Order Code RS22249
September 9, 2005

CRS Report for Congress

Received through the CRS Web

Income Tax Relief in Times of Disaster

Pamela J. Jackson
Analyst in Public Sector Economics
Government and Finance Division

Summary

In response to the devastation caused by Hurricane Katrina, disaster areas have been designated in 64 parishes in Louisiana, 52 counties in Mississippi, six counties in Alabama, and three counties in Florida. Special provisions are available for taxpayers to help recover from the impact of a disaster.

Generally, individuals and businesses can claim an income tax deduction for casualty losses. When the casualty losses occur in a presidentially-declared disaster area special tax provisions come into play. For example, taxpayers can shorten the amount of time it takes to receive an income tax refund by filing an amended tax return for the previous tax year to claim losses from the disaster. Another special tax rule allows for the deferral of capital gain from involuntary conversions of assets.

Taxpayers in a presidentially-declared disaster area who receive grants from FEMA, state programs, charitable organizations or employers to cover medical, transportation, or temporary housing expenses are able to exclude these grants from taxable income.

In response to Hurricane Katrina, Congress may choose to consider enacting additional tax relief. This has been the case in past disasters, notably in response to the terrorist attacks of September 11, 2001. A provision enacted by the Victims of Terrorism Tax Relief Act of 2001 allowed an exemption from income taxes for any individual who died as a result of wounds or injury incurred from the terrorist attacks, along with a few other forms of tax relief.

This report will be updated in the event of legislative or regulatory changes.

As a result of Hurricane Katrina, which struck on Monday, August 29, 2005, many individuals and businesses have experienced losses. Special tax law provisions for taxpayers are available to help recover from the impact of a disaster, especially in the event of presidentially-declared disasters such as Hurricane Katrina.[1]

On August 30, 2005, the Internal Revenue Service reported that 49 regions had been designated as presidentially-declared disaster areas.[2] Thirty-one parishes in Louisiana, 15 counties in Mississippi, and three counties in Alabama were included in the initial declaration. On September 2, 2005, the IRS expanded the list of regions to include an additional 33 parishes in Louisiana, 37 counties in Mississippi, and three counties in both Alabama and Florida. Currently, areas eligible for tax relief are:

- 64 Louisiana parishes: Acadia, Allen, Ascension, Assumption, Avoyelles, Beauregard, Bienville, Bossier, Caddo, Caldwell, Calcasieu, Cameron, Catahoula, Claiborne, Concordia, Desoto, East Baton Rouge, East Carroll, East Feliciana, Evangeline, Franklin, Grant, Iberia, Iberville, Jackson, Jefferson, Jefferson Davis, Lafayette, Lafourche, LaSalle, Lincoln, Livingston, Madison, Morehouse, Natchitoches, Orleans, Ouachita, Pointe Coupee, Plaquemines, Rapides, Red River, Richland, Sabine, St. Bernard, St. Charles, St. Helena, St. James, St. John, St. Landry, St. Mary, St. Martin, St. Tammany, Tangipahoa, Tensas, Terrebonne, Union, Vermilion, Vernon, Washington, Webster, West Baton Rouge, West Carroll, West Feliciana, and Winn;

- 52 Mississippi counties: Adams, Amite, Attala, Chickasaw, Choctaw, Claiborne, Clarke, Clay, Copiah, Covington, Forrest, Franklin, George, Greene, Hancock, Harrison, Hinds, Itawamba, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Lee, Lincoln, Lowndes, Madison, Marion, Monroe, Neshoba, Newton, Noxubee, Oktibbeha, Pearl River, Perry, Pike, Rankin, Scott, Simpson, Smith, Stone, Walthall, Warren, Wayne, Webster, Wilkinson, and Winston;

- Six Alabama counties: Baldwin, Clarke, Choctaw, Mobile, Sumter, and Washington; and

- Three Florida counties: Broward, Miami-Dade, and Monroe.

Tax Relief for Losses

Casualty losses can result from the destruction of, or damage to, property from any sudden, unexpected, and unusual event such as a flood, hurricane, tornado, fire, earthquake, or even volcanic eruption. If property is destroyed, damaged, or stolen due to a casualty, taxpayers may be entitled to an itemized tax deduction. The deduction is limited to the casualty loss minus 10% of the taxpayer's adjusted gross income (AGI) and $100 per casualty event. Further, the deduction is reduced by any reimbursement for the

---

[1] Areas declared by the President of the United States to warrant federal assistance as the result of a disaster are designated as presidentially-declared disaster areas.

[2] U.S. Department of Treasury, Internal Revenue Service, website [http://www.irs.gov /newsroom/article/0,,id=147055,00.html], visited Sept. 1, 2005.

damaged property (such as insurance). In cases where the recovery amount exceeds a taxpayer's basis, a casualty gain occurs and is taxable.

