POINTS TO **REMEMBER**

INTRODUCTION: The two Points in this issue address very different but equally timely subjects. In the first, Francine Lipman and Sean Stegmaier provide a primer on the tax consequences of natural disasters, including the legislation recently enacted in response to the devastation that followed Hurricane Katrina, as well as the prospect of legislation that would extend the new provisions to victims of Hurricanes Rita and Wilma. Next, Matt Belcher and Glen Mincey describe long-awaited and recently proposed regulations on the award of compensatory partnership equity interests and explain how tax advisors will have to modify what is now standard practice if these proposals are finalized.

—Alice G. Abreu, Philadelphia, PA

RELIEF FROM THE RUBBLE: **TAX ASSISTANCE FOR VICTIMS** OF THE 2005 HURRICANE SEASON

by Francine J. Lipman and Sean M. Stegmaier, Orange County, CA

A record-breaking hurricane season in 2005 pounded the South with some of the most extreme weather and tragic losses that we have seen in a very long time. August brought Hurricane Katrina, an overwhelming and historically destructive disaster, to the Gulf Coast, displacing millions and injuring and killing thousands of people. September brought Hurricane Rita and its 100-plus-mile-an-hour winds and relentless rain back to the battered southeast. October brought Hurricane Wilma, destroying homes and businesses across Florida. Hundreds of billions of dollars of losses and thousands of lives were swept away in these three horrible hurricanes.

Homeless and devastated, thousands of victims have relocated either temporarily or permanently. As they begin to reassemble the pieces of their lives, they have a number of questions relating to the tax consequences of their losses and their receipt of disaster relief.

This article will address the most common tax questions facing disaster victims and provide answers for victims of presidentially declared disasters generally and Hurricane Katrina victims specifically. Although the tax laws generally provide relief for taxpayers who have suffered casualty losses, they provide more favorable treatment for victims of disasters that have been declared a major disaster by the President. Victims of Hurricane Katrina have been provided even more favorable treatment under the Katrina Emergency Tax Relief Act of 2005 (KETRA) signed into law by President Bush in late September. As this article goes to press members of Congress are considering extending the more favorable tax treatment under KETRA to victims of Hurricanes Rita and Wilma.

DISASTER LOSSES AND DEFERRAL OF DISASTER GAINS RECOGNITION OF CASUALTY LOSSES

The most common tax relief provisions available for victims of disasters are casualty loss deductions and the deferral of recognition of casualty gains. If a victim of a presidentially declared disaster suffers losses that are not fully reimbursed, she may either claim a deduction for the year in which the loss occurred or deduct the loss in the prior tax year by filing an amended return. By taking the deduction in the prior year, the taxpayer may receive a greater tax benefit and an immediate refund. Taxpayers have until the due date (without extensions) of their tax return for the year in which the disaster actually occurred to amend their prior year tax return to claim any available casualty loss deduction. Therefore, taxpayers will each have to amend their 2004 tax returns no later than April 15, 2006, if they elect to deduct their 2005 casualty losses in 2004.

CASUALTY LOSS CALCULATIONS

Unless Congress acts, victims of hurricanes Rita and Wilma will be subject to less favorable tax treatment than victims of Katrina. This less favorable treatment for victims of presidentially declared non-Hurricane Katrina disasters depends upon whether the property damaged was used personally or for business.

PERSONAL USE PROPERTY

Taxpayers calculate their casualty losses on personal use property by taking the lesser of the adjusted basis of the property or the decrease in fair market value due to the disaster, and then subtracting any insurance or other reimbursement taxpayers have received or expect to receive. This calculation may provide an unpleasant surprise for taxpayers who have suffered a loss of unrealized appreciation. Because the unrealized appreciation in their property was never recognized, the loss of the appreciation does not give rise to a tax deduction.

When calculating casualty losses, a taxpayer must take into account the amount of insurance payments that she *expects* to receive. If a taxpayer later receives less insurance money than expected, she may include that difference as a loss for the tax year in which she expects no further insurance or other reimbursement. If a taxpayer chooses not to file an insurance claim, then her disaster loss cannot exceed the amount of her insurance deductible.

