2005 Workbook

Supplement: Hurricanes Katrina and Rita Tax Relief

KATRINA EMERGENCY TAX RELIEF ACT OF 2005 (KETRA)

Caution. This bill is specific to Katrina victims only. Victims of other disasters, past or future, cannot reliably use this act.

On September 23, 2005, President Bush signed a $6.1 billion bill to assist the victims of Hurricane Katrina. The provisions of this bill pertain only to the Katrina disaster. They do not relate to any other disasters, past or future.

Some provisions in the bill apply to the "Hurricane Katrina disaster area" while others apply only to the "core disaster area." The Hurricane Katrina disaster area is an area in which a major disaster was declared by the President before September 14, 2005 under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act related to Katrina. The core disaster area is the portion of the Katrina disaster area determined to warrant individual and public assistance from the Federal Government under Section 2(2) of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Observation. The core disaster areas are those which were hardest hit. Exact locations are listed on FEMA's web site at **http://www.fema.gov/news/disasters.fema**

USE OF RETIREMENT FUNDS

Early Distributions from Retirement Plans

Penalty-Free Distributions. KETRA allows Katrina victims to take early distributions from **IRAs and other eligible retirement plans** without the 10% penalty under IRC §72(t). Qualifying victims are those whose principal place of abode was in the Katrina disaster area on August 28, 2005 and who suffered an economic loss due to the hurricane. The penalty-free distributions are **limited to $100,000** from all IRAs and other eligible retirement plans of the taxpayer.

Note. The $100,000 limitation is applied to "an individual." Therefore, both spouses are eligible to take $100,000 penalty-free early distributions.

These distributions must be made **on or after August 25, 2005 and before January 1, 2007**.

Note. Even though the distributions are penalty-free, they are subject to regular income tax rules unless they are repaid as discussed next.

Repayment of Penalty-Free Distributions. Taxpayers are allowed **three years** to repay the penalty-free distributions. The three-year period begins on the day after the distribution is received. **If the distribution is repaid within the three-year period, the rollover provisions apply.** Otherwise, the penalty-free distributions are subject to regular income tax rules.

> **Note.** If a taxpayer receives distributions, pays tax on them, and later repays them within the three-year period, an amended return must be filed to request a refund.

The repayments can be made either in a single repayment or in multiple repayments.

Special Averaging Provisions for Penalty-Free Distributions. Distributions which are not repaid are eligible for a special **three-year averaging** for regular income tax purposes. This averaging method applies unless the taxpayer elects to pay tax on the entire distribution in the year received.

Eligible Retirement Plans. These include:

- Individual retirement accounts
- §408(b) individual retirement annuities
- §401(a) qualified trusts
- §403(a) qualified annuity plans
- §457(b) deferred compensation plans
- §403(a) annuity contracts

Example 1. Tom, a Katrina victim, takes a $60,000 early distribution from his traditional IRA on October 1, 2005 to rebuild his restaurant. The entire $60,000 distribution is taxable. He does not elect out of the special three-year averaging provision. Due to his improved economic situation, he makes a $45,000 repayment to his IRA trustee on January 15, 2008. Tom is age 35 in 2005.

Tax Solution for Example 1

- On his 2005 return, Tom reports $20,000 as a taxable IRA distribution. He is not liable for the 10% penalty under §72(t).
- On his 2006 return, Tom will report $20,000 as a taxable IRA distribution. He is not liable for the 10% penalty under §72(t).
- On his 2007 return, Tom will report a $5,000 taxable IRA distribution, He is not liable for the 10% penalty under §72(t).

  Explanation. Since he made a $45,000 repayment before his 2007 return was prepared, **only $15,000 of the $60,000 IRA distribution received in 2005 is taxable.** Using the special three-year averaging provision, **$5,000 is taxable in each of the tax years 2005, 2006, and 2007.**

- Tom must file amended returns for 2005 and 2006 to request refunds.

  Explanation. He reported $20,000 as taxable IRA distributions on both his 2005 and 2006 tax returns. Due to the $45,000 repayment, he made in January 2008, only $5,000 is taxable in those years.