If property is not completely destroyed or stolen, or if it is personal-use property, the loss is determined by first figuring the decrease in fair market value of the property as a result of the casualty event. Then the decrease in fair market value is compared with the adjusted basis in the property. The adjusted basis is usually the cost of the property plus or minus certain adjustments. From the smaller of these two amounts, the taxpayer subtracts any insurance or other reimbursement received or expected to be received. The result is the loss from the casualty. If business or income-producing property is completely destroyed or stolen, a decrease in fair market value is not considered. The loss is the adjusted basis of the property, minus any salvage value and any insurance or other reimbursement that is received or expected to be received.

Casualty losses are generally deductible only in the year the casualty occurred. However, if a deductible loss occurs as a result of a disaster in a presidentially-declared disaster area, taxpayers can choose to deduct that loss on the tax return for the year immediately preceding the year of the casualty. If taxpayers have already filed a tax return for the preceding year, the loss may be claimed in the preceding year by filing an amended return (Form 1040X for individuals or Form 1120X for corporations).

In the particular case of the victims of Hurricane Katrina, taxpayers have the option to claim the disaster loss in one of two years. They can either claim the disaster loss in the year the disaster occurred when filing the 2005 tax returns by April 15, 2006, or claim the loss for the 2004 tax year by filing an amended return. Claiming the loss for 2004 allows the issuance of a tax refund more quickly.

Postponement of Deadlines and Abatement of Interest or Fees or Both

The IRS may postpone certain tax deadlines of taxpayers who are affected by a presidentially-declared disaster. On September 8, 2005, the IRS extended tax filing deadlines through January 3, 2006, for the residents of, and relief workers in, disaster areas in four states.[3] The tax deadline includes those for filing income, estate, gift, generation-skipping transfer, certain excise, and employment tax returns, paying taxes associated with those returns, and making contributions to a traditional IRA or Roth IRA.

If the IRS postpones the due date for filing returns and for paying taxes and taxpayers are affected by a presidentially-declared disaster area, the IRS may abate the interest on underpaid tax that would otherwise accrue for the period of the postponement. Taxpayers located in a presidentially-declared disaster area do not have to pay interest on taxes due for the length of any extension for filing their tax returns granted by the Secretary of the Treasury.

[3] U.S. Department of Treasury, Internal Revenue Service, "Katrina Victims Will Have Until Jan. 3 to File and Pay Taxes," *News Release IR-2005-96*, website [http://www.irs.gov /newsroom/article/0,,id=147371,00.html], visited Sept. 8, 2005.

Deferral of Gain on Involuntary Conversions

When personal property is involuntarily converted into cash, i.e., insurance proceeds, it is generally taxed unless the proceeds are used to replace the destroyed property with similar property within a specified period. In contrast, special rules are provided for a taxpayer's principal residence, or any of its contents, when involuntarily converted (damaged and replaced with insurance proceeds) as a result of a presidentially-declared disaster. The Disaster Relief and Emergency Assistance Act (DREAA; P.L. 100-707) included a provision that allows taxpayers to defer the recognition (i.e., taxation) of any gain realized on an involuntary conversion of property that occurs as a result of a presidentially-declared disaster. The gain on the involuntary conversion is deferred until a taxable sale or exchange occurs.[4]

The replacement period for property involuntarily converted and located within the presidentially-declared disaster area under DREAA is four years after the close of the first taxable year in which any part of the gain upon conversion is realized.

A single exception to the involuntary conversion was provided to taxpayers who do not own their residences. The rules apply to taxpayers who rent the home that serves as their principal residence and have damaged or destroyed property.

Taxpayer Assistance at Local Disaster Recovery Centers

The Internal Revenue Service announced on September 7, 2005, that it will partner with the American Institute of Certified Public Accountants (AICPA) to provide assistance to taxpayers at local disaster recovery centers established by the Federal Emergency Management Agency (FEMA). Volunteer accountants and other tax personnel will help address some of the tax issues and concerns that victims will face by providing technical expertise to explain the laws regarding disaster-related tax relief.

Disaster Relief Payments

Taxpayers in a presidentially-declared disaster area who receive grants from FEMA, state programs, charitable organizations or employers to cover medical, transportation, or temporary housing expenses are able to exclude these grants from taxable income. However, unemployment assistance payments under the Disaster Relief and Emergency Assistance Act are taxable unemployment compensation. Taxpayers may exclude from

---

[4] In the case of unscheduled personal property (property that is not specifically identified in the insurance policy but is nonetheless insured), no gain is recognized when the taxpayer receives insurance proceeds. There is no requirement that the proceeds replace the destroyed property. The same treatment is not available for other insurance proceeds (i.e., proceeds for scheduled property). However, other insurance proceeds for the principal residence or its contents may be treated as a common pool of funds. If the common pool of funds is used to purchase any property similar to, or related in service or use to, the converted residence (or its contents), the taxpayer may elect to recognize gain only to the extent that the amount of the pool of funds exceeds the cost of the replacement property.

