Summary of the Katrina Emergency Tax Relief Act of 2005

Provided by:

MRW FINANCIAL BROKERAGE

Life Insurance, Annuities and Long-Term Care

The Katrina Emergency Tax Relief Act of 2005 (KETRA) was passed unanimously by Congress on September 21, 2005 and signed into law by President Bush on September 23, 2005. This tax package is designed primarily to extend temporary tax relief to individuals and businesses in Louisiana, Mississippi and Alabama suffering from the devastation of Hurricane Katrina.

The Katrina Emergency Tax Relief Act of 2005 also extends help to the thousands of relief workers, as well as to those who are contributing to relief efforts through donations and in other ways.

NOTE: Victims of other disasters, such as Hurricane Rita, will not automatically receive the benefits of KETRA unless enabling legislation is passed and signed into law.

As you review the attached summary, pay particular attention to any provisions you feel may impact on your situation. If you would like additional information on KETRA or to discuss the impact of specific provisions on your planning, please call my office.

Katrina Emergency Tax Relief Act of 2005

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Many of the benefits in this legislation are applied to the "Hurricane Katrina disaster area," which is the area connected with Katrina that was declared by President Bush to be a major disaster area prior to September 14, 2005. The designated counties/parishes can be found on the FEMA website at http://www.fema.gov/news/disasters.fema.

Individual Tax Relief:

Individual tax relief is provided not just to victims of Hurricane Katrina, but also to individuals and businesses helping in the recovery.

Preservation of Tax Benefits

Hurricane Katrina displaced hundreds of thousands of people who are without homes and many are now jobless. Since both relocation and joblessness can affect a person's tax status, KETRA gives Katrina evacuees the option of using 2004 income to calculate the child tax credit and earned income credit on their 2005 tax returns. To be eligible, taxpayers must have:

- Lived in the core disaster area or the Hurricane Katrina disaster area and have been displaced from their homes as of August 25, 2005; and
- 2005 earned income that is less than 2004 earned income.

In addition, the IRS is authorized to make adjustments in the application of tax laws so that taxpayers do not lose any tax benefits or experience a change in filing status in 2005 and 2006 due to temporary relocations caused by Hurricane Katrina.

Extension of Tax Deadlines

Katrina victims have until February 28, 2006 to file and pay taxes for any tax return, payment or deposit due on or after August 25, 2005.

Limits on Casualty Losses

Uninsured casualty losses are generally deductible only to the extent that they exceed 10% of a taxpayer's adjusted gross income plus a $100 floor. For example, a taxpayer with a $30,000 adjusted gross income and a $5,000 casualty loss can deduct only $1,900 of the loss.

For victims of Hurricane Katrina, however, KETRA eliminates these limits, meaning that the full amount of any uninsured casualty losses that occurred on or after August 25, 2005 that are attributable to Katrina may be deducted in full. In our example, the full $5,000 casualty loss could be deducted.

The new law does not change the fact that a taxpayer must itemize in order to deduct casualty losses. Taxpayers who do itemize, however, have the option of deducting a casualty loss in either 2005 or on their 2004 return, which may mean a larger refund for Katrina victims who elect to file an amended 2004 return.

Gains from Insurance Recoveries

If taxable gain is created by insurance proceeds received for damaged or destroyed property, that gain can go unrecognized if replacement property is acquired within a certain period of time…four years for personal residence property and two years for business replacement property. KETRA extends that timeframe to five years for damaged or destroyed personal residence property or business property in the Hurricane Katrina disaster area.

Discharged Personal Indebtedness

Certain mortgage lenders plan to forgive outstanding mortgage balances in instances where the residence was underinsured. Generally, a discharge of indebtedness is a taxable event. For victims of Hurricane Katrina, however, whose principal place of residence was in the Hurricane Katrina disaster area on August 25, 2005 and who suffered an economic loss, discharged indebtedness is not taxed as income if the discharge is made on or after August 25, 2005 and before January 1, 2007.

Retirement Plan and IRA Distributions

KETRA relaxes many of the requirements that apply to qualified retirement plan and IRA distributions. The new law makes the following changes for qualified Hurricane Katrina distributions:

- Up to $100,000 can be withdrawn without penalty from an IRA or qualified retirement plan after August 25, 2005 and before January 1, 2007, so long as Katrina victims had their principal place of residence in the Katrina disaster area on August 28, 2005 and suffered an economic loss. The $100,000 limit is per taxpayer and not per retirement account.
- While such withdrawals are penalty free, they may still be subject to income tax. Taxpayers can elect to spread that income over three years, thus paying the income tax due over a three-year period instead of all in one year.
- Taxpayers who are able to repay withdrawals can do so within three years and have the repayment treated as a rollover (meaning that no income tax is due on the withdrawn amount). Any income tax that was paid on withdrawals that are subsequently repaid within the three-year period can be recovered by filing an amended tax return.
- Taxpayers who withdrew funds after February 28, 2005 and before August 29, 2005 for a first-time home purchase, but who could not complete the purchase because of Hurricane Katrina, may put the money back in the plan without penalty if done by February 28, 2006.
- Qualified Hurricane Katrina distributions are not subject to the 20% withholding requirement.
- Hurricane Katrina victims can borrow more from company retirement plans…up to the lesser of $100,000 (increased from $50,000) or 100% of the account. This provision is effective for loans made from September 23, 2005 and before January 1, 2007.
- Any qualified loan outstanding on or after August 25, 2005 that has a required payment due date between August 25, 2005 and December 31, 2006 has that required due date delayed for one year.