Recontribution of Withdrawals for Home Purchases

First-time home buyers who used their IRA to fund the home purchase may repay the distribution if they were unable to complete the purchase because of Katrina. These repayments must be made by February 28, 2006, in order to avoid the 10% early withdrawal penalty. This rule applies for first-time home buyer distributions received between February 28, 2005 and August 29, 2005. The IRA distribution must have been for a home purchase or construction in the Katrina disaster area.

Example 2. Sonya, a Katrina victim, took the maximum $10,000 traditional IRA distribution on August 1, 2005 for her planned purchase of an existing residence in Biloxi, MS. She qualified as a "first-time homebuyer" and therefore avoided the 10% early distribution penalty. If the home purchase transaction is voided due to Katrina, Sonya must repay the $10,000 IRA distribution prior to March 1, 2006. If she doesn't, the distribution is taxable on her 2005 return.

Loans from Qualified Employer Plans

KETRA increases the amount of loans which a taxpayer can take from qualified employer plans. The current $50,000 limit is increased to $100,000 for Katrina victims. This limit applies to loans received between September 24, 2005 and December 31, 2006.

Taxpayers have five years to repay the loans without the loan being classified as a distribution. If the loan is not repaid within five years, the unpaid amount is treated as a distribution. Loans over $100,000 will be treated as distributions, subject to the early distribution penalty and not eligible for three-year averaging.

Katrina victims who had a plan loan outstanding at the time of the disaster, with a due date between August 25, 2005 and December 31, 2006, will have an additional year to repay the loan.

EMPLOYMENT RELIEF

Work Opportunity Credit

KETRA encourages the hiring of Katrina victims by offering a Work Opportunity Tax Credit (WOTC) to employers. Katrina victims are treated as a targeted group under IRC §51. Eligibility for this new targeted group requires that either of the following two conditions be met:

1. An individual has a principal place of abode in the core disaster area on August 28, 2005 and is hired during the two-year period beginning on August 28, 2005 for a position in a principal place of employment which is located in the core disaster area.
2. An individual whose principal place of abode on August 28, 2005 was in the core disaster area and who is displaced from that place of abode because of Katrina is hired during the period beginning on August 28, 2005 and ending on December 31, 2005.

These targeted employees are not required to have certification and any reasonable evidence that the employee is a Katrina victim is acceptable. IRC §51(i)(2) dealing with rehires is not applicable for these employees unless the employee was an employee of the employer on August 28, 2005.

The WOTC is set to expire on December 31, 2005 but will be extended for the Katrina victims.

Example 3. Brian, who lived and worked in the disaster area, lost both his home and job due to the storm. His employer decided not to reopen the business. If Brian finds a new job in the core area, his new employer will be able to claim a WOTC if Brian is hired before August 28, 2007.

Example 4. Brianna, another Katrina victim, also lost her home and job. Brianna has decided to move to Kansas and find a job. If she is hired by December 31, 2005, her new Kansas employer will be eligible for the WOTC.

Observation. The WOTC generally equals 40% of the first $6,000 of an eligible employee's compensation.

Employee Retention Credit

KETRA also contains a new credit for employee retention. Any business in the core area which became inoperable after August 28, 2005 and before January 1, 2006 is eligible for the credit if they continued to pay their employees while the business was inoperable. As long as the employee is paid during the inoperable period, it does not matter if:

- The employee provides no service to the employer,
- Provides service to the employer at a different place of employment, or
- Provides services at the principal place of employment before significant operations resume.

The credit is 40% of the first $6,000 of compensation paid during the inoperable period for each employee. This credit applies only to small employers who employee 200 or fewer employees. An employee cannot qualify the employer for both the WOTC and the retention credit.

Example 5. Joe's insurance agency employed an average of three employees prior to Hurricane Katrina. Building and equipment damage caused the business to close between August 28, 2005 and October 1, 2005. During the closed period, the business continued to pay the wages of the three employees.

Two employees were allowed to remain at home and performed no services for Joe during the closed period. The third employee remained in the disaster area to help Joe restore the business to operational status. All three employees qualify for the retention credit.