income any amount received that is a qualified disaster relief payment.[5] A qualified disaster relief payment is an amount paid to the taxpayer:

1. To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses that result from a qualified disaster;
2. To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of the taxpayer's home or repair or replacement of its contents to the extent it is due to a qualified disaster;
3. By a person engaged in the furnishing or sale of transportation as a common carrier because of the death or personal physical injuries incurred as a result of a qualified disaster; and
4. By a federal, state, or local government or agency, or instrumentality in connection with a qualified disaster in order to promote the general welfare.

Disaster relief payments were originally excluded from income by the Victims of Terrorism Tax Relief Act of 2001, which added a new section (Section 139) to the Internal Revenue Code.

State and Local Responses

Aside from the federal response for tax relief, some states may enact tax relief that is similar to federal provisions. An example would be allowing taxpayers additional time to file returns or to make payment of taxes. Already, the California Franchise Tax Board will cancel interest, late filing, and late payment penalties that would otherwise apply to taxpayers in the federally declared disaster areas affected by Hurricane Katrina.[6] Further, the Georgia, Pennsylvania, and New Jersey Departments of Revenue announced that businesses or individuals in the presidential disaster area struck by Hurricane Katrina are eligible for extensions until October 31, 2005 to file state tax returns and submit payments with original due dates falling between August 29 and October 31, 2005.[7]

In Louisiana, Hurricane Katrina victims and others who use hotel rooms for extended periods longer than two consecutive months are exempt from state sales tax on their room occupancy charges, according to the Louisiana Department of Revenue.[8]

In Texas, the state comptroller communicated that businesses affected by Hurricane Katrina's devastation may postpone paying taxes owed to Texas. In particular, businesses will, upon request, be granted an extension of 90 days to file tax returns due in September

---

[5] U.S. Department of Treasury, Internal Revenue Service, *Taxable and Non-Taxable Disaster Payments/Benefits*, website [http://www.irs.gov/businesses/small/article/0,,id=147166,00.html, visited] Sept. 9, 2005.

[6] Laura Mahoney, "FTB Extends Deadlines, Waives Penalties For Taxpayers Affected by Hurricane Katrina," *Daily Tax Report*, Sept. 2, 2005, p. H-1.

[7] Barney Tumey, "Revenue Agency Offers Relief To Victims of Hurricane Katrina," *Daily Tax Report*, Sept. 2, 2005, p. H-2 and Lorraine McCarthy, "Taxpayers in Hurricane Katrina Disaster Area Receive State Tax Filing, Payment Extensions," *Daily Tax Report*, Sept. 9, 2005, p. H-2.

[8] Susanne Pagano, "DOR Officials Highlight for Katrina Victims Sales Tax Break on Long-Term Room Rental," *Daily Tax Report*, Sept. 1, 2005, p. H-2.

and October 2005, with additional extensions granted if necessary. The comptroller reported that about 7,138 Texas businesses have operations in Louisiana, Mississippi, or Alabama.[9]

Victims of Terrorism Tax Relief Act of 2001

In response to Hurricane Katrina, Congress may choose to consider enacting additional tax relief. This has been the case in past disasters, notably in response to the terrorist attacks of September 11, 2001. The Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134) included an exemption from income taxes for individuals who died as a result of wounds or injuries incurred from the terrorist attacks against the United States, or who died as a result of illness incurred from a terrorist attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002. The law also excluded from gross income certain death benefits paid by an employer to a victim of the attacks, and set special (lowered) estate tax rates applicable to combat zone related deaths of members of the armed forces and victims of the attacks.

IRS Publications

The Internal Revenue Service has several publications available for taxpayers who have experienced losses related to disasters. These documents explain the tax rules and provide the filing forms and information that taxpayers may require.

Publication 547, Casualties, Disasters and Thefts
[http://www.irs.gov/pub/irs-pdf/p547.pdf]

Publication 2194, Disaster Losses Kit for Individuals
[http://www.irs.gov/pub/irs-pdf/p2194.pdf]

Publication 2194B, Disaster Losses Kit for Businesses
[http://www.irs.gov/pub/irs-pdf/p2194b.pdf]

Publication 3833, Disaster Relief: Providing Assistance through Charitable Organizations
[http://www.irs.gov/pub/irs-pdf/p3833.pdf]

Publication 559, Survivors, Executors, and Administrators
[http://www.irs.gov/pub/irs-pdf/p559.pdf]

---

[9] Kurt Fernandez, "Comptroller Says Businesses Impacted By Katrina May Postpone Tax Payments," *Daily Tax Report*, Sept. 1, 2005, p. H-2.