Order Code RS22941
August 20, 2008

CRS Report for Congress

Disaster Tax Relief for the Midwest

Erika Lunder
Legislative Attorney
American Law Division

Summary

The Midwestern Disaster Tax Relief Act of 2008 (S. 3322 and H.R. 6587) is intended to assist with the recovery from the severe weather that affected the Midwest during the summer of 2008. The Jobs, Energy, Families, and Disaster Relief Act of 2008 (S. 3335) includes some similar provisions, but these are not limited to the Midwest disaster. The disaster relief in the three bills is similar to that provided to assist with the recovery from the 2005 hurricanes and the 2007 Kansas tornadoes. This report broadly discusses the disaster relief provisions in S. 3322/H.R. 6587 and S. 3335.

The Midwestern Disaster Tax Relief Act of 2008 (S. 3322/H.R. 6587), introduced by Senator Grassley and Representative Loebsack, provides temporary tax relief intended to assist with the recovery from the severe storms, tornadoes, and flooding that occurred during the summer of 2008 in the Midwest. The relief would be available in the presidentially declared disaster areas in Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin, primarily in the areas determined by the President to warrant individual or individual and public assistance.

The Jobs, Energy, Families, and Disaster Relief Act of 2008 (S. 3335), introduced by Senator Baucus, contains some temporary tax provisions intended to assist in disaster recovery generally.[1] Its provisions are not limited to the Midwest disaster — in general, the provisions would be effective after December 31, 2007, and apply to any federally declared disaster occurring before January 1, 2010. S. 3335 has fewer relief provisions than S. 3322/H.R. 6587. The ones it does contain are generally similar to those in S. 3322/H.R. 6587, accounting for the differences that are due to the fact that S. 3335 is not limited to the Midwest disaster.

Tax-Exempt Bonds. Section 2(e)(1) of the Grassley/Loebsack bill would allow affected states to issue tax-exempt bonds to finance (1) qualified activities involving

[1] It would also amend provisions providing relief for past events. Section 511 would modify the New York Liberty Zone benefits; e.g., it would provide a credit for employment withholding taxes to area governmental units with qualifying project expenditures. Section 240 would extend the provision in the work opportunity credit for Hurricane Katrina employees by one year.

residential rental projects, nonresidential real property, and public utility property located in the disaster area; and (2) below-market-rate mortgages for low- and moderate-income homebuyers whose principal residences were damaged by the disaster. Among other requirements, the bonds would have to be designated by the appropriate state authority on the basis of providing assistance to where it was most needed. Bonds would have to be issued prior to January 1, 2013, and the maximum face amount of bonds each state could issue would be capped at $1,000 multiplied by the portion of the state's population in the disaster area. The Baucus bill does not include a similar provision.

Both the Grassley/Loebsack bill (§ 2(a)(1)(G), (e)(1)) and the Baucus bill (§ 504) would provide similar, although not identical, modifications to temporarily ease the restrictions on mortgage revenue bond financing under IRC § 143 for areas or taxpayers affected by the Midwest disaster or federally declared disasters, respectively. The Grassley/Loebsack bill would also allow operators of low-income residential rental projects financed by IRC § 142(d) bonds to rely on the representations of displaced individuals regarding their income qualifications so long as the tenancy began within six months of the displacement. The Baucus bill does not include a similar provision.

Low-Income Housing Tax Credit. The low-income housing tax credit in IRC § 42 allows owners of qualified residential rental property to claim a credit over a 10-year period that is based on the costs of constructing, rehabilitating, or acquiring the building attributable to low-income units. Owners are allocated the credit by a state. Each state's allocation is limited to the greater of $2,000,000 or $1.75 times its population, with both amounts adjusted for inflation (they are $2,325,000 and $2.00 for 2008). For 2009, 2010, and 2011, the Grassley/Loebsack bill (§ 2(e)(2)) would permit affected states to allocate additional amounts for use in the disaster area of up to $4.00 multiplied by the state's disaster area population. The Baucus bill has no similar provision.

Bonus Depreciation. IRC § 168(k), as amended by the Economic Stimulus Act of 2008 (P.L. 110-185), allows taxpayers who acquire certain types of property in 2008 to claim an additional depreciation amount equal to 50% of the property's adjusted basis for the year the property is placed in service. The Grassley/Loebsack bill (§ 2(e)(3)) includes a 50% bonus depreciation provision for taxpayers who suffered an economic loss due to the Midwest disaster. Among other requirements, the property would have to rehabilitate or replace property damaged by the severe weather and be similar to and located in the same county as such property. The property would have to be placed in service no later than December 31, 2011 (December 31, 2012, for nonresidential real and residential rental property). The Baucus bill has no similar provision.

