# TECHNICAL EXPLANATION OF H.R. 3768, THE "KATRINA EMERGENCY TAX RELIEF ACT OF 2005"

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 15, 2005
JCX-64-05R

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# INTRODUCTION

This document, prepared by the staff of the Joint Committee on Taxation, provides a Technical Explanation of H.R. 3768, the Katrina Emergency Tax Relief Act of 2005.

This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 3768, the "Katrina Emergency Tax Relief Act of 2005,"* (JCX-64-05R), September 15, 2005.

# I. GENERAL TAX RELIEF PROVISIONS

## A. Extension of Replacement Period for Nonrecognition of Gain (sec. 101 of the bill)

### Present Law

Generally, a taxpayer realizes gain to the extent the sales price (and any other consideration received) exceeds the taxpayer's basis in the property. The realized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the cost of such property, reduced by the amount of gain not recognized.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period").

Special rules extend the replacement period for certain real property and principal residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized. Similarly, the replacement period for livestock sold on account of drought, flood, or other weather-related conditions is extended from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. In the case of property compulsorily or involuntarily converted as a result of the terrorist attacks on September 11, 2001, in the New York Liberty Zone, the replacement period is extended from two years to five years, but only if substantially all of the use of the replacement property is in the city of New York (sec. 1400L(g)).

### Explanation of Provision

The provision extends from two to five years the replacement period in which a taxpayer may replace converted property, in the case of property that is located in a certain area and that is compulsorily or involuntarily converted as a result of Hurricane Katrina. The converted property must be located in an area determined by the President to warrant individual or individual and public assistance from the Federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be located in this area.

### Effective Date

The provision is effective upon enactment.

## B. Suspension of Limitations on Charitable Contributions for Relief Efforts Relating to Hurricane Katrina (sec. 102 of the bill)

### Present Law

#### In general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

#### Percentage limitations

Contributions by individuals

For individuals, in any taxable year, the amount deductible as a charitable contribution is limited to a percentage of the taxpayer's contribution base. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. The contribution base is defined as the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

Contributions by an individual taxpayer of property (other than appreciated capital gain property) to a charitable organization described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

Contributions by corporations

For corporations, in any taxable year, charitable contributions are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating loss or capital loss carrybacks.

For purposes of determining whether a corporation's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions.

Carryforward of excess contributions

Charitable contributions that exceed the applicable percentage limitation may be carried forward for up to five years (sec. 170(d)). The amount that may be carried forward from a taxable year ("contribution year") to a succeeding taxable year ("succeeding year") may not exceed the applicable percentage of the contribution base for the succeeding taxable year less the sum of contributions made in the succeeding taxable year plus contributions made in taxable years prior to the contribution year and treated as paid in the succeeding taxable year under this provision.

**Overall limitation on itemized deductions ("Pease" limitation)**

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's adjusted gross income in excess of a certain threshold. The otherwise allowable itemized deductions may not be reduced by more than 80 percent. For 2005, the adjusted gross income threshold is $145,950 ($72,975 for a married taxpayer filing a joint return). These dollar amounts are adjusted for inflation.

The otherwise applicable overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation is repealed for taxable years beginning after December 31, 2009, and reinstated for taxable years beginning after December 31, 2010.

## Explanation of Provision

**Increase in percentage limitations**

Under the provision, in the case of an individual, the deduction for qualified disaster contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried forward as contributions to which section 170(b)(1)(A) applies under the rules of section 170(d). Similar rules allow qualified disaster contributions to offset the entire taxable income of a corporation.

Qualified disaster contributions are cash contributions made during the period beginning on August 28, 2005, and ending on December 31, 2005, for relief efforts related to Hurricane

Katrina to a charitable organization described in section 170(b)(1)(A) (other than a supporting organization described in section 509(a)(3)).

Except as provided above, subsections (b) and (d) of section 170 are applied by not taking into account qualified disaster contributions.

