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Katrina Emergency Tax Relief Act of 2005

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CRS Report for Congress

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Summary

On September 23, 2005, President Bush signed the Katrina Emergency Tax Relief Act of 2005 (KETRA; H.R. 3768) into law, P.L. 109-73. It primarily contains temporary tax relief intended to directly and indirectly assist individuals in recovering from Hurricane Katrina. The provisions cover a variety of areas, including work credits, charitable giving, and casualty losses. This report summarizes the act.

The Katrina Emergency Tax Relief Act of 2005, P.L. 109-73, provides tax relief that is intended to assist the victims of Hurricane Katrina.¹ Some of its provisions distinguish between the “Hurricane Katrina disaster area,” which is the presidentially declared disaster area, and the “core disaster area,” which is the portion of the disaster area determined by President Bush to warrant individual or individual and public assistance under the Stafford Act.

Title I — Use of Retirement Funds for Hurricane Katrina Relief

Section 101 waives the 10% penalty tax that would otherwise apply on an early withdrawal from a retirement plan² if the individual’s principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area and the individual sustained an economic loss due to the Hurricane. The section applies to distributions made between August 24, 2005, and January 1, 2007, and the maximum amount that can be withdrawn without penalty is \$100,000. The funds may be re-contributed to a qualified plan over a three-year period and receive tax-free rollover treatment. Additionally, with respect to the taxable portion of the distribution, the individual may include one third of such amount in his or her income for three years rather than the entire amount in the year of distribution.

¹ Section 501 is the act’s sole provision that does not deal with tax relief. It designates any part of the act that has an effect on receipts, budget authority, or outlays to be an emergency requirement pursuant to section 402 of H.Con.Res. 95.

² IRC § 72(t).

Section 102 allows individuals to re-contribute, without tax consequences, distributions that were made between February 28, 2005, and August 29, 2005, to purchase or construct a principal residence in the Hurricane Katrina disaster area and were not used because of the Hurricane. The contributions must be made between August 24, 2005, and March 1, 2006.

Section 103 increases the amount that Hurricane Katrina victims may borrow from their retirement plans without immediate tax consequences.³ The provision applies to individuals whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area and who sustained an economic loss due to the Hurricane. Under current law, the maximum amount that may be borrowed without being treated as a taxable distribution is the lesser of (a) \$50,000, reduced by certain outstanding loans or (b) the greater of \$10,000 or 50% of the present value of the employee's nonforfeitable accrued benefits. For loans made between September 23, 2005, and January 1, 2007, the act increases this to the lesser of (1) \$100,000, reduced by certain outstanding loans, or (2) the greater of \$10,000 or 100% of the present value of the employee's nonforfeitable accrued benefits. The section also extends repayment due dates by one year if the original date fell between August 24, 2005, and January 1, 2007.

Section 104 contains transition rules for plans adopting these new provisions.

Title II — Employment Relief

Work opportunity tax credit. Under IRC § 51, businesses that hire individuals from groups with high unemployment rates or special employment needs, such as high-risk youths and veterans, may claim the work opportunity tax credit. The credit may be claimed for the wages of up to \$6,000 that were paid during the employee's first year. For an employee who worked at least 400 hours, the credit equals 40% of his or her wages — thus, the maximum credit is \$2400. For an employee who worked between 120 and 400 hours, the credit equals 25% of his or her wages. The credit does not apply to wages paid after December 31, 2005.

Section 201 allows the work opportunity credit to be claimed for wages of Hurricane Katrina employees. Eligible employees are individuals who had a principal place of abode in the core disaster area on August 28, 2005, and either (1) are hired during the 2-year period beginning on that date for a position in the area or (2) were displaced by the Hurricane and are hired between August 27, 2005, and January 1, 2006.

Retention credit. For employers with an active business that was rendered inoperable due to damage from Hurricane Katrina for any day between August 28, 2005, and January 1, 2006, section 202 provides a new credit for continuing to pay their employees' wages. The credit is equal to 40% of the wages, limited to \$6,000, of each employee whose principal place of employment with the employer on August 28, 2005, was in the core disaster area. It applies to wages paid between the date the business became inoperable at the employee's principal place of employment and the date it resumed significant operations there, but no later than December 31, 2005. It may not be

³ IRC § 72(p).

claimed by an employer with more than 200 employees or one who claims a work opportunity credit for the wages.

Title III — Charitable Giving Incentives

Limits on charitable deductions. Under IRC § 170, individuals may not claim a charitable deduction that exceeds 50% of their “contribution base” (adjusted gross income with certain adjustments) and corporations may not claim a deduction that exceeds 10% of their taxable income with certain adjustments. Any excess contributions may be carried forward for five years. Section 301 suspends the 50% and 10% limitations for cash contributions made between August 27, 2005, and January 1, 2006. For individuals, the deduction may not exceed the amount that the taxpayer’s contribution base exceeds his or her other charitable contributions. For corporations, the deduction is allowed only for contributions used for Hurricane Katrina relief efforts and may not exceed the amount that the corporation’s taxable income exceeds its other contributions. The act also suspends the overall limitation on itemized deductions for individuals.