LIMITS ON CASUALTY LOSS DEDUCTIONS FOR PERSONAL USE PROPERTY

Casualty losses are deductible only to the extent they exceed $100 (per event) plus an overall limit of 10% of the taxpayer's adjusted gross income

(AGI). Casualty losses are itemized deductions, not subject to the cutback of itemized deductions for high-income taxpayers or any adjustment under the alternative minimum tax (AMT). If casualty losses exceed a taxpayer's income for the tax year in which she claims the loss, the taxpayer may have a net operating loss (NOL). A taxpayer can offset an NOL against taxable income in her two prior tax years, generating a refund. Any excess NOL will offset future taxable income, providing a tax benefit in the subsequent twenty years until exhausted. However, if a taxpayer does not itemize her deductions and claims the standard deduction, she will not receive any tax benefit from her casualty loss deduction.

NO LIMITS FOR HURRICANE KATRINA VICTIMS

Under KETRA, the $100 and 10% of AGI limits on personal use property casualty losses have been deleted to the extent they arise in the Hurricane Katrina disaster area on or after August 25, 2005 and are attributable to Hurricane Katrina.

BUSINESS USE PROPERTY

Business use property casualty losses are determined in the same manner as personal use property casualty losses except that they are not subject to the $100 (per event) or the 10% AGI limits. In addition, business casualty losses are generally treated as deductions in arriving at AGI and not as itemized deductions unless the loss arises out of an employee relationship. Casualty losses of property used as an employee are characterized as "miscellaneous itemized deductions" only deductible to the extent they exceed 2% of AGI and not deductible for AMT purposes.

DEFERRAL OF CASUALTY GAINS

Taxpayers realizing a gain on the involuntary conversion of their property into cash may defer gain recognition if they elect to purchase an adequate amount of qualifying replacement property within the replacement period. Qualifying replacement property is property that is "similar or related in service or use" to the destroyed property. While there is no definition of "similar or related in service or use," the government has narrowly applied this definition in numerous interpretive rulings. However, for presidentially declared disasters if the damaged property was used in a trade or business or held for investment, this definition is expanded significantly to include **any** tangible property held for productive use in a trade or business or for investment. The replacement period for property destroyed in a presidentially declared disaster area is two years from the close of the tax year in which any gain is first realized. A taxpayer with reasonable cause for not being able to replace within this period may apply for an extension.

A taxpayer must recognize gain realized to the extent the conversion proceeds exceed the purchase price of qualifying replacement property. Taxpayers may retain their cash and finance the purchase of qualifying replacement property without adverse tax consequences if their purchase price is at least equal to the conversion proceeds. However, a taxpayer's basis in the replacement property will be its cost, reduced by the amount of any deferred gain. A taxpayer's holding period in the replacement property will include the holding period in the damaged property.

A taxpayer electing to defer gain recognition must attach a statement to her tax return for any year she has realized casualty gain. She must attach another statement to her return containing information about the purchase of any qualifying replacement property for each tax year during the replacement period. If a taxpayer fails to purchase an adequate amount of qualifying replacement property within the replacement period, she must file an amended return for the year she realized her gain and report any gain that cannot be deferred.

PRINCIPAL RESIDENCE CASUALTY GAINS

A taxpayer may exclude a maximum of $250,000 ($500,000 if married filing jointly) of gain on the qualifying sale, including an involuntary conversion, of a principal residence. If a personal residence casualty gain is more than the allowable exclusion amount, a taxpayer can defer recognizing any excess gain by purchasing qualifying replacement property within four years of the close of the tax year in which any gain is first realized.

In addition, a taxpayer does not have to recognize gain on any insurance proceeds received for unscheduled personal property that was part of the contents of the taxpayer's residence. Any insurance proceeds received from the taxpayer's principal residence or scheduled personal property can be treated as received for a single item of property for measuring the required amount of reinvestment. A taxpayer can postpone recognizing any gain realized by purchasing replacement property that is similar or related in service or use to the residence or its contents.

HURRICANE KATRINA VICTIMS

Victims of Hurricane Katrina will have five years to replace **any** property located in the Hurricane Katrina disaster area, which is compulsorily or involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina, but **ONLY** if substantially all of the replacement property is located in the Hurricane Katrina disaster area.

EXTENSION OF TAX DEADLINES FOR VICTIMS OF HURRICANES KATRINA, RITA, OR WILMA

Taxpayers affected by Hurricanes Katrina, Rita, or Wilma will have until February 28, 2006, to file returns, pay taxes and perform other time-sensitive acts due in 2005. The IRS encourages all victims of these hurricanes to identify themselves by writing "Hurricane Katrina, [Rita] or [Wilma]" in red ink

at the top of their tax forms or any other filed documents. Victims of these three disasters can get free copies of prior tax returns and tax records from the IRS on an expedited basis.