CHARITABLE CONTRIBUTIONS INCENTIVES

Suspension of Contribution Limits

Individuals are normally limited in the amount of charitable deductions they may claim as an itemized deduction. Generally, they are limited to 50% of their charitable base income (AGI less net operating loss carryback) for contributions made to tax-exempt charitable organizations. **KETRA increases this limit to 100% of the charitable base for Katrina donations made between August 28, 2005 and December 31, 2005**. Excess donations may be carried forward for five years.

Example 6. Sue and Steven Brown's 2005 AGI is $90,000. They had no NOL carryback. Prior to August 28, 2005, they made $50,000 of contributions to tax-exempt organizations. Between August 28 and December 31, 2005, they make an $80,000 donation to the Red Cross for the benefit of the Katrina victims. Their 2005 charitable contribution deduction is limited to $90,000. Their $40,000 carryforward to 2006 is calculated as:

Donation	Amount	Limit	Excess
50% limitation contributions	$ 50,000	$45,000	$ 5,000
100% limitation contributions	80,000	45,000	35,000
Total	$130,000	$90,000	$40,000

The $40,000 carryover can be used in tax years 2006 through 2010, subject to the 50% limit.

Itemized deductions are normally reduced by 3% of the amount of taxpayer's AGI in excess of $145,950. Qualified Katrina donations are exempted from an application of this reduction.

Corporate charitable contribution deductions are normally limited to 10% of taxable income. KETRA increases this limit to 100% of taxable income less other contributions, for Katrina donations paid in cash between August 28 and December 31, 2005. Excess qualified contributions may be carried forward five years.

Example 7. U.S.A. Corporation has taxable income in 2005 of $125,000 without regard to contributions. The corporation makes $15,000 of regular contributions and $140,000 of qualified Katrina contributions in 2005. U.S.A. is limited to deducting $12,500 (10% × $125,000) of regular contributions and $112,500 of Katrina contributions ($125,000 – $12,500.) The excess contributions of $30,000 may be carried forward five years.

Exemption for Housing Katrina Displaced Individuals

Taxpayers who house Katrina victims in 2005 and 2006 may claim an exemption amount for the displaced victims. **The amount of the exemption is $500 per displaced individual but limited to $2,000 for the two-year period.** A displaced individual may be claimed only one time. Therefore, only $500 may be claimed for the individual even if he lives in the taxpayer's home in both 2005 and 2006. Displaced individuals must meet the following **three** conditions:

1. Their principal place of abode on August 20, 2005 must have been in the Katrina disaster area.
2. They are displaced from their abode, or in the case of an abode located outside of the core disaster area:
   - The abode was damaged by Katrina, **or**
   - The person was evacuated from the abode because of Katrina.
3. They receive free housing in the principal residence of the taxpayer for a period of 60 consecutive days which ends in the tax year the exemption is claimed.

To claim the deduction the displaced individual **cannot** be the spouse or the dependent of the taxpayer. **In addition, the taxpayer may not receive any compensation from any source for housing the displaced individual.** The exemption amount is not subject to the phase-out rules and is allowed in computing AMT.

Example 8. Marissa invited five displaced Katrina victims to reside in her home rent free from September 1, 2005 to December 15, 2005. Marissa can reduce her 2005 taxable income by $2,000 (4 × $500). She will not be entitled to a similar special exemption deduction in 2006, even if victims live in her home for 60 days or more in 2006.

Standard Mileage Rate for Charitable Use of Vehicles

From August 25, 2005 through December 31, 2006, taxpayers who use a personal vehicle to provide Katrina-related charity work can deduct **70% of the standard business mileage rate.** The deduction is rounded to the next highest cent.

For the period of August 25 through August 31, 2005, the standard business mileage rate was 40.5¢ per mile. Therefore, the Katrina-related charitable mileage rate is 29¢ per mile. The standard business mileage rate was increased to 48.5¢ on September 1, 2005 resulting in the Katrina charitable mileage rate of 34¢ per mile.