Expensing. In general, capital expenditures must be added to the property's basis rather than being expensed (deducted in the current year). IRC § 179 provides an exception so that a business may expense the costs of certain property in the year it is placed in service. In general, the total cost of the § 179 property cannot exceed $125,000, and the deduction is decreased by one dollar for every dollar that the total cost of all property the business placed in service during the year exceeds $500,000 — both numbers are adjusted for inflation and would be $128,000 and $510,000 for 2008; however, the Economic Stimulus Act of 2008 (P.L. 110-185) increased the 2008 limitations to $250,000 and $800,000. IRC § 198, meanwhile, allows taxpayers to expense environmental remediation costs paid or incurred prior to January 1, 2008, for the abatement or control of hazardous substances at a qualified contaminated site.

The Grassley/Loebsack bill (§ 2(e)(4)) would increase the § 179 limitations for taxpayers who suffered an economic loss due to the Midwest disaster by $100,000 and $600,000 for qualified disaster area property. Sections 2(e)(5) and (6) would extend § 198 expensing through 2010 for qualified sites and permit taxpayers to expense 50% of pre-2011 qualified clean-up costs for the removal of debris or the demolition of structures on business-related real property in the Midwest disaster area. The Baucus bill (§ 502) would permit full expensing (subject to depreciation recapture) of qualified expenditures for the abatement or control of hazardous substances released on account of a federally declared disaster, the removal of debris or the demolition of structures on business-related real property damaged by such a disaster, and the repair of business-related property damaged by such a disaster.

Rehabilitation Credit. Under IRC § 47, taxpayers rehabilitating qualified buildings may claim a credit equal to 10% of the qualifying expenditures (20% for a certified historic structure). The Grassley/Loebsack bill (§ 2(e)(7)) would increase this to 13% and 26% for expenditures made no later than December 31, 2010, to rehabilitate buildings and structures damaged by the disaster. The Baucus bill has no such provision.

Net Operating Losses. Under IRC §§ 172 and 56, net operating losses (NOLs) are generally carried back for two years and, for purposes of the alternative minimum tax, the NOL deduction is limited to 90% of alternative minimum taxable income. Section 2(e)(8) of the Grassley/Loebsack bill would extend the carryback period to five years and suspend the 90% limitation for qualified Midwest disaster losses. Section 503 of the Baucus bill appears intended to provide similar treatment for qualified disaster losses.

Tax Credit Bonds. Section 2(e)(9) of the Grassley/Loebsack bill would permit affected states to issue tax credit bonds to pay the principal, interest, or premiums on qualified governmental bonds or to make loans to political subdivisions to make such payments. Bondholders would claim a credit based on a credit rate and the bonds' outstanding face amount. Among other requirements, the bonds would have to be issued between December 31, 2008, and January 1, 2010, and could not have a maturity date beyond two years. The maximum amount of bonds that could be issued by states with disaster area populations of at least 2 million would be $100,000,000; the cap would be $50,000,000 for states with disaster area populations between 1 million and 2 million; and the other states could not issue any bonds. The Baucus bill has no similar provision.

Education Credits. Under IRC § 25A, individuals with eligible tuition and related expenses may claim the Hope Scholarship or Lifetime Learning credit. The Hope credit is 100% of the first $1,000 of eligible expenses plus 50% of the next $1,000 of eligible expenses, both adjusted for inflation ($1,200 for 2008). The Lifetime Learning credit equals 20% of up to $10,000 of eligible expenses. For students attending school in the Midwest disaster area, the Grassley/Loebsack bill (§ 2(e)(10)) would allow any qualified higher education expenses to qualify for the credits, double the adjusted $1,000 limitation, and increase the 20% to 40%. The Baucus bill has no similar provision.

Employer-Provided Housing. The Grassley/Loebsack bill (§ 2(e)(11)) would exclude the value of employer-provided temporary housing, limited to $600 per month, from the employee's income and allow the employer to claim a credit equal to 30% of that amount. The employee must have had a principal residence in the disaster area and perform substantially all employment services for the employer in that area. The employer must have a trade or business in the disaster area. The provision would only apply during a six-month period. The Baucus bill has no such provision.