ADDITIONAL TAX RELIEF UNDER KETRA

Congress has provided enhanced tax relief for victims of Hurricane Katrina. While more disaster relief is expected, including a possible expansion of these benefits to victims of Hurricanes Rita and Wilma, to date KETRA provides the following tax relief only for victims and heroes of Hurricane Katrina (unless otherwise noted).

- **Earned Income Tax Credits and Refundable Child Tax Credit** calculations for qualifying low-income victims for tax year 2005 may be based upon 2004 earned income.
- **Preservation of dependency exemptions, filing status, etc.** for taxpayers who may jeopardize tax benefits because of temporary relocations caused by Hurricane Katrina.
- **Additional personal exemptions** for taxpayers who house (rent-free) dislocated persons from Hurricane Katrina for a minimum of 60 days in their principal residences. The additional exemption is $500 per person to a maximum of $2,000 per year for 2005 or 2006. This deduction is not phased-out and is allowed under the AMT.
- **Gross income exclusion** for certain cancellation of nonbusiness indebtedness for discharges made through December 31, 2006.
- **Retirement plan withdrawals, rollovers and loans** will be more favorable. Eligible victims may withdraw a maximum of $100,000 from their IRAs and pensions without paying the 10% early withdrawal penalty and may pay any income tax on the distribution ratably over a 3-year period beginning on the date of the distribution. Income tax is not due if the distribution is repaid to the account within 3 years.

  Any portion of a qualified distribution may, during the period beginning August 25, 2005, and ending February 28, 2006, be recontributed to a plan, annuity, or IRA to which a rollover is permitted and excluded from a taxpayer's gross income.

  Allowable tax-free loan limits are increased through 2006 and loan due dates from August 25, 2005 through December 31, 2006 are extended one year.
- **A new Work Opportunity Tax Credit target group** for Hurricane Katrina employees comprised of individuals who, prior to the hurricane, lived in the area that is now within the disaster zone. Employers hiring Hurricane Katrina employees will qualify for a 40% credit on the first $6,000 of wages paid to the employee in the first year.
- **Employee retention credit** for small employers located in the disaster area. The tax credit equals 40% of the first $6,000 of wages paid to employees between August 28, 2005 and before January 1, 2006. The credit is available to small employers whose businesses are inoperable as a result of damage sustained by Hurricane Katrina. The credit is not affected if the employee reports to work at another location during the period the business is inoperable.
- **Greater access to mortgage revenue bond proceeds** by waiving the first-time homebuyer requirement through 2007 for qualified Hurricane Katrina recovery residences and providing loans up to $150,000 for repairs to damaged homes.
- **Charitable donations will be given tax favored treatment.** Suspension of limits on charitable contributions for individuals and corporations in 2005. Individuals may elect to deduct cash contributions made from August 28, 2005 to December 31, 2005 to qualifying charities in an amount equal to 100% of AGI. This deduction will be an itemized deduction not subject to the overall itemized deduction limit for high-income taxpayers. Corporations may elect to deduct cash contributions for relief efforts related to Hurricane Katrina made during the same period in an amount equal to 100% of their taxable income.

  Donations of educational books to public schools and food inventory will be enhanced to the lesser of (i) basis plus 1/2 of the item's appreciated value or (ii) two times the basis for any business through 2005.

Charitable mileage deductions will be computed using a rate equal to 70% of the business mileage rate in effect on the date of the contribution, provided the taxpayer uses the vehicle in providing donated services solely for the purpose of relief related to Hurricane Katrina. Volunteers may exclude from gross income reimbursements for the costs of using vehicles up to an amount that does not exceed the business standard mileage rate through 2006 (44.5 cents as of January 1).

TREASURY ISSUES MUCH-ANTICIPATED **PROPOSED PARTNERSHIP EQUITY COMPENSATION** REGULATIONS

by Matthew Belcher and Glenn Mincey, New York, NY

On May 20, 2005, the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") issued much-anticipated proposed regulations (the "Proposed Regulations") addressing the U.S. federal income tax treatment of certain transfers of partnership equity (including options to acquire partnership equity) in connection with the performance of services ("compensatory partnership interests"). The Proposed Regulations