



CCH Tax Briefing: KATRINA EMERGENCY TAX RELIEF ACT OF 2005

Special Report

September 23, 2005

Highlights

- ✓ \$6.11 Billion in Tax Breaks
- ✓ 21 Major Relief Provisions
- ✓ Varying Sunset Dates Through 2007
- ✓ Penalty-free Withdrawals from Retirement Plans
- ✓ Relaxed Casualty-Loss Rules
- ✓ Higher Charitable Mileage Rate
- ✓ Enhanced WOTC
- ✓ Roundup of IRS administrative relief
- ✓ Predictions of more legislative relief

Contents:

Help for Individuals	1
Checklist of Major Benefits ...	2
Scope of Katrina Relief	3
Charitable Contributions	4
Helping Business Recover ...	6
IRS Responds to Katrina ..	6
Time Line of Katrina Act Benefits	7

President Signs Emergency Tax Relief Act To Aid Katrina Victims, Volunteers And Donors; IRS Also Takes Action

“We will rebuild this great city,” President Bush told the nation on September 15. The rebuilding of New Orleans and the rest of the hurricane-ravaged Gulf Coast will require a massive investment in financial and human capital. Congress has responded quickly, unanimously passing the Katrina Emergency Tax Relief Act of 2005 on September 21. President Bush promptly signed the bill into law on September 23. The \$6.1 billion act speeds tax relief to individuals and businesses reeling from the devastation of Hurricane Katrina. It also helps the thousands of relief workers and those who are contributing through donations and in other ways.

future disasters will not automatically receive similar treatment without further enabling legislation.

HELP FOR INDIVIDUALS

The Katrina Emergency Tax Relief Act of 2005 contains tax breaks not only for victims of the disaster but also for individuals and businesses helping in the recovery. Sen. Max Baucus, D-Montana, predicted that the new law is just the beginning. “Additional legislation is being readied that will facilitate reconstruction, spur economic development and address the needs of the working poor.”

Billions in relief

Immediately after Hurricane Katrina hit, Congress appropriated \$10.6 billion for relief work. Congress has since added \$51.8 billion and is likely to appropriate even more. In addition to these huge appropriations, Congress has passed the Katrina Emergency Tax Relief Act of 2005 (H.R. 3768). The new law gives Hurricane Katrina victims – individuals and businesses – temporary tax breaks scored by the Joint Committee on Taxation at over \$6 billion.

Casualty losses

The new law lifts all casualty loss restrictions for victims of Hurricane Katrina. Generally, nonbusiness casualty losses are deductible only to the extent they exceed: (1) 10 percent of the taxpayer’s adjusted gross income and (2) a \$100 floor. Casualty losses that arise in the Hurricane Katrina disaster area on or after August 25, 2005, and that are attributable to Hurricane Katrina are not subject to these restrictions.

Impact Most of the special relief provisions in the Katrina Emergency Tax Relief Act of 2005 are specific only to Hurricane Katrina victims. Within that group, benefits vary depending upon location. Victims of

Impact The new law effectively treats Hurricane Katrina losses as a separate deduction from all other casualty losses. Hurricane Katrina losses are disregarded

Continued on page 2

when computing other casualty losses sustained by the taxpayer. Other casualty losses remain subject to the 10 percent threshold and \$100 floor.

Impact The new law does not change the fact that only taxpayers who itemize deductions can take a casualty loss. However, for those who do itemize, the more generous casualty loss limits also apply in computing alternative minimum tax (AMT).

Planning tip. Taxpayers in Presidentially-declared disaster areas have the option of deducting the loss on the return for the year in which the loss occurred (2005 for Hurricane Katrina victims) or deducting the loss on their previous-year returns (2004). Elimination of the 10 percent/\$100 limits will mean larger refunds for Katrina victims who amend 2004 returns.

