Order Code RS22269
September 19, 2005

CRS Report for Congress
Received through the CRS Web

H.R. 3768: the Katrina Emergency Tax Relief Act of 2005

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Summary

On September 15, 2005, the House and Senate passed different versions of a bill that contains tax provisions intended to assist the victims of Hurricane Katrina. H.R. 3768, the Katrina Emergency Tax Relief Act of 2005, was passed by voice vote in the House, while the Senate passed an amended version by unanimous consent. This report compares the House and Senate versions of the bill. It will be updated as events warrant.

This report compares the provisions in H.R. 3768, the Katrina Emergency Tax Relief Act of 2005, as passed by the House with those in the amended version of the bill that was passed by the Senate. The version passed by the House will be referred to as H.R. 3768, while the version passed by the Senate will be referred to as S.Amdt. 1728. The provisions are grouped by topic and not discussed in the section order found in the House or Senate version of the bill.

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.[1] This rule is based on the idea that the taxpayer has been enriched from not having to pay a debt that he or she was legally obligated to pay. 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.[2] 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.[3]

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[1] IRC § 61(a)(12).

[2] IRC §§ 102 and 108.

[3] IRC § 108(a).

Both versions of the bill would allow victims of Hurricane Katrina to exclude a cancelled debt under certain circumstances. Section 104 of H.R. 3768 and section 401 of S.Amdt. 1728 would allow individuals who lived in the Hurricane Katrina disaster area on August 28, 2005, or who owned real property in the area on the date of the discharge to exclude non-business debt that was forgiven by a governmental agency or certain financial institutions, if the discharge occurred before January 1, 2007. Individuals with certain tax attributes (such as basis) would be required to reduce them by the amount excluded from income. This would have the effect of deferring the tax on the cancelled debt.

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.[4] 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 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").[5] 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.[6] Additionally, the IRS has the discretion to extend the time period on a case-by-case basis.

Section 101 of the H.R. 3768 and section 405 of S.Amdt. 1728 would increase the time period that the taxpayer has to purchase the replacement property to five years. The extended period would apply if both the property that was damaged and the replacement property is within the presidentially-declared disaster area for Hurricane Katrina.

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[4] IRC § 1033.

[5] 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.

[6] 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).

Casualty losses. There are several circumstances under which taxpayers may deduct losses of property not connected to a trade or business. One of these circumstances is when the losses are from a casualty, such as a hurricane.[7] 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 adjustments). The cost of repairing the property may be used as evidence of the amount of loss.[8] 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 106 of H.R. 3768 and section 402 of S.Amdt. 1728 would waive both the $100 and 10% floors for casualty losses from Hurricane Katrina.

Employment tax incentives. Under current law, businesses that hire individuals from groups with high unemployment rates or special employment needs may claim the work opportunity credit.[9] Examples of these groups include high-risk youth, veterans, ex-felons, and food stamp recipients. The credit may only be claimed for the wages paid during the employee's first year and depends on how much the employee worked during the year. For an employee who worked at least 400 hours, the credit equals 40% of his or her wages, with wages limited to $6,000 per employee. For an employee who worked between 120 and 400 hours, the credit equals 25% of his or her wages, with wages limited to $6,000 per employee. For a summer youth employee, the wages are limited to $3,000.

Section 110 of H.R. 3768 would allow the work opportunity credit to be claimed for wages paid to an employee who had a principal place of abode in the Hurricane Katrina disaster area on August 28, 2005, who is being hired for a position in the area, and who begins working during the two-year period beginning on August, 29, 2005. Section 201 of S.Amdt. 1728 would allow the credit to be claimed for employees who had a principal place of abode in disaster area on August 28, 2005 and were unemployed because of Hurricane Katrina. The credit in S.Amdt. 1728 would be available beginning on August 29, 2005, to employers outside the disaster area for six months and to employers within the disaster area for two years.

For employers in the disaster area with an active business that was rendered inoperable because of damage from Hurricane Katrina for any day between August 28, 2005, and January 1, 2006, the Senate amendment would provide a new tax credit for continuing to pay their eligible employees' wages. While employers may generally deduct

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[7] IRC § 165.

[8] 26 CFR § 1.65-7(a)(2)(ii).

[9] IRC § 51.

all the wages paid to their employees, section 202 of S.Amdt. 1728 would create an additional credit equal to 40% of each eligible employee's wages, up to $6,000 per employee (thus, a maximum credit of $2,400 per employee). Eligible employees would be employees (a) whose principal place of employment on August 28, 2005, was in the disaster area or (b) who are activated military Reservists and Guards whose principal place of employment immediately prior to serving on active duty was in the disaster area. The credit would apply to wages paid between the date the business became inoperable at the employee's principal place of employment and the date the business resumed significant operations there, but no later than December 31, 2005. H.R. 3768 does not have this provision.

Housing provisions. Both versions of the bill would allow taxpayers who provide free housing to persons displaced by Hurricane Katrina to claim personal exemptions for the displaced persons. Under current law, individuals may claim exemptions that equal $3100 per person for themselves, their spouses, and dependents.[10] Section 107 of H.R. 3768 and section 304 of S.Amdt. 1728 would allow individuals who allow displaced Hurricane Katrina victims to stay in their homes to claim exemptions for the displaced persons. The housing would have to be provided for free and for at least sixty days. The exemption would be $500 per person, with a maximum of four exemptions. The exemption would be available in 2005 and 2006, although a taxpayer could only claim a specific individual once.