For example, assume an individual's contribution base for 2005 is $100,000; aggregate qualified disaster contributions are $70,000; and other charitable contributions to which section 170(b)(1)(A) applies are $60,000. Under the provision, the taxpayer is allowed a deduction of $100,000 for 2005 ($50,000 determined without regard to qualified disaster contributions plus $50,000 for the qualified disaster contributions). $30,000 is treated as a contribution described in section 170(b)(1)(A) paid in each of the five succeeding taxable years (subject to the limitations of section 170(d)(1)(A)(i) and (ii)). $30,000 is the sum of the $10,000 excess referred to in section 170(d)(1)(A) (the excess of $60,000 over $50,000) and the $20,000 excess referred to in subsection (b)(1)(B) of this provision (the excess of $70,000 over $50,000).

The provision requires that qualified disaster contributions be made for relief efforts related to Hurricane Katrina. Taxpayers must substantiate that the contribution is made for such purpose. For example, it is intended that a receipt from a charity acknowledging that a contribution is intended to be used for such relief efforts generally would be sufficient. Other forms of substantiation could include a taxpayer making a notation on the taxpayer's check of the intended use of the contribution. However, such a notation generally would not establish that the contribution was made for the relief efforts of related to Hurricane Katrina if the donee organization was not involved in Katrina-related disaster relief. Other contemporaneous evidence showing the taxpayer's intent may be used.

**Limitation on overall itemized deductions**

Under the provision, the deduction for qualified disaster contributions (as defined above) is not treated as an itemized deduction for purposes of the overall limitation on itemized deductions.

## Effective Date

The provision is effective on the date of enactment.

## C. Mileage Rate for Charitable Purposes Related to Hurricane Katrina (sec. 103 of the bill)

### Present Law

In general, an itemized deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization − such as out-of-pocket transportation expenses necessarily incurred in performing donated services − may qualify as a charitable contribution (Treasury Regulation section 1.170A-1(g)). No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel (section 170(j)).

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile (section 170(i)). The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.

In lieu of actual operating expenses, an optional standard mileage rate may be used in computing the deductible costs of business use of an automobile. The business standard mileage rate is determined by the IRS and updated periodically. For expenses incurred on or after January 1, 2005, and before September 1, 2005, the business standard mileage rate specified by the IRS is 40.5 cents per mile. For expenses incurred on or after September 1, 2005, and before January 1, 2006, the business standard mileage rate specified by the IRS is 48.5 cents per mile (IRS Announcement 2005-99 (September 9, 2005)).

The standard mileage rate for charitable purposes is lower that the standard business rate because the charitable rate covers only the out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile in performing the donated services that a taxpayer may deduct as a charitable contribution. The charitable rate does not include costs that are not deductible as a charitable contribution such as general repair or maintenance expenses, depreciation, insurance, and registration fees. Such costs are, however, included in computing the business standard mileage rate.

## Explanation of Provision

The provision allows a taxpayer who uses a vehicle in providing donated services to charity solely for the provision of relief related to Hurricane Katrina to compute the taxpayer's charitable mileage deduction using a standard mileage rate equal to 70 percent of the business mileage rate in effect on the date of the contribution, rather than the charitable standard mileage rate generally in effect under section 170(i) (currently 14 cents per mile). For purposes of this provision, the term vehicle includes any vehicle described in section 170(f)(12)(E)(i) (i.e., a motor vehicle manufactured primarily for use on the public streets, roads, and highways). A taxpayer may determine the amount of the deduction using either the standard mileage rate or actual out-of-pocket expenditures.

It is intended that in addition to the present law substantiation requirements for use of the statutory mileage rate, a taxpayer must substantiate that expenses are incurred in providing relief related to Hurricane Katrina. For example, a taxpayer who uses the statutory mileage rate generally must keep, at a minimum, reliable written records regarding the number of miles driven, the dates on which he incurred the mileage, the name of the charitable organization for which services were provided, the locations in which he provided services to the charitable organization, and the charitable purposes of the services, which purposes must relate to providing relief related to Hurricane Katrina. The present-law statutory rate applies if a taxpayer fails to substantiate that the expenses are incurred for the provision of relief related to Hurricane Katrina, assuming all other present-law requirements are met.

## Effective Date

The provision is effective for contributions made before January 1, 2007.