Preserving tax benefits

Many of the evacuees from the Gulf Coast left home with very little. Not only are they homeless, many are jobless. Relocation and a change in employment affect a person's tax status. Hurricane Katrina victims can, if they choose, use their 2004 income to calculate the child credit and the earned income tax credit for a tax year that includes August 25, 2005. To be eligible, taxpayers must have lived in (1) the core disaster area or (2) the Hurricane Katrina disaster area and been displaced from his or her home by reason of Hurricane Katrina, as of August 25, 2005. In addition, the earned income for 2005 must be less than 2004 earned income. For tax years beginning in 2005 or 2006, the IRS is authorized to make adjustments in the application of the tax laws necessary to ensure that tax-

payers do not lose any deduction or credit or experience a change in filing status by reason of temporary relocations caused by Hurricane Katrina. Any such adjustment must also ensure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit. The JCT explanation points out that such adjustments may include addressing the application of the residency requirements relating to dependency exemptions.

Extended tax deadlines

After Hurricane Katrina hit the Gulf Coast, the IRS extended tax filing and payment deadlines to January 3, 2006. Congress is now giving affected taxpayers even more time. Qualifying taxpayers have until February 28, 2006, to file any returns and pay taxes for any period that had not expired before August 25, 2005.

Comment Some lawmakers questioned whether the IRS had the authority to extend excise and employment tax deadlines in addition to income, estate, and gift tax deadlines. Congress included this provision to remove any doubt.

Early distributions from IRAs and pensions

Early distributions from IRAs, 401(k) plans, and other retirement savings vehicles are

usually discouraged and taxpayers risk penalties for making early distributions unless there are special circumstances. The new law relaxes the tough restrictions for qualified Hurricane Katrina distributions.

Penalty-free withdrawals. Victims may withdraw up to \$100,000 from an IRA, 401(k) plan, or similar savings plan without penalty for distributions made on or after August 25, 2005, and before January 1, 2007. Qualifying victims must have had their principal home in the Katrina disaster area on August 28, 2005, and must have sustained an economic loss. (The \$100,000 limit is applied for each taxpayer and not to each retirement account.)

Extended rollover period. Taxpayers who are able to repay the distributions have three years to put the funds back and generally qualify for rollover treatment. Otherwise, they will be taxed on their distributions.

Additionally, taxpayers who withdrew funds from an IRA after February 28, 2005, and before August 29, 2005, for a first-time home purchase but who could not complete that purchase, because of Hurricane Katrina, may put the funds back in their IRAs without penalty, if done by February 28, 2006.

Three-year income averaging. Taxpayers who cannot avoid income tax on their penalty-free withdrawals are allowed to spread that income evenly over three years (unless they elect out of this special treatment).

CHECKLIST OF MAJOR BENEFITS

The *Katrina Emergency Tax Relief Act of 2005* includes provisions that include:

- Suspension of personal casualty loss AGI and dollar floors
- Penalty waivers/income averaging for IRA/retirement plan withdrawals
- Expanded qualified plan loan limits
- Exemptions for housing displaced individuals
- Higher standard mileage rate for vehicle use by volunteers
- 2004 income to compute 2005 earned income/child tax credits
- No discharge of indebtedness income
- Extended replacement period for gain nonrecognition
- Suspension of limits on charitable deductions
- Expanded food/book donation deduction
- Work Opportunity Credit to cover Hurricane Katrina employees
- New Employee Retention Credit for small business
- Relaxed mortgage revenue bond rules

Impact *Qualified Hurricane Katrina distributions are not subject to the 20 percent withholding normally required of distributions other than trustee-to-trustee rollovers. There also is no requirement on the size of the economic loss sustained by a qualifying taxpayer or on the necessity that any withdrawal be used to address an economic loss.*

Planning tip. *Victims who expect to be unemployed for awhile might want to defer withdrawals until 2006 and then elect not to 3-year income average, thereby putting all of their distribution income into the year when their gross income is otherwise low.*

The new law also increases the amount Hurricane Katrina victims can borrow from their pension plans. Instead of a maximum of \$50,000, they can borrow up to \$100,000. This provision is effective for loans made on or after September 23, 2005, and before January 1, 2007.

