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Tax Favored Treatment for Early Distributions from IRAs and other Retirement Plans for Victims of Hurricane Katrina

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WASHINGTON — The Internal Revenue Service today is advising taxpayers who suffered losses as a result of Hurricane Katrina to be aware of recent changes in the tax law that may be beneficial if they have funds in certain retirement plans. The new law provides for tax-favored withdrawals, recontributions, and loans.

To qualify, the distribution must be made on or after Aug. 25, 2005, and before Jan. 1, 2007, from an eligible retirement plan such as a qualified plan or an IRA, to an eligible individual – one whose principal residence was in the Hurricane Katrina disaster area on Aug. 28, 2005, and who sustained an economic loss from Hurricane Katrina. The total amount of tax favored distributions an individual can receive from all plans, annuities, or IRAs is \$100,000.

An individual who receives qualified Hurricane Katrina distributions does not have to pay the 10-percent additional tax on early distributions. The distributions generally are included in income, and can be included ratably over a three year period. However, if the individual recontributes the distribution into an eligible retirement plan within 3 years, the distribution is treated as a rollover.

For example, if an individual receives a qualified Hurricane Katrina distribution in 2005, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent additional tax on early distributions. If, in 2007 the amount of the qualified Hurricane Katrina distribution is recontributed to an eligible retirement plan, the individual may file an amended return (or returns) to claim a refund of the tax attributable to the amount of the distribution previously included in income.

Under the new law, these qualified Hurricane Katrina distributions are not subject to the mandatory 20-percent withholding.

A loan from a qualified employer plan to an eligible individual, defined above, is not treated as a taxable distribution of plan benefits if it is made on or after Aug. 25, 2005 and before Jan. 1, 2007 and does not exceed a certain dollar limitation.

To figure the dollar limit, the individual would start with (a) \$100,000 and subtract the highest outstanding balance of loans from these plans during the prior year and compare that figure to (b) the individual's vested benefit under the plan. Which ever figure is less is the limit that the individual can borrow from the employer's plans without a tax consequence.

A qualified individual who, after Feb. 28, 2005, and before Aug 29, 2005, took a distribution such as a hardship distribution from a 401(k) plan or 403(b) annuity or a qualified first-time homebuyer distribution from an IRA to purchase or construct a home in the Hurricane Katrina disaster area, but it was not purchased or constructed as a result of Hurricane Katrina, could recontribute the funds to the plan without any tax consequence. The individual must recontribute the funds during the period beginning on Aug. 25, 2005 and ending on Feb. 28, 2006.

For example, on Aug. 28, 2005, a taxpayer received a qualified first-time homebuyer distribution from an IRA. The taxpayer is scheduled to close on the sale of a home that happens to be located in the Hurricane Katrina disaster area, and the home is destroyed by the storm. The taxpayer has until Feb.28, 2006 to recontribute the funds to the plan.

The IRS is in the process of issuing guidance on the tax favored treatment of distributions from retirement plans as they apply to victims of Hurricane Katrina. The agency is drafting Form 8915, Qualified Hurricane Katrina Retirement Plan Distributions and Repayments, which taxpayers will use to report distributions and determine the amount included in income.