Retirement Plan Distributions. Section 2(e)(12) of the Grassley/Loebsack bill would waive the 10% early withdrawal penalty in IRC § 72(t) on qualifying distributions made before January 1, 2010, of up to $100,000 for individuals with a principal place of abode in the Midwest disaster area who sustained an economic loss due to the disaster. The funds could be re-contributed to a qualified plan over a three-year period and receive tax-free rollover treatment. Any taxable portion of a distribution could be included in income over a three-year period. Section 505 of the Baucus bill includes a similar provision, applicable to distributions made within the 15-month period after a disaster.

Section 2(e)(12) would also increase the amount that qualifying individuals could borrow from their plans without immediate tax consequences. Under IRC § 72(p), the maximum amount that may be borrowed without being treated as a taxable distribution is generally the lesser of (a) $50,000 or (b) the greater of $10,000 or 50% of the present value of the employee' nonforfeitable accrued benefit. For loans made between July 30, 2008, and December 31, 2009, the Grassley/Loebsack bill would increase this to the lesser of (1) $100,000 or (2) the greater of $10,000 or 100% of the accrued benefit's present value. Certain loan repayment dates would be extended by one year. The Baucus bill includes a similar provision, applicable to loans made within 18 months after a disaster.

Under the Grassley/Loebsack bill, individuals who had received a qualifying distribution to buy or construct a principal residence in the Midwest disaster area and were unable to buy or construct the home due to the disaster could re-contribute the funds to a qualified plan without tax consequences. The distribution must have occurred during the six-month period ending on the disaster date. The Baucus bill has a similar provision for distributions received during the six-month period prior to a disaster.

Employee Retention Credit. The Grassley/Loebsack bill (§ 2(e)(13)) would provide a credit for disaster-damaged businesses that continued to pay their employees' wages, regardless of whether they performed services. Eligible employers would be those who (1) had active businesses in the disaster area that were rendered inoperable due to damage caused by the severe weather and (2) generally employed no more than 200 employees per day during the year before the disaster. Eligible employees would be those whose principal place of employment at the time of the disaster was with the eligible employer in the disaster area. The credit would equal 40% of the employee's first $6,000 in wages paid between the date the business became inoperable and the date it resumed significant operations, but before January 1, 2009. Section 505 of the Baucus bill has a similar provision that is applicable during the four-month period after a disaster.

Charitable Contributions. In general, a charitable contribution deduction may not exceed a specified percentage of an individual's contribution base or a corporation's taxable income (computed with adjustments). The Grassley/Loebsack bill (§ 2(e)(14)) would allow a larger deduction for substantiated cash contributions made in 2008 to qualifying charities for Midwest disaster relief. The deduction would be allowed to the extent it did not exceed the difference between the taxpayer's contribution base/taxable income and the deduction for other charitable contributions. It would not count for purposes of the overall limitation on itemized deductions. The Baucus bill (§ 505) has a similar provision for contributions made during the 18-month period after a disaster.

Casualty Losses. Under IRC § 165, individuals may deduct losses of property not connected to a trade or business if due to a casualty or theft. In addition to losses arising from actual damage done by the casualty, an individual in a presidentially-declared disaster area has a casualty loss if ordered, within 120 days of the area's designation, by a state or local government to demolish or relocate his or her home because it is unsafe due to the disaster. There is no loss to the extent an individual is reimbursed through insurance or other means. There are several limitations, including that losses are deductible only to the extent that (1) the amount of the loss from each event exceeds $100 and (2) the amount of all losses (after applying the $100 limitation) exceeds 10% of adjusted gross income (special rules apply if the taxpayer has both personal casualty losses and gains). The deduction is claimed in the year of the loss, although a loss in a presidentially-declared disaster area may be deducted in the year prior to the disaster.

The Grassley/Loebsack bill (§ 2(e)(15)) would waive the $100 and 10% floors for Midwest disaster casualty losses. Section 2(b) would permit taxpayers who claimed a deduction for a principal residence casualty loss and later received reimbursement under a federal or state program to file an amended return to reduce the deduction by the amount of the reimbursement (thus, the tax benefit doctrine, which would otherwise require the taxpayer to include the reimbursement in income, would not apply). The Baucus bill (§ 501) would waive the 10% floor for net disaster losses and include the losses in the standard deduction. It would also increase the $100 floor to $500 for post-2008 taxable years, not limited to casualties that are federally declared disasters.

Credit Computations. The Grassley/Loebsack bill (§ 2(e)(16)) appears intended to allow qualifying disaster victims to compute this year's child tax and earned income credits using last year's earned income. The Baucus bill has no similar provision.

