

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The text is centered within the hourglass shape.

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*Income Tax Relief in Times of Disaster*

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**Abstract.** Most recently, in response to hurricanes in the Gulf region (Katrina, Wilma, and Rita), Congress enacted additional tax relief. H.R. 3768, the Katrina Emergency Tax Relief Act of 2005, became P.L. 109-73 on September 23, 2005, and H.R. 4440, the Gulf Opportunity Zone Act of 2005, became P.L. 109-135 on December 22, 2005. The new laws expand existing tax relief for victims of the hurricanes.

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# CRS Report for Congress

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## Income Tax Relief in Times of Disaster

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### Summary

Income tax relief in times of disaster is varied, but typically includes several key provisions in the federal tax code. These provisions include a deduction for casualty losses, the postponement of filing deadlines, and the abatement of interest and/or fees.

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.

Most recently, in response to hurricanes in the Gulf region (Katrina, Wilma, and Rita), Congress enacted additional tax relief. H.R. 3768, the Katrina Emergency Tax Relief Act of 2005, became P.L. 109-73 on September 23, 2005, and H.R. 4440, the Gulf Opportunity Zone Act of 2005, became P.L. 109-135 on December 22, 2005. The new laws expand existing tax relief for victims of the hurricanes.

This report will be updated as warranted by legislative events.

Special tax law provisions are designed to help taxpayers recover financially from the impact of a disaster. Although recent legislative attention has focused on the hurricanes of the fall of 2005, other disasters have included storms and floods, land and mud slides, wildfires, and tornados. In many cases these disasters result in a presidential declaration of disaster that affords victims special benefits and incentives to assist in the recovery. Specifically, 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. Depending on the circumstances, the IRS may grant additional time to file returns and pay taxes. Individuals and businesses in a presidentially declared disaster area

can obtain a faster refund by claiming losses related to the disaster on the tax return for the previous year, usually by filing an amended return.

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

The Katrina Emergency Tax Relief Act (P.L. 109-73) enacted a provision that waives both the limitation of the deduction to 10% of the taxpayer's adjusted gross income and the \$100 per casualty event. The waiver applies to losses that arise in the Hurricane Katrina disaster area on or after August 25, 2005.

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). Claiming the loss in this manner 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. The extensions apply to tax deadlines for filing most tax returns, including individual income tax returns, corporation and S-corporation income tax returns, partnership tax returns, estate and trust income tax returns, estate and gift tax returns, exempt organization returns, employment tax returns, and certain excise tax returns.

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.

## **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. There are, however, special rules 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.<sup>1</sup>

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 for 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 partners with tax professionals to provide assistance to taxpayers at local disaster recovery centers that are usually established by the Federal Emergency Management Agency (FEMA). These partners include the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), the National Association of Tax Professionals (NATP), and other organizations. 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.

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<sup>1</sup> 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.

State disaster assistance coordinators also support the IRS effort at local disaster recovery centers. Coordinators assist victims by distributing tax kits, advising about reconstructing lost financial records, counseling on the determination of deductible casualty losses, and preparing tax returns.

## 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 income any amount received that is a qualified disaster relief payment.<sup>2</sup> 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. States can also cancel interest and late filing and late payment penalties that would otherwise apply to taxpayers.

## Special Tax Relief Enacted for Gulf Region in 2005

The Katrina Emergency Tax Relief Act of 2005, P.L. 109-73, provides tax relief that is intended to assist the victims of Hurricane Katrina. Some of the provisions enacted distinguish between the "Hurricane Katrina disaster area," which is the presidentially declared disaster area, and the "core disaster area," which is the portion of the disaster

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<sup>2</sup> 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.

area determined by President Bush to warrant individual or individual and public assistance under the Stafford Act.<sup>3</sup>

The Gulf Opportunity Zone Act of 2005, P.L. 109-135, was signed into law on December 22, 2005. The act provides tax benefits to assist in the recovery from Hurricanes Katrina, Rita, and Wilma. Some of its provisions expand several sections of the Katrina Emergency Tax Relief Act to apply to victims of Hurricanes Rita and Wilma.<sup>4</sup>

## IRS Publications and Disaster Information Resources

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>]

The toll-free IRS disaster help line is (866) 562-5227.

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<sup>3</sup> See CRS Report RS22269, *Katrina Emergency Tax Relief Act of 2005*, by Erika Lunder for more detailed information.

<sup>4</sup> See CRS Report RS22344, *The Gulf Opportunity Zone Act of 2005*, by Erika Lunder for more detailed information.