Example 9. The Smith's used their SUV to pull a trailer, loaded with relief supplies, to New Orleans. They left Decatur, IL on August 29, 2005 and returned on September 2, 2005. The round trip was 780 miles. **They may claim a charitable mileage deduction of $456.** The Smith's also drove 1,500 charitable miles in 2005 that were not Katrina related.

Date	Mileage	Rate	Deduction
1/1/05–12/31/05	$1,500	$0.14	$210
8/29/05–8/31/05	390	0.29	113
9/1/05–12/31/05	390	0.34	133
Total	$2,280		$456

Mileage Reimbursements for Charitable Volunteers

If taxpayers who use their personal automobile for Katrina-related charitable travel are reimbursed by a charitable organization, they **may exclude the reimbursement from taxable income if:**

1. The reimbursement was for use occurring between August 25, 2005 and December 31, 2006.
2. They were reimbursed at the standard mileage rate in effect at the time.
3. The reimbursement was not for any services performed for compensation by the volunteer.

No double benefit is allowed for the expenses excluded.

Contributions of Food Inventory

C corporations were previously allowed a charitable contribution deduction for donating food inventory to §501(c)(3) organizations. The deduction was limited to the **lesser** of:

- The basis of the donated property plus one-half of its appreciation (excess of FMV minus the basis), or
- Twice the basis of the donated property.

KETRA allows any taxpayer engaged in **a trade or business** to claim a deduction for food inventory contributions. Therefore, all businesses, including S corporations, partnerships, and sole proprietorships are eligible. In order to claim the deduction:

1. The use of the food must be consistent with the donee's exempt purpose solely for the care of infants, needy or elderly.
2. The donee must not transfer the inventory for money, property, or services.
3. The donee must furnish the taxpayer with a statement that its use of the inventory is consistent with the two above requirements.

The deduction is limited to 10% of the donor's taxable income. The donation is available only for "wholesome food." Food is considered wholesome if it is intended for human consumption even if it is not marketable because of appearance, age, freshness, grade, size, surplus, or other conditions.

This provision of KETRA applies only to food inventory contributions made between August 28 and December 31, 2005

Example 10. Shady Lane Produce Farm, a partnership, regularly donates its excess produce to the local food pantry. It will be eligible to claim a deduction for the produce donated between August 28 and December 31, 2005.

Contributions of Book Inventories to Public Schools

KETRA provides a new charitable deduction only for C corporations which donate qualified books to public schools. A public school is one which provides elementary or secondary education through grade 12. The school must have regular teachers and a regular enrolled student body. **The book donations must occur between August 28, 2005 and December 31, 2005.**

The public school must certify that the books will be used in its educational programs and that they are suitable in terms of content, currency, and quantity. The amount of the deduction is computed identically to the deduction for charitable contributions of food inventory.

Example 11. Educational Publishers, Inc. produces high school textbooks. It is overstocked with high school physics textbooks. The production cost of this book is $2 and sales price to schools is $10. Their deduction for each donated book is limited to the **lesser** of:

- Twice the $2 basis ($2 × 2) or $4, or
- The $2 basis plus one-half of its appreciation ($2 + (($10 − 2) ÷ 2) = $6

ADDITIONAL TAX RELIEF PROVISIONS

Discharge of Non-Business Indebtedness

This provision of KETRA applies to individuals who live in the core disaster area or in the Katrina disaster area but outside the core area and who suffered economic loss because of Katrina. The provision does not apply to business indebtedness or real property indebtedness on property located outside the disaster area. **The amount of discharged debt will be excluded from gross income of the borrower.** This provision is effective for discharges made between August 25, 2005 and December 31, 2006.

Observation. Some lenders have indicated they will forgive personal residence mortgage debt in situations where the borrower's property was underinsured.

Personal Casualty Losses

Personal casualty or theft losses are limited by a $100 floor. In addition, net casualty and theft losses must exceed 10% of the taxpayer's AGI. These limits are eliminated for non-business casualty or theft losses occurring in the Katrina disaster area on or after August 25, 2005. When applying the 10% AGI limit for non-Katrina casualty losses, the Katrina losses are not taken into account.