Authority to Make Adjustments. Section 2(e)(17) of the Grassley/Loebsack bill would authorize the Treasury Secretary to make adjustments in the application of the tax laws for 2008 and 2009 so that temporary relocations due to the disaster would not cause taxpayers to lose dependency exemptions or child credits or to have a change of filing status. No similar provision is in the Baucus bill.

Additional Exemption. The Grassley/Loebsack bill (§ 2(f)(1)) would allow individuals who housed, without charge, displaced Midwest disaster victims in their homes for at least 60 consecutive days to claim a $500 personal exemption for each person, limited to $2,000. The exemptions could be claimed in 2008 and 2009 (a person could only be claimed once by the taxpayer). Among other requirements, the displaced person's principal place of abode must have been in the disaster area. Section 505 of the Baucus bill includes a similar provision, applicable to the two years after a disaster.

Mileage Rate. Under IRC § 170(i), individuals using their personal vehicles for charitable purposes may claim a deduction equal to 14 cents per mile. Section § 2(f)(2) of the Grassley/Loebsack bill would set the rate for 2008 at 70% of the standard business mileage rate (rounded to the next highest cent) for vehicles used for Midwest disaster relief. That rate is currently 58.5 cents per mile. Section 505 of the Baucus bill has a similar provision that is applicable during the 18-month period after a disaster.

Mileage Reimbursement. Section 2(f)(3) of the Grassley/Loebsack bill would exclude from a volunteer's gross income any qualifying mileage reimbursements received for the operating expenses of his or her passenger automobile from a charity helping with disaster recovery, applicable until December 31, 2008. Section 505 of the Baucus bill includes a similar provision applicable to the 18-month period following a disaster.

Discharge of Indebtedness. When all or part of a debt is forgiven, the amount of the cancellation is ordinarily included in income in the year of discharge, although deferral or permanent exclusion may be available under IRC § 108. Section 2(f)(4) of the Grassley/Loebsack bill would allow affected individuals to exclude non-business debt that was forgiven by a governmental agency or certain financial institutions if the discharge occurred between the date of the disaster and January 1, 2010. The individual must have had a principal place of abode in the Midwest disaster area (if the home was in an area determined by the President to only warrant public assistance, then he or she must also have suffered an economic loss due to the severe weather). The Baucus bill (§ 505) has a similar provision for discharges occurring in the 18-month period after a disaster.

Involuntary Conversions. An involuntary conversion occurs when property is converted to cash or other property because of, for example, its complete or partial destruction. The taxpayer has a gain if the cash or property received is worth more than the basis of the converted property. Under IRC § 1033, the gain is not immediately taxable if the property is converted to property that is similar or related in service or use. However, if the property is converted to cash or dissimilar property, the taxpayer must recognize any gain unless he or she purchases similar property within a certain time period, in which case 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 generally ends two years after the close of the first taxable year in which any gain is realized, but is increased in certain situations (e.g., to three years if the converted property is business real property and four years if it is the taxpayer's principal residence or its contents that were involuntarily converted due to a presidentially-declared disaster). The Grassley/Loebsack bill (§ 2(f)(5)) would increase the time period to five years for Midwest disaster area property that was converted due to the severe weather so long as substantially all of the use of the replacement property is in the disaster area. The Baucus bill (§§ 505, 501) has a similar provision for federally declared disasters and clarifies existing law regarding property damaged by such disasters.

Inventory. Under IRC § 170(e)(3), while donors of inventory may claim a charitable deduction equal to their basis in the inventory (typically its cost), C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus 50% of the property's appreciated value or (2) two times basis. A special rule permitted other businesses that donated wholesome food inventory to claim the enhanced deduction if donated no later than December 31, 2007. Another special rule allowed C corporations to claim an enhanced deduction for donations of book inventory to public schools if made no later than December 31, 2007. The Grassley/Loebsack bill (§§ 3, 4) would extend the two inventory provisions until December 31, 2009, and create a special temporary rule for food donations made by qualified farmers and ranchers. The Baucus bill (§§ 236, 237) would extend the inventory provisions through 2008 and has the special rule.

Reporting. Both the Grassley/Loebsack bill (§ 5) and the Baucus bill (§ 512) would require that § 501(c)(3) organizations provide information regarding their disaster relief activities and contributions on the annual information return (Form 990). The provisions would be applicable to returns due after December 31, 2008.