## D. Exclusion for Certain Cancellations of Indebtedness (sec. 104 of the bill)

### Present Law

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income (except for discharges of real property business indebtedness), taxpayers generally exclude discharge of indebtedness from income but reduce tax attributes by the amount of the discharge of indebtedness. The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Present law generally requires "applicable entities" to file information returns with the IRS regarding any discharge of indebtedness in the amount of $600 or more (section 6050P). This requirement applies without regard to whether the debtor is subject to tax on the discharged indebtedness. The term "applicable entities" includes: (1) any financial institution (as described in section 581 (relating to banks) or section 591(a) (relating to savings institutions)); (2) any credit union; (3) any corporation that is a direct or indirect subsidiary of an entity described in (1) or (2) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; (4) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, certain other Federal executive agencies, and any successor or subunit of any of them; (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. section 3701(a)(4)); and (6) any other organization a significant trade or business of which is the lending of money. Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers generally is $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

### Explanation of Provision

The provision provides that gross income of a qualified individual does not include any amount which would otherwise be includible in gross income by reason of a discharge (in whole or in part) of qualified nonbusiness debt if the indebtedness is discharged by an applicable entity. Qualified nonbusiness debt is any indebtedness other than indebtedness incurred in connection with a trade or business. A qualified individual is any natural person who was a resident as of August 28, 2005 of, or who owned real property (as of the date of such discharge) in, an area determined by the President to warrant individual assistance or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The discharge of indebtedness relief allowed under this provision is limited to indebtedness secured by property within such area. An applicable entity is an executive, judicial, or legislative agency (as defined in section 3701(a)(4) of title 31 of the U.S. Code) and an applicable financial entity (as defined 6050P(c)(2) of the Code). Similar to the present-law rules, the amount excluded from gross income under this provision reduces the tax attributes of the taxpayer.

**Effective Date**

The provision applies to discharges made before January 1, 2007.

## E. Special Rules for Mortgage Revenue Bonds (sec. 105 of the bill)

### Present Law

**In general**

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") (secs. 103(b)(1) and 141).

**Qualified mortgage bonds**

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement). The first-time homebuyer requirement does not apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress.

A temporary provision waived the first-time homebuyer requirement for residences located in certain Presidentially declared disaster areas (sec. 143(k)(11)). In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The special rule for residences located in Presidentially declared disaster areas does not apply to bonds issued after January 1, 1999.

### Explanation of Provision

The provision waives the first-time homebuyer requirement for qualified Hurricane Katrina recovery residences by treating such residences as if they were targeted area residences. A qualified Hurricane Katrina recovery residence is defined as any residence located in an area which is determined by the President to warrant individual assistance or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The provision applies to residences financed before January 1, 2008.

## Effective Date

The provision is effective on the date of enactment.

## F. Suspension of Certain Limitations on Personal Casualty Losses (sec. 106 of the bill)

### Present Law

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise (sec. 165). For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

### Explanation of Provision

The provision permits individual taxpayers to claim casualty or theft losses attributable to Hurricane Katrina regardless of whether the loss exceeds $100. In addition, personal casualty or theft losses attributable to Hurricane Katrina are deductible without regard to whether the loss exceeds 10 percent of a taxpayer's adjusted gross income. For purposes of applying the 10 percent threshold to other personal casualty or theft losses, losses attributable to Hurricane Katrina are disregarded. The provision has the effect of treating personal casualty or theft losses from Hurricane Katrina as a deduction separate from all other casualty losses.

### Effective Date

The provision is effective on the date of enactment.

## G. Additional Exemption for Hurricane Katrina Displaced Individuals (sec. 107 of the bill )

### Present Law

In order to determine taxable income, an individual reduces adjusted gross income ("AGI") by any personal exemptions and either the standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse if filing jointly, and any dependents (as defined in sec. 151). Personal exemptions are not allowed for purposes of determining a taxpayer's alternative minimum taxable income.

For 2005, the amount deductible for each personal exemption is $3,200. This amount is indexed annually for inflation. The deduction for personal exemptions is phased out ratably for taxpayers with AGI over certain thresholds. These thresholds are indexed annually for inflation. Specifically, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. (The phaseout rate is two percent for each $1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed are phased out over a $122,500 range (which is not indexed for inflation), beginning at the applicable threshold. The applicable thresholds for 2005 are $145,900 for single individuals, $218,950 for married individuals filing a joint return, $182,450 for heads of households, and $109,475 for married individuals filing separate returns. For 2005, the point at which a taxpayer's personal exemptions are completely phased out is $268,450 for single individuals, $341,450 for married individuals filing a joint return, $304,950 for heads of households, and $170,725 for married individuals filing separate returns.