Housing exemption. Section 302 of the bill allows individuals who provide free housing for at least 60 consecutive days to persons displaced by Hurricane Katrina to claim personal exemptions for those persons. The exemption is \$500 per person, with a maximum of four exemptions per year. They are available in 2005 and 2006, although a taxpayer may claim a person only once. The taxpayer must include on his or her return the displaced person’s taxpayer identification number. In order to qualify, the displaced person must have had a principal place of abode on August 28, 2005, in the Hurricane Katrina disaster area. If the home was not in the core disaster area, then either the home had to have been damaged by the Hurricane or the person was evacuated due to it.

Mileage rate for charitable contribution deduction. Individuals who use their personal vehicles for charitable purposes may claim a deduction based on the number of miles driven. The statutory amount is 14 cents per mile.⁴ Section 303 sets the rate at 70% of the standard business mileage rate (rounded to the next highest cent) if the vehicle is used for Hurricane Katrina relief between August 24, 2005, and January 1, 2007. The standard business mileage rate is periodically set by the IRS and is currently 48.5 cents per mile.

Mileage reimbursement. Section 304 excludes from a charitable volunteer’s gross income any qualifying mileage reimbursements received from the charitable organization for the operating expenses of the volunteer’s passenger automobile. The expenses must arise from using the vehicle for Hurricane Katrina relief between August 24, 2005, and January 1, 2007.

Inventory. In general, donors of food inventory who are not C corporations may only claim a charitable deduction that equals their basis in the inventory (typically, its cost).⁵ C corporations may deduct the lesser of (1) the basis plus 50% of the property’s appreciated value or (2) two times basis. Section 305 allows all donors of wholesome

⁴ IRC § 170(i).

⁵ IRC § 170(e).

food inventory to benefit from this enhanced deduction if the donation is made between August 28, 2005, and January 1, 2006. Donors who are not C corporations may not compute the deduction using contributions in excess of 10% of their net business income.

Section 306 allows C corporations to claim an enhanced deduction for donations of book inventory to public schools if made between August 27, 2005, and January 1, 2006. The corporation may deduct the lesser of (1) the basis plus 50% of the property's appreciated value or (2) two times basis. The school must certify that the books are suitable and will be used in its educational program.

Title IV — Additional Tax Relief Provisions

Discharge of indebtedness. When all or part of a debt is forgiven, the amount of the cancellation is ordinarily included in the income of the taxpayer receiving the benefit of the discharge.⁶ There are currently several exceptions to the general rule that a cancelled debt is included in taxable income in the year of discharge. For example, no amount of the discharge is included in income if the cancellation is intended to be a gift or is from the discharge of student loans for the performance of qualifying services.⁷ There are also certain situations in which the taxpayer may defer taxation, with the possibility of permanent exclusion, on income from the discharge of indebtedness, such as if discharge occurs when the debtor is in title 11 bankruptcy proceedings or insolvent.⁸

Section 401 allows victims of Hurricane Katrina to exclude non-business debt that was forgiven by a governmental agency or certain financial institutions if the discharge occurred between August 24, 2005, and January 1, 2007. Individuals are eligible for this benefit if their principal place of abode on August 25, 2005, was in the core disaster area or if it was in the Hurricane Katrina disaster area and they suffered an economic loss due to the Hurricane. The exclusion does not apply if the real property that secured the debt was located outside of the Hurricane Katrina disaster area.⁹ Individuals with certain tax attributes (such as basis) would be required to reduce them by the amount excluded from income, which has the effect of deferring the tax on the cancelled debt.

Casualty losses. There are several circumstances under which taxpayers may deduct losses of property not connected to a trade or business, including when the losses are from a casualty, such as a hurricane.¹⁰ In addition to losses from the actual damage caused by the casualty, a taxpayer in a presidentially declared disaster area has a casualty loss if ordered, within 120 days of the area's designation, by the state to demolish or relocate his or her home because it is unsafe due to the disaster. The amount of the loss is the lesser of (1) the decrease in the property's fair market value due to the casualty or (2) the taxpayer's adjusted basis in the property (i.e., the cost of the property with certain

⁶ IRC § 61(a)(12).

⁷ IRC §§ 102 and 108.

⁸ IRC § 108(a).

⁹ The heading of section 401(c)(2) refers to “[r]eal property outside core disaster area,” while the section’s language refers to real property located outside of the Hurricane Katrina disaster area.

¹⁰ IRC § 165.

adjustments). The cost of repairing the property may be used as evidence of the amount of loss.¹¹ There is no loss if the taxpayer is reimbursed by insurance or other means. The taxpayer may only claim a deduction to the extent that the loss from the casualty exceeds (1) \$100 plus (2) the sum of 10% of the taxpayer's adjusted gross income and any taxable gains from property that was involuntarily converted due to a casualty (discussed above). In general, the deduction may only be claimed in the year of the loss, although a loss in a presidentially declared disaster zone may be deducted in the year prior to the loss.