Mortgage Revenue Bonds

KETRA expands eligibility for state and local government-issued mortgage revenue bonds used to finance low-interest mortgages. Typically only first-time homebuyers are eligible for these mortgages. KETRA waives the first-time homebuyer requirement for qualified Hurricane Katrina recovery residences.

Charitable Tax Provisions:

In addition to helping victims of Hurricane Katrina, KETRA helps those who have volunteered or donated to the hurricane relief effort.

Shelter to Evacuees

Individuals who provide housing free of charge in their principal residence to Hurricane Katrina displaced individuals for at least 60 consecutive days in 2005 or 2006 receive a special $500 per evacuee income tax deduction. The maximum deduction is capped at $2,000 and may be claimed just once, in 2005 or 2006. This deduction may be taken whether or not the taxpayer itemizes deductions. Note, however, that each evacuee's taxpayer identification number must be included on the tax return of the taxpayer claiming the deduction.

Charitable Contribution Limit

Taxpayers who itemize generally cannot deduct cash contributions to charities that exceed 50% of the taxpayer's adjusted gross income, with any excess amount carried forward for up to five years. KETRA removes the 50% limitation for all cash contributions made to a qualifying charitable organization beginning on August 28, 2005 and ending on December 31, 2005. Such donations are also exempted from the phase-out of itemized deductions for higher-income taxpayers with adjusted gross incomes in excess of $145,950.

NOTE: This is one of the few KETRA provisions that does not require a connection to Hurricane Katrina. Any and all cash contributions made by an individual taxpayer from August 28, 2005 through December 31, 2005 to a qualified charity, whether or not involved in Katrina relief efforts, are exempt from the 50% limit.

Mileage Reimbursement

Taxpayers who use a personal vehicle for charitable work may claim a 14 cents-per-mile tax deduction in lieu of deducting actual expenses. KETRA raises this deduction for Katrina-related charity work to 70% of the standard business mileage rate. This means that the mileage rate for Katrina charity work is 29 cents-per-mile from August 25, 2005 through August 31, 2005 and increases to 35 cents-per-mile from September 1, 2005 through the end of the year. Once the IRS releases the 2006 mileage rates, it will be adjusted for 2006.

Corporate Charitable Cash Donations

Corporations generally cannot deduct charitable contributions in excess of 10% of taxable corporate income, with any excess carried over for up to five years. KETRA waives the 10% limitation for Hurricane Katrina cash contributions to a qualified charity made by corporate donors from August 28, 2005 through December 31, 2005. Unlike individual taxpayers, corporations must substantiate that the charitable contribution was made for Hurricane Katrina relief efforts.

Food and Book Donations by a Business

All businesses, not just C corporations, may claim a deduction for the donation of food inventory to a 501(c)(3) organization and for the donation of books to elementary and/or secondary schools, if the contributions are made after August 28, 2005 and before January 1, 2006.

Business Recovery:

Certain provisions of KETRA are designed to help businesses and their employees in the Hurricane Katrina disaster area recover.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) is designed to encourage employers to hire certain target groups who are considered to face barriers to employment. The credit generally equals 40% of the first $6,000 of wages paid to the employee in the first year ($2,400 maximum credit).

KETRA creates a new WOTC target group: Hurricane Katrina employees…individuals whose principal place of residence was in the core disaster area on August 28, 2005. Companies can claim the WOTC for Hurricane Katrina employees hired after August 27, 2005. Employers inside the core disaster area can claim the credit for Hurricane Katrina employees hired by August 27, 2007. For employers outside of the core disaster area, the credit is available for Hurricane Katrina employees hired by December 31, 2005.

Retention Tax Credit

Small employers (a business that employed an average of 200 or fewer employees during the tax year) in the core disaster area who continue to pay employees while business operations are suspended may claim a tax credit equal to 40% of the first $6,000 paid to each eligible employee while the business is inoperable from August 28, 2005 through December 31, 2005.

Claiming Tax Relief:

- **Individual Assistance Areas:** Relief is automatic in the hardest-hit areas, designated as individual assistance areas by FEMA. Taxpayers need not take any action to obtain the extensions and tax relief provided by KETRA.
- **Public Assistance Areas:** In areas designated by FEMA as public assistance areas, taxpayers must identify themselves as Hurricane Katrina victims.
- **Outside of the Disaster Area:** Taxpayers outside of the disaster area who qualify for extensions or other KETRA relief must also identify themselves as victims of Hurricane Katrina.

SUGGESTION: The IRS recommends that all affected taxpayers write **"Hurricane Katrina"** in red across the top of tax forms.