### Explanation of Provision

The provision provides an additional exemption of $500 for each Hurricane Katrina displaced individual of the taxpayer. The taxpayer may claim the additional exemption for no more than four individuals. Thus, the maximum additional exemption amount is $2,000. The exemption with respect to any Hurricane Katrina displaced individual may only be claimed one time for all taxable years.

A Hurricane Katrina displaced individual is an individual who (1) was (as of August 28, 2005) a resident of any area which is determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina, (2) is displaced from their residence located in the area described in (1), and (3) is provided housing free of charge by the taxpayer in the principal residence of the taxpayer for a period of not less than 60 consecutive days. Such term does not include the spouse or any dependent of the taxpayer.

The additional exemption is not subject to the income-based phaseouts applicable to other personal exemptions, and is allowed as a deduction in computing alternative minimum taxable income.

## Effective Date

The provision applies to taxable years beginning in 2005 and 2006.

## H. Special Look-Back Rule for Determining Earned Income Credit and Refundable Child Credit (sec. 108 of the bill)

### Present Law

Present law provides eligible taxpayers with an earned income credit and a child credit. In general, the earned income credit is a refundable credit for low-income workers (sec. 32). The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no qualifying children. Earned income generally includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.

Taxpayers with incomes below certain threshold amounts are eligible for a $1,000 credit for each qualifying child (sec. 24). The child credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of $10,000. (The $10,000 income threshold is indexed for inflation and is currently $11,000 for 2005.) Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000 (indexed for inflation).

### Explanation of Provision

The provision permits qualified individuals to elect to calculate their earned income credit and refundable child credit for the taxable year which includes August 28, 2005, using their earned income from the prior taxable year. Qualified individuals are permitted to make the election only if their earned income for the taxable year which includes August 28, 2005, is less than their earned income for the preceding taxable year. Qualified individuals are individuals who on August 28, 2005, were residents of any area which is determined by the President to warrant individual or individual and public assistance from the Federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

For purposes of the provision, in the case of a joint return for a taxable year which includes August 28, 2005, the earned income which is attributable to the taxpayer for the preceding taxable year is the sum of the earned income which is attributable to each spouse for such preceding taxable year. Any election to use the prior year's earned income under the provision applies with respect to both the earned income credit and refundable child credit. For administrative purposes, the incorrect use on a return of earned income pursuant to an election under this provision is treated as a mathematical or clerical error. An election under the provision is disregarded for purposes of calculating gross income in the election year.

### Effective Date

The provision is effective for the taxable year of a qualified individual that includes August 28, 2005.

## I. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status for Taxpayers Affected by Hurricane Katrina (sec. 109 of the bill)

### Present Law

In order to determine taxable income, an individual reduces adjusted gross income ("AGI") by any personal exemptions and either the standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents (as defined in sec. 151). Personal exemptions are not allowed for purposes of determining a taxpayer's alternative minimum taxable income.

For 2005, the amount deductible for each personal exemption is $3,200. This amount is indexed annually for inflation. The deduction for personal exemptions is phased out ratably for taxpayers with AGI over certain thresholds. These thresholds are indexed annually for inflation. Specifically, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. (The phaseout rate is two percent for each $1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed are phased out over a $122,500 range (which is not indexed for inflation), beginning at the applicable threshold. The applicable thresholds for 2005 are $145,900 for single individuals, $218,950 for married individuals filing a joint return, $182,450 for heads of households, and $109,475 for married individuals filing separate returns. For 2005, the point at which a taxpayer's personal exemptions are completely phased out is $268,450 for single individuals, $341,450 for married individuals filing a joint return, $304,950 for heads of households, and $170,725 for married individuals filing separate returns.

Present law provides eligible taxpayers with an earned income credit and a child credit. In general, the earned income credit is a refundable credit for low-income workers. The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no qualifying children. Earned income generally includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.

Taxpayers with incomes below certain threshold amounts are eligible for a $1,000 credit for each qualifying child. The child credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of $10,000. (The $10,000 income threshold is indexed for inflation and is currently $11,000 for 2005.) Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000 (indexed for inflation).