Section 402 waives the \$100 and 10% floors for casualty losses from Hurricane Katrina.

IRS Authority to suspend tax-related deadlines. Under IRC §§ 7508 and 7508A, the IRS has the authority to postpone tax-related deadlines for certain taxpayers, including those affected by a presidentially declared disaster.¹² These deadlines include those for filing returns and making payments for income, gift, and estate taxes. Income taxes withheld at source and employment taxes are explicitly excluded, and excise taxes are not mentioned.¹³ Section 403 gives the IRS the authority to postpone deadlines related to employment and excise taxes. Additionally, while the IRS announced in News Release IR-2005-96 that it would extend deadlines for Hurricane Katrina victims until January 3, 2006, section 403 further extends the deadlines to February 28, 2006.

Mortgage revenue bonds. Mortgage revenue bonds are tax-exempt bonds used to finance below-market rate mortgages for low and moderate-income homebuyers who have not owned a home for the past three years.¹⁴ Homes in targeted areas, which are areas that are low-income or of chronic economic distress, are subject to special rules that, among other things, remove the requirement that the homebuyer not have owned a home for the past three years. Section 404 similarly removes the three-year requirement if the home is in the core disaster area or if it is a replacement residence for an individual whose original residence in the Hurricane Katrina disaster area was made uninhabitable by the Hurricane. The provision applies to financing provided before January 1, 2007. The section also increases the limitation on qualified home improvement loans from \$15,000 to \$150,000 for loans used to repair damage from the Hurricane.

Involuntary conversions. An involuntary conversion occurs when property is converted to money or other property because of its complete or partial destruction, theft, seizure or condemnation, or if it is disposed of under threat of condemnation.¹⁵ An example of an involuntary conversion is when an individual receives an insurance payment for damaged property. If the cash or property that was received is worth less than the basis of the property that was converted, the taxpayer has a loss, which may qualify for deduction under the casualty loss rules discussed below. If the cash or

¹¹ 26 CFR § 1.65-7(a)(2)(ii).

¹² The actual authority to postpone the deadlines is granted to the Secretary of the Treasury. For information on IRS administrative actions after Hurricane Katrina, see CRS Report RS22261, *Hurricane Katrina: The Response by the Internal Revenue Service*, by Erika Lunder.

¹³ IRC §§ 7508(a)(1)(A) and (B).

¹⁴ IRC § 143.

¹⁵ IRC § 1033.

property received is worth more than the basis of the property that was converted, then the taxpayer has a gain, which may or may not be immediately taxable.

There are no immediate tax consequences if the property is converted to property that is similar or related in service or use (“similar property”).¹⁶ If, on the other hand, the property is involuntarily converted to cash or dissimilar property, the taxpayer must recognize any gain unless he or she purchases similar property within a certain time period. If the taxpayer purchases the replacement property in a timely manner, then he or she may elect to only recognize gain to the extent that the amount realized from the involuntary conversion exceeds the cost of the new property. The time period is generally two years. It is increased to three years if the converted property is business real property and to four years if the property is the taxpayer’s principal residence or its contents which were involuntarily converted due to a presidentially-declared disaster.¹⁷ Additionally, the IRS has the discretion to extend the time period on a case-by-case basis.

Section 405 increases the time period to purchase the replacement property to five years. The extended period applies for property in the Hurricane Katrina disaster area that was converted due to the Hurricane so long as substantially all of the use of the replacement property occurs in the disaster area.

Credit computations. Section 406 allows Hurricane Katrina victims to elect to use last year’s earned income for computing the child tax credit [IRC § 24] and the earned income tax credit [IRC § 32] instead of this year’s income. It applies to individuals whose principal place of abode on August 25, 2005, was in the core disaster area or was in the Hurricane Katrina disaster area and who were displaced by the Hurricane.

Authority to make adjustments relating to status. Section 407 allows the Treasury Secretary to make adjustments in the application of the tax laws for tax years 2005 and 2006 so that temporary relocations due to Hurricane Katrina or the receipt of relief does not cause taxpayers to lose dependency exemptions or child credits or to have a change of filing status.

¹⁶ The taxpayer’s basis in the new property is the same as in the converted property; thus, he or she is able to defer recognition of any gain until he or she sells or exchanges the new property.

¹⁷ When a taxpayer’s principal residence or its contents are involuntarily converted due to a presidentially-declared disaster, he or she does not recognize any gain upon receiving insurance proceeds covering unscheduled personal property located in the residence. The other insurance proceeds, including amounts received for the residence and scheduled items, are combined into a common pool of funds. The taxpayer has four years to use any of the pooled funds to purchase replacement property for the residence or its content in order to take advantage of the non-recognition rules. IRC § 1033(h).