.

The Act allows taxpayers to claim an enhanced deduction for donations of book inventory equal to the lesser of fair market value or twice basis.

10. Donation of Food Inventory

Section 305 of the Act extends to individual taxpayers (currently restricted to C Corporations) the tax deduction for charitable contributions of food inventory made between August 28 and December 31, 2005.

Under current law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically cost) in the inventory. However, for contributions of food inventory, C Corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (e.g., basis plus one half of fair market value in excess of basis) or (2) two times basis.

The Act allows all taxpayers (including S-Corporations, Partnerships and Sole Proprietors) to claim an enhanced deduction for donations of food inventory equal to the lesser of fair market value or twice basis.

11. Using a Personal Vehicle for Charitable Work

In response to dramatic gas price increases, the IRS announced that the optional standard mileage rate increased 8 cents to 48.5 cents a mile for all business miles driven between September 1 and December 31, 2005.

Section 303 of the Act increases (to 70% of the optional mileage rate for business usage) the mileage rate for the tax deduction for charitable use of an automobile for Hurricane Katrina relief between August 25, 2005 and December 31, 2006.

August 25 - August 31, 2005:	29 cents per mile
September 1 - December 31, 2005:	34 cents per mile

The mileage rate (14 cents) individuals may use to compute a tax deduction for personal vehicle expenses associated with charitable work is statutory and has not been increased since 1997.

In all other cases, the mileage rate for charitable activities remains at 14 cents a mile.

12. Reimbursements to Volunteers for Auto Expenses

Section 304 of the Act excludes from gross income reimbursements to volunteers for automobile expenses for providing Hurricane Katrina disaster relief between August 25, 2005, and December 31, 2006.

13. Additional Child Tax Credit and Earned Income Tax Credit

"Qualified individuals" can elect to use their earned income for the immediately prior tax year to calculate the child credit and the EITC for their tax year that includes August 25, 2005. "Qualified individuals" include those who on August 25, 2005 had their principal residence in an Individual Assistance Area, as well as those who on such date lived in a Public Assistance Area and were displaced from their homes because of Hurricane Katrina. Any election applies to both the additional child tax credit and the EITC.

In the case of a joint return for the tax year that includes August 25, 2005, this look-back provision applies if either spouse is a "qualified individual." The earned income attributable to the immediately prior tax year is the sum of the earned income attributable to each spouse for that tax year.

14. Employee Retention Tax Credit

Section 202 of the Act allows small employers (fewer than 200 employees) in a core disaster area a business tax credit for 40% of the first \$6,000 of wages paid to core disaster area employees after August 28, 2005, and before January 1, 2006. Note: The "fewer than 200 employees" was contained in the 9/11 bill for the Work Opportunity Tax Credit.

The employee's usual and principal workplace must have been in the disaster area, but employers can claim the credit for employees no longer providing any services and for employees now working outside the hurricane disaster area.

15. Work Opportunity Tax Credit

Section 201 of the Act includes a Hurricane Katrina employee as a member of a targeted group for purposes of the Work Opportunity Tax Credit (Code section 51). It defines "Hurricane Katrina employee" as any individual who is reasonably identified as having a principal residence in a core disaster area on August 28, 2005.

Employers outside of the disaster area who hire hurricane evacuees can claim the credit through the end of 2005. Employers within the disaster area can claim the credit for two years (2005 & 2006).

Note: The WOTC is available to employers who hire someone who was unemployed before Hurricane Katrina. There is no requirement that an individual must have lost his/her job because of Hurricane Katrina.

16. Extension of Deadlines

Section 403 of the Act extends deadlines for the filing of certain tax returns (including excise and employment tax returns) and for the payment of such taxes until February 28, 2006, for taxpayers in the Hurricane Katrina disaster area.

Both individuals and businesses qualify for this extension. It applies to any original or extended return deadlines on or after August 25, 2005. Thus it applies to the September 15, 2005 deadline for estimated taxes, the September 15, 2005 calendar-year corporate returns with automatic extensions, the October 17, 2005 deadline for individuals who received a second extension for filing their individual income tax returns, and employment (e.g., Social Security, Medicare and federal income taxes withheld from employee paychecks) and excise deposits due on or before February 28, 2006.

No interest or late filing or paying penalties will be due for the period of August 25, 2005 through February 28, 2006 if the return is filed and all taxes are paid in full by February 28, 2006.

Taxpayers affected by Hurricane Katrina may be eligible for tax relief, regardless of where they live.

Prior to the Act, the IRS had administratively agreed to extend the filing deadlines to January 3, 2006. Congress was more generous.