### Explanation of Provision

The provision authorizes the Secretary of the Treasury to make such adjustments in the application of the Federal tax laws as may be necessary to ensure that taxpayers do not lose dependency exemptions or child credits or experience a change of filing status by reason of temporary relocations or the receipt of relief as a result of Hurricane Katrina. Such adjustments may include, for example, addressing the application of the residency requirements relating to dependency exemptions in the case of relocations due to Hurricane Katrina. Any adjustments made under this provision must insure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit.

**Effective Date**

The provision is effective on the date of enactment.

## J. Work Opportunity Tax Credit For Certain Individuals (sec. 110 of the bill)

### Present Law

#### Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under State or Federal law; (2) being a member of an economically disadvantaged family; and (3) having a hiring date within one year of release from prison or conviction.

#### Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

#### Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

#### Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

#### Qualifying rehires

No credit is available for any individual if, prior to the hiring date of such individual, such individual had been employed by the employer at any time.

#### Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee for which the employer claims the welfare-to-work tax credit.

**Other rules**

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. In addition, many other technical rules apply.

**Expiration date**

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2006.

## Explanation of Provision

The provision provides that a Hurricane Katrina employee is treated as a member of a targeted group for purposes of the work opportunity tax credit. A Hurricane Katrina employee is an individual who on August 28, 2005, had a principal place of abode in the Hurricane Katrina disaster area.

The provision shall only apply to wages (within the meaning of section 51(c) of the Code) paid or incurred to any individual who: (1) is hired for a position, the principal place of employment of which is located in a Hurricane Katrina disaster area, and (2) begins work for the employer during the two-year period beginning on August 29, 2005. The Hurricane Katrina disaster area means the area determined by the President to warrant individual assistance or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

The present-law rule that denies the credit with respect to wages of employees who had been previously employed by the employer is waived except in the case of an employee of the employer (within the meaning of section 51 of the Code) on August 28, 2005 or an employee initially hired after such date.

The present-law work opportunity tax credit expiration date is waived for purposes of Hurricane Katrina employees.

## Effective Date

The provision is effective on the date of enactment.

## II. PENALTY FREE USE OF RETIREMENT FUNDS IN CASE OF HURRICANE KATRINA

### A. Penalty Free Withdrawals from Retirement Plans for Qualified Disaster Relief Distributions Due to Hurricane Katrina (sec. 201 of the bill and secs. 72(t), 401(k), 402(c), 403(b), and 457(d) of the Code)

#### Present Law

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a "403(b) annuity"), an eligible deferred compensation plan maintained by a State or local government (a "governmental 457 plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed. In addition, a distribution from a qualified retirement plan, a 403(b) annuity, or an IRA received before age 59-½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies.

An eligible rollover distribution from a qualified retirement plan, a 403(b) annuity, or a governmental 457 plan, or a distribution from an IRA, generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Any amount rolled over is not includible in income (and thus also not subject to the 10-percent early withdrawal tax).

Distributions from a qualified retirement plan, 403(b) annuity, a governmental 457 plan, or an IRA are generally subject to income tax withholding unless the recipient elects otherwise. An eligible rollover distribution from a qualified retirement plan, 403(b) annuity, or governmental 457 plan is subject to income tax withholding at a 20-percent rate unless the distribution is rolled over to another plan, annuity or IRA by means of a direct transfer.

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a "401(k) plan") or in a 403(b) annuity may not be distributed before severance from employment, age 59-½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan may not be distributed before severance from employment, age 70-½, or an unforeseeable emergency of the employee.

#### Explanation of Provision

The provision provides an exception to the 10-percent early withdrawal tax in the case of a qualified disaster-relief distribution from a qualified retirement plan, a 403(b) annuity or an IRA. A qualified disaster-relief distribution is any distribution made: (1) to an individual who has sustained a loss as a result of a major disaster declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Stafford Act") by reason of Hurricane Katrina and who, immediately before the disaster declaration, has a principal place of abode in a qualified disaster area; and (2) during the one-year period beginning on the date of the disaster declaration. A qualified disaster area is an area determined by the President to warrant individual assistance or individual and public assistance from the Federal Government under the Stafford Act by reason of Hurricane Katrina. The total amount of qualified disaster-relief distributions that an individual can receive from all plans, annuities, or IRAs is $100,000. Thus, any distributions in excess of $100,000 during the applicable one-year period are not qualified disaster-relief distributions.