Example 12. Jan and Jim suffer a $65,000 casualty loss on their Biloxi residence due to Katrina. They relocate to Illinois. In December 2005, Jim's valuable uninsured Chicago Cubs memorabilia is stolen. Its fair market value was $15,000. Jim's cost in it was $10,000. Therefore, they have total casualty or theft losses of $75,000 in 2005. Their 2005 AGI is $80,000. Their 2005 casualty and theft loss is computed as follows:

Property	Loss	Allowable Loss
Katrina loss	$65,000	$65,000 (no limitations apply)
Cubs memorabilia*	10,000	1,900 ($10,000 − $100 − $8,000)

*The theft loss of Cubs memorabilia is subject to both the $100 floor and the 10% of AGI limitation.

Suspension of Tax Responsibilities for Employment and Excise Taxes

The IRS has the right to suspend the deadlines for complying with required acts relating to certain tax returns. Currently, the IRS has suspended the deadline for these acts for individual tax returns of military personnel serving in a combat zone. In the past, the deadlines for excise and employment taxes could not be suspended. KETRA gives the IRS the authority to suspend the deadlines for these taxes as well.

The deadline for complying with required acts relating to excise and employment taxes are suspended until February 28, 2006 for taxpayers in the Katrina disaster area. The temporary suspension applies to performing an act which had not yet expired before August 25, 2005.

Extension of Replacement Period Time for Nonrecognition of Gain

When taxpayers have involuntary conversion gains on property, the realized gain is the difference between the insurance proceeds received and the adjusted basis in the property. If the proceeds are reinvested in similar property within two years, the gain is not taxed. Instead, the untaxed gain must be used to reduce the basis of the replacement property. The replacement property must be similar or related in service or use to the converted property.

KETRA extends the replacement period to **five years** if the:

1. Converted property was in the Katrina disaster area,
2. Property was involuntarily converted after August 24, 2005 because of Katrina, and
3. Replacement property is substantially used in the Katrina disaster area.

Example 13. Rosa's delivery business lost nine delivery vans due to Katrina. She intends to purchase nine new vans as replacements for the involuntarily converted vans. Eight of the replacement vans will be used primarily in the Katrina disaster area. The other replacement van is used for long hauls. It will be used outside the Katrina disaster area 85% of the time after its purchase.

Rosa must replace the long-haul van within **two years** after the close of the 2005 tax year, or by December 31, 2007. Rosa has **five years** to replace the vans used substantially in the Katrina area. Consequently, she has until December 31, 2010 to replace these eight vans.

Using 2004 Earned Income to Compute 2005 EIC

Both the 2005 earned income credit and the refundable child tax credit are based on a taxpayer's 2005 earned income. Taxpayers displaced because of Katrina could possibly experience a reduction in these 2005 credits because they may lose their jobs after the disaster. KETRA allows taxpayers to calculate their 2005 earned income for these two credits by using their 2004 earned income instead. This election can be made only if their 2005 earned income is **less** than their 2004 earned income.

This applies only to individuals who were:

1. Located in the core disaster area, or
2. Located within the Katrina disaster area (but outside the core area) and displaced because of the hurricane.

In the case of taxpayers who file a joint return, only one of the taxpayers need be a qualified individual. The earned income for 2005 is the total of both taxpayers' earned income for 2004.

> **Note.** If an electing taxpayer calculates his 2005 earned income incorrectly, he will be considered to have made a mathematical or clerical error.

Taxpayer and Dependency Status

KETRA gives the IRS authority to make adjustments in the application of law to ensure taxpayers do not lose the benefit of exemption deductions or filing status because of temporary relocations caused by Katrina. Adjustments will not be made which will allow more than one taxpayer the same tax benefit.