Both versions of the bill would also ease requirements relating to mortgage revenue bonds. These tax-exempt bonds are used to finance below-market interest rate mortgages for low and moderate-income homebuyers who have not owned a home for the past three years.[11] The price of the house generally cannot exceed 90% of the average purchase price of homes in the area. 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 105 of H.R. 3768 and section 404 of S.Amdt. 1728 would treat homes in the Hurricane Katrina disaster area as targeted area residences so that there would be no requirement that the homebuyer not have owned a home in the three prior years. H.R. 3768 would apply to financing provided before January 1, 2008. S.Amdt. 1728, which would also increase the limitation on qualified home improvement loans from $15,000 to $150,000 for loans used to repair damage from the Hurricane, would apply to bonds issued between August 28, 2005, and August 29, 2008.

Charitable giving.

Limits on charitable deductions. Both versions of the bill would increase the maximum amount that individuals and corporations may deduct as a charitable contribution. Under current law, individuals may not claim a charitable deduction that exceeds 50% of their adjusted gross income (the amount may be reduced depending on the type of donee and property) and corporations may not claim a deduction that exceeds

[10] IRC § 151.

[11] IRC § 143.

10% of their taxable income.[12] Section 102 of H.R. 3768 and section 301 of S.Amdt. 1728 would suspend these limitations for individuals and corporations for cash contributions made for Hurricane Katrina relief efforts between August 27, 2005, and January 1, 2006.

Inventory. S.Amdt. 1728 would permit all businesses to use the special enhanced deduction rules that apply when C corporations donate food inventory. Presently, donors who donate food inventory but are not C corporations may only claim a charitable deduction that equals their basis in the inventory (generally, the inventory's cost).[13] Under the enhanced deduction rules, C corporations may deduct the lesser of (1) the basis plus 50% of the property's appreciated value or (2) two times basis. Section 302 of the amendment would allow all donors of food inventory to benefit from the enhanced deduction rules if the donation is made between August 28, 2005, and January 1, 2006. Donors, other than C corporations, could not compute the deduction using contributions in excess of 10% of the taxpayer's net business income. H.R. 3768 does not include this provision.

S.Amdt. 1728 would also create a special enhanced deduction for donations of book inventory. Section 303 of the amendment would allow businesses that donate book inventory for educational purposes to deduct the lesser of the book's fair market value or two times basis. The donations must be made between August 28, 2005, and January 1, 2006. There is no comparable provision in H.R. 3768.

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.[14] Section 103 of H.R. 3768 and section 305 of S.Amdt. 1728 would set the rate at 70% of the standard business mileage rate for contributions made before January 1, 2007. The standard business mileage rate is periodically set by the IRS and is currently 48.5 cents per mile.

Section 306 of S.Amdt. 1728 would also exclude from a charitable volunteer's gross income qualifying mileage reimbursements received from the charitable organization for the operating expenses of the volunteer's passenger automobile. The provision would apply for taxable years ending after the act's enactment. H.R. 3728 does not have a similar provision.

Credit computations. Section 108 of H.R. 3768 would allow individuals who were residents of the Hurricane Katrina disaster area on August 28, 2005, 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. Section 406 of S.Amdt. 1728 would permit a similar election.

Early withdrawals from retirement plans. Section 201 of H.R. 3768 and section 101 of S.Amdt. 1728 would waive the 10% penalty tax on early withdrawals of

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[12] IRC § 170(b).

[13] IRC § 170(e).

[14] IRC § 170(i).

up to $100,000 from retirement plans if the taxpayer's principal residence is in the presidentially-declared Hurricane Katrina disaster area and the distribution is made within one year after the declaration was made. These individuals could also re-contribute the money to a qualified plan over a three-year period and receive tax-free rollover treatment. Under section 202 of H.R. 3768 and section 102 of S.Amdt. 1728, Hurricane Katrina victims who receive an early withdrawal could, rather than being taxed on the entire taxable amount in the year of distribution, include an equal portion of the amount in their income over a period of three years. Section 203 of H.R. 3768 and section 103 of S.Amdt. 1728 would allow the Hurricane victims to re-contribute, without tax consequence, distributions that were made between February 28, 2005, and August 29, 2005, to purchase or construct a home in the disaster area and were not used because of the Hurricane. Section 204 of H.R. 3768 and section 104 of S.Amdt. 1728 would increase the amount that Hurricane Katrina victims could borrow from their plans and extend repayment due dates by one year if the original date fell between August 29, 2005, and August 30, 2006. Section 205 of H.R. 3768 and section 105 of S.Amdt. 1728 would provide transition rules for plans to make amendments that adopt the new provisions.

IRS Administration Provisions. Section 109 of H.R. 3768 and section 407 of S.Amdt. 1728 would allow the Treasury Secretary to make adjustments in the application of the tax laws for tax years 2005 and 2006 so that temporary relocations after Hurricane Katrina or the receipt of hurricane relief do not cause taxpayers to lose dependency exemptions or child credits or have a change of filing status.

Section 403 of S.Amdt. 1728 would amend the authority of the IRS to suspend various tax filing and payment deadlines for taxpayers affected by natural disasters and terroristic activity to include employment and excise taxes. This provision is not temporary. 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 would further extend the deadlines to February 28, 2006. H.R. 3768 does not include a similar provision.