In addition, under the provision, any portion of a qualified disaster-relief distribution from a qualified retirement plan, a 403(b) annuity, a governmental 457 plan, or an IRA may, during the three-year period beginning the day after the date of the disaster declaration, be recontributed to a plan, annuity or IRA to which a rollover can be made. Any amount withdrawn pursuant to the provision is includible in gross income, except to the extent of recontributions, which are treated as a rollover. For example, if an individual receives a qualified disaster-relief distribution in 2005, that amount is included in income, but not subject to the 10-percent early withdrawal tax. (Under another provision of the bill, the amount required to be included in income may be spread over three years.) If the amount of the distribution is recontributed in 2007 to a qualified retirement plan, 403(b) annuity, governmental 457 plan, or IRA, the individual may file an amended return to claim a refund of the tax attributable to the amount previously included in income.

A qualified disaster-relief distribution is a permissible distribution from a 401(k) plan, 403(b) annuity, or governmental 457 plan, regardless of whether a distribution would otherwise be permissible.

Under the provision, qualified disaster-relief distributions are subject to the income tax withholding rules applicable to distributions other than qualified rollover distributions. Thus, 20-percent mandatory withholding does not apply.

## Effective Date

The provision is effective for distributions received after August 28, 2005.

## B. Income Averaging for Disaster-Relief Distributions Related to Hurricane Katrina (sec. 202 of the bill)

### Present Law

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a “403(b) annuity”), an eligible deferred compensation plan maintained by a State or local government (a "governmental 457 plan"), or an individual retirement arrangement (an “IRA”) is generally included in income for the year distributed (secs. 402(a), 403(b), 408(d), 457(a)).

### Explanation of Provision

Under the provision, an amount required to be included in income by a qualified individual as a result of a qualified disaster-relief distribution from a qualified retirement plan, a 403(b) annuity, a governmental 457 plan, or an IRA is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have the provision apply. A qualified disaster-relief distribution is defined as under the provision relating to penalty-free withdrawals due to hurricane Katrina and includes a distribution made to a qualified individual during the one-year period beginning on the date of the disaster declaration, subject to a limit of $100,000.

For this purpose, a qualified individual is an individual who has sustained a loss as a result of the major disaster declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the “Stafford Act”) by reason of Hurricane Katrina and who, immediately before the disaster declaration, has a principal place of abode in a Hurricane Katrina disaster area. A Hurricane Katrina disaster area is an area which is determined by the President to warrant individual assistance or individual and public assistance from the Federal Government under the Stafford Act by reason of Hurricane Katrina.

Certain rules apply for purposes of the provision. For example, the amount required to be included in income for any taxable year in the three-year period cannot exceed the total amount to be included in income with respect to the qualified disaster-relief distribution, reduced by amounts included in income for preceding years in the period.

Under the provision relating to penalty-free withdrawals, an individual who receives a qualified disaster-relief distribution may recontribute the amount of the distribution to a qualified retirement plan, a 403(b) annuity, a governmental 457 plan, or an IRA, and the recontribution is treated as a tax-free rollover. If such a recontribution is made before the full amount of the distribution has been included in income under this provision, any remaining amount is reduced by the amount of the recontribution.

### Effective Date

The provision is effective on the date of enactment.

## C. Recontributions of Withdrawals for Home Purchases Cancelled Due to Hurricane Katrina (sec. 203 of the bill)

### Present Law

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a "403(b) annuity"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed (secs. 402(a), 403(b), and 408(d)). In addition, a distribution from a qualified retirement plan, a 403(b) annuity, or an IRA received before age 59-1/2, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)). An exception to the 10-percent tax applies in the case of a qualified first-time homebuyer distribution from an IRA, i.e., a distribution (not to exceed $10,000) used within 120 days for the purchase or construction of a principal residence of a first-time homebuyer.

An eligible rollover distribution from a qualified retirement plan or a 403(b) annuity or a distribution from an IRA generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Any amount rolled over is not includible in income (and thus also not subject to the 10-percent early withdrawal tax).

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a "401(k) plan") or a 403(b) annuity may not be distributed before severance from employment, age 59-½, death, disability, or financial hardship of the employee. For this purpose, subject to certain conditions, distributions for costs directly related to the purchase of a principal residence by an employee (excluding mortgage payments) are deemed to be distributions on account of financial hardship.

