HURRICANE KATRINA TAX RELIEF – PART I

September 22, 2005

The House and Senate have unanimously passed a package of tax provisions designed to advance cash to individuals and remove tax burdens from citizens in the Katrina destruction area.

Note that all provisions are temporary and generally apply only in the disaster zone. Check with your tax advisor for specific details.

Real Estate-Related Provisions

Cancellation of debt: Under current law, if a lender forgives debt, the borrower recognizes income and pays tax on the forgiven amount. The relief package removes this requirement, so forgiveness of mortgage and other debt will not create taxable phantom income. The relief applies to non-business debt only. (Note that current law provides relief for some business debt.) If the debt is secured by real estate (such as mortgages or installment agreements), the secured property must be located within the disaster zone. The relief is provided for debt forgiveness provided between August 25, 2005 and December 31, 2006 within Katrina areas.

Involuntary conversions: Under current law, property owners have 2 years in which to replace property that has been condemned or destroyed. The Katrina package allows a 5-year replacement period, so long as the replacement property is within the Katrina disaster zone. Replacement property outside the Katrina disaster zone will continue to be subject to the 2-year rule.

Casualty losses: Under current law, deductions for casualty losses (such as those from a natural disaster) are allowed only if the amount of the loss is greater than 10% of adjusted gross income. The Katrina package eliminates the 10% floor, so any amount of casualty loss is allowed. (Note that the amount of a casualty loss is reduced by any reimbursement from insurance.)

Mortgage revenue bonds: Affected states are granted significant new authority to issue mortgage revenue bonds. Many administrative requirements are eased and eligibility requirements are relaxed so that more individuals will qualify for this assistance.

Charitable Contributions

Contribution limits: Numerous limitations, based primarily on income, currently apply to the amount of a deductible charitable contribution an individual, corporation, partnership or S Corp can make. The relief package essentially eliminates those limitations for contributions made to qualified agencies providing Katrina relief.

Donated housing deductions: A special deduction is created for individuals who, during 2005 or 2006, provide free, non-reimbursed housing to displaced persons for 60 or more consecutive days. The deduction reduces taxable income by $500 for each housed, displaced person, up to a
cap of $2000. The housing must be provided in the donor’s principal residence. The donor must include the displaced person’s tax identification information (usually a Social Security number) when the tax return is filed.

**Mileage deductions:** The current allowance for the use of a vehicle in the performance of charitable services is 14 cents per mile. That allowance is increased to 70% of the standard mileage allowance for business use of an auto, which is currently 48.5 cents. Thus, for Katrina-related charitable services, the mileage rate will be 33.5 cents for services performed between August 25, 2005 and December 31, 2006. (Note that the IRS may round this to 34 cents.) In addition, volunteers who receive reimbursement from a charitable organization providing relief need not report the reimbursement as income.

**Contributions of food and school books:** A charitable deduction will be allowed for contributions of food inventory and school books made by businesses, including partnerships and S corps.

**Access to Retirement Savings**

*Current law generally requires an individual who withdraws funds from either personal or employer-sponsored retirement plans (including IRAs) to recognize income and pay tax on the withdrawn amount. Individuals who are younger than age 59 1/2 are also subject to penalties for withdrawals from these accounts.*

*The Katrina relief legislation eliminates these restrictions for individuals in the affected areas in order to provide them with immediate access to cash.*

**Use of retirement savings:** Affected individuals will be permitted to withdraw funds from IRA, 401(k) and similar retirement savings accounts without penalty. In addition, unlike current law, mechanisms are provided to permit individuals to restore the withdrawn funds to these accounts. The funds must be restored to the account(s) within 3 years. If the funds are not restored, then withdrawn amounts will be treated as income. The 10% penalty is waived. No more than a total of $100,000 may be withdrawn.

**Withdrawals for purchase of a home:** Current law allows an individual (and certain family members) to withdraw without penalty no more than $10,000 from a retirement account for the first-time purchase of a principal residence. The relief bill permits individuals who had made such withdrawals in anticipation of a home purchase to restore withdrawn amounts to their accounts if the purchase or construction cannot be completed because of Katrina. The provision is valid between August 25, 2005 and February 28, 2006.

**Loans from retirement plans:** Some employer-sponsored retirement plans permit workers to borrow as much as $50,000 from the plan. The Katrina relief package increases this amount to $100,000 and bars employers from charging interest on delays in the borrower’s payments on those loans through the end of 2006.
**Tax Credits for Employers**

**Hiring new employees:** The Work Opportunity Tax Credit (WOTC) is expanded so that employers (no matter where they are located) may use the WOTC when they hire persons displaced by Katrina.

**Retaining employees:** Employers who retain and continue to compensate their pre-Katrina employees between August 28, 2005 and January 1, 2006 may take a tax credit for 40% of the wages paid during that period. This credit is available only to employers who have fewer than 200 employees in the affected region. The maximum credit is $6000 per employee.

**No double dipping:** Employers may not use *both* the WOTC and the retention credits for any employee.

**Additional Relief**

The tax-writing committees are crafting more extensive packages that will target investment in the affected areas by providing a mix of tax relief and incentives for new investment in both business and housing. That package will be considered later this year.