OTHER HURRICANE RELIEF PROVISIONS

IDENTIFICATION OF KATRINA RETURNS

IRS Notice 2005-73, released October 17, 2005, indicates Katrina-related returns should be marked **in red** with the words **"Hurricane Katrina"** at the **top** of the return and other documents. This notice clarifies and summarizes the relief previously given to affected taxpayers. The notice applies to the following Code sections:

- **IRC §6081** — extension of time for filing any return, declaration, statement, or other document required by the Internal Revenue Code.
- **IRC §6161** — extension of time for paying the amount of tax shown or required to be shown on any return or declaration.
- **IRC §6656** — provides for an addition to tax for any failure to deposit tax in a government depository as required by the Code or regulations on the date prescribed, unless the failure is due to reasonable cause and not due to willful neglect.
- **IRC 7508A** — authority to postpone the time for performing certain acts under the internal revenue laws if the taxpayer is determined to be affected by a Presidentially declared disaster.

In previous notices, relief was given only to taxpayers in the disaster area or the "core area." This notice extends relief for the above Code sections to:

1. Any individual who is a relief worker assisting in the covered disaster area.
2. Any individual who does **not** live in the covered area and any business entity whose principal place of business is **not** located in the covered area, but whose records, necessary to meet a filing payment deadline, **are maintained** in the covered area. This also covers individuals and business entities whose tax preparer is located in the covered area.
3. Any estate or trust whose tax records, necessary to meet a filing or payment, are located in the covered area.
4. Any spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife.
5. Individuals visiting the covered area that were killed or injured because of Katrina and its aftermath. This also includes the estate of the deceased individual.

While relief is given to passthrough entities, relief is not given to the partners, shareholders, or beneficiaries who live in areas outside the covered area. These taxpayers should file for an extension of time if they fail to receive their Schedule K-1 in time file their tax return. If the Schedule K-1 is not received by the time the extension deadline expires, they should make a reasonable estimate of the passthrough income or deductions. They can then file an amended return when the actual Schedule K-1 is received.

Observation. None of the IRS notices released at the time of printing mention whether taxpayers can electronically file their income tax returns if they contain special Katrina provisions.

DONATION OF VACATION, SICK LEAVE, AND PERSONAL LEAVE

IRS Notice 2005-68, (September 8, 2005) announced that taxpayers who donate vacation, sick leave, or personal leave time will not be required to include the amount of the donation as income because of constructive receipt rules. If an employer established a program where they contribute to Hurricane Katrina relief for any employee who wishes to forego vacation, sick leave, or personal leave time, the **employer** will be able to claim the donation as a business expense.

Because the donation is not considered income to the employee, the employee will **not** be able to claim a charitable deduction. The donation must be made before January 1, 2007.

> **Note.** This program is very beneficial to employees who are considering taking vacation pay and then making a cash Katrina contribution. Donating the time frees them from all payroll taxes and does not require they itemize their personal deduction to receive the tax benefit.

DEADLINE EXTENSIONS

IRS Notice 2005-66, (September 9, 2006) extends many deadlines for Katrina victims. If the deadline for an IRS action is on or after September 6, 2005 and before January 3, 2006, the new deadline is January 3, 2006.

The extended deadline applies to:

- Making tax assessments
- Issuing deficiencies notices
- Allowing tax credits or refunds
- Collecting tax liabilities
- Bringing suit
- Returning property, and discharging executors from personal liability

The extended deadlines apply to taxpayers who live in the areas of Alabama, Mississippi, Louisiana, and Florida declared as disaster areas by President Bush.

HURRICANE RITA RELIEF

IRS ANNOUNCEMENT

In IRS Announcement 2005-110, (September 27, 2005), the IRS announced it would extend certain deadlines for Rita victims similar to the extensions given to Katrina victims. Deadlines for filing tax returns, pay taxes, and performing certain other time-sensitive acts is postponed until February 28, 2006.

The extension is given for any form or document with a filing deadline on or after September 23, 2005. Late fees, and penalties will be abated. The taxpayers must live in a region that FEMA designated as "individual assistance areas." When filing any forms or documents with the IRS, the taxpayer should write "Hurricane Rita" in **red** at the top of the form.

> **Note.** The extended deadline does not apply to the Forms W-2, 1098, 1099, 5498 series, Form 1042-S or Form 8027. Nor does it apply to employment or excise taxes.