### Explanation of Provision

In general, under the provision, a distribution received from a 401(k) plan, 403(b) annuity, or IRA in order to purchase a home in an area declared a disaster area by reason of Hurricane Katrina may be recontributed to such a plan, annuity, or IRA in certain circumstances.

The provision applies to an individual who receives a qualified distribution. A qualified distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA: (1) that is received after February 28, 2005, and before August 29, 2005; and (2) that was to be used to purchase or construct a principal residence in a Hurricane Katrina disaster area, but which is not used to purchase or construct the residence. A Hurricane Katrina disaster area is an area which is determined by the President to warrant individual assistance or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

Under the provision, any portion of a qualified distribution may, within the six-month period beginning the day after the date of the disaster declaration, be recontributed to a plan, annuity or IRA to which a rollover is permitted. Any amount recontributed is treated as a rollover. Thus, that portion of the qualified distribution is not includible in income (and also is not subject to the 10-percent early withdrawal tax).

## Effective Date

The provision is effective on the date of enactment.

## D. Loans from Qualified Plans in Connection with Hurricane Katrina (sec. 204 of the bill)

### Present Law

An individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated.

Subject to certain exceptions, a loan from a qualified employer plan to a plan participant is treated as a taxable distribution of plan benefits. A qualified employer plan includes a qualified retirement plan under section 401(a), a tax-deferred annuity under section 403(a) or section 403(b), and any plan that was (or was determined to be) a qualified employer plan or a governmental plan.

An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or (2) the greater of $10,000 or one half of the participant's accrued benefit under the plan. This exception applies only if the loan is required, by its terms, to be repaid within five years. An extended repayment period is permitted for the purchase of the principal residence of the participant. Plan loan repayments (principal and interest) must be amortized in level payments and made not less frequently than quarterly, over the term of the loan.

### Explanation of Provision

The proposal provides special rules that in the case of a loan from a qualified employer plan to a qualified individual made after the date of enactment and before the date which is one year after the disaster declaration date. A qualified individual is an individual who has sustained a loss as a result of the major disaster declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina and who, immediately before the disaster declaration, has a principal place of abode in a Hurricane Katrina disaster area (as previously defined). The disaster declaration date is the date on which the President designated the area as a Hurricane Katrina disaster area.

Under the proposal, the exception to the general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or (2) the greater of $10,000 or the participant's accrued benefit under the plan.

Under the proposal, in the case of a qualified individual with an outstanding loan on or after August 26, 2005, from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning after August 29, 2005, and ending before August 30, 2006, such due date is extended for one year. Any subsequent repayments with respect to such loan shall be appropriately adjusted to reflect the delay in the due date and any interest accruing during such delay. The period during which required repayment is delayed is disregarded in complying with the requirements that the loan be repaid within five years and that level amortization payments be made.

**Effective Date**

The proposal is effective on the date of enactment.

## E. Provisions Relating to Plan Amendments in Connection with Hurricane Katrina (sec. 205 of the bill)

### Present Law

Present law provides a remedial amendment period during which, under certain circumstances, a plan may be amended retroactively in order to comply with the qualification requirements (sec. 401(b)). In general, plan amendments to reflect changes in the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The Secretary of the Treasury may extend the time by which plan amendments need to be made.

### Explanation of Provision

The provision permits certain plan amendments made pursuant to the changes made by the provisions of Title I of the bill, or regulations issued thereunder, to be retroactively effective. If the plan amendment meets the requirements of the provision, then the plan will be treated as being operated in accordance with its terms. In order for this treatment to apply, the plan amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2007, or such later date as provided by the Secretary of the Treasury. Governmental plans are given an additional two years in which to make required plan amendments. If the amendment is required to be made to retain qualified status as a result of the changes made by Title I of the bill (or regulations), the amendment is required to be made retroactively effective as of the date on which the change became effective with respect to the plan, and the plan is required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to the changes made by Title I of the bill (or regulations) may be made retroactively effective as of the first day the plan is operated in accordance with the amendment. A plan amendment will not be considered to be pursuant to changes made by Title I of the bill (or regulations) if it has an effective date before the effective date of the provision under the bill (or regulations) to which it relates.

### Effective Date

The provision is effective on the date of enactment.