Impact *Hurricane Katrina victims need to carefully weigh the pros and cons of taking early distributions and loans from IRAs and other savings plans. Taxpayers who are far from retirement may want to preserve their savings for when they retire and, in the meantime, seek a personal loan from a bank or possibly borrow from family members or friends.*

Any qualified loan outstanding on or after August 25, 2005, with any required payment due date falling between August 25 and December 31, 2006, will have that required due date delayed for one year. Subsequent repayment schedules will be adjusted accordingly for the five-year and level-payment requirements.

Comment *The IRS has separately made some changes to the hardship distribution and loan rules for 401(k) plans and similar plans. Plans can make loans or distributions based on the employee's authorization, without waiting for the normal documentation required to justify the distribution. The plan can make the loan or distribution even if its terms do not authorize the payment. Plan participants in another part of the country can take a loan or hardship distribution to help family members living in the disaster area.*

Extended nonrecognition replacement period

Generally, taxable gain created by insurance proceeds received for damaged property may go unrecognized if the taxpayer acquires replacement property within a cer-

tain period of time. That replacement period has been extended, both for business and for personal residence property. An individual whose principal place of business is located within a Presidentially-declared disaster area normally has four years to replace the residence without recognizing any gain on insurance reimbursement. For principal residences damaged by Hurricane Katrina, the replacement period has been extended to five years. Businesses generally must invest in replacement property within two years. The new law also extends that reinvestment timeframe to five years. For both individuals and businesses, the replacement property must be located in the disaster area to qualify for the extended replacement period.

Planning tip: *Many homeowners will be better off recognizing the gain and using the \$250,000/\$500,000 homesale exclusion available to all taxpayers, since*

SCOPE OF KATRINA RELIEF

The "Hurricane Katrina disaster area" is the area declared by the President to be a major disaster area before September 14 in connection with Hurricane Katrina.

A "Core Disaster area" is that part of the generally declared disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Benefits applied to the general Hurricane Katrina disaster area include:

- Retirement plan distributions/loans
- Cancellation of nonbusiness debt (if economic loss)
- Replacement period for nonrecognition of gain
- Earned income credit (only if displaced from principal residence)
- Exemption for housing a displaced individual
- Suspension of personal casualty loss limitations
- Exclusion for housing a displaced individual
- Employee retention credit for businesses

Benefits limited to Core disaster areas include:

- Work Opportunity Tax Credit
- Employee Retention Credit for businesses
- Cancellation of nonbusiness debt
- Mortgage revenue bonds
- Earned income credit qualification

Benefits if attributable to or in connection with Hurricane Katrina:

- Suspension of charitable Corporate contribution limitations
- Filing and payment deadlines extended
- Exclusion from income of mileage reimbursements to charitable volunteers

using the replacement property rules requires carryover basis. The use of the nonrecognition provision is elective. Those homeowners with gain in excess of the homesale exclusion should consider using the replacement-period rule for that excess portion of their gain only.

Discharge of indebtedness

A discharge of indebtedness generally is taxable. The new law removes this restriction for victims of Hurricane Katrina whose principal residence on August 25, 2005, was located in the core disaster area or in the Hurricane Katrina disaster area (but outside the core area) and who suffered economic loss. The debt provision applies to discharges made on or after August 25, 2005, and before January 1, 2007.

Comment *Certain mortgage lenders plan to forgive outstanding mortgage balances in instances in which there was underinsurance.*

Caution. *The provision applies only to nonbusiness debt. In addition, it does not apply to any discharge of indebtedness to the extent that real property constituting security for such indebtedness is located outside the Hurricane Katrina disaster area.*

Mortgage revenue bonds

The new law expands eligibility for state and local-government issued mortgage revenue bonds to finance low-interest mortgages. Typically, only first-time homebuyers are eligible for the below-market mortgages. The new law waives the first-time homebuyer requirement for qualified Hurricane Katrina recovery residences. A "qualified Hurricane Katrina recovery residence" is any residence in the core disaster area or any other resi-

dence, if on August 28, 2005, the mortgagor owned a principal residence in the Hurricane Katrina disaster area that was rendered uninhabitable by reason of Hurricane Katrina and the residence being financed is located in the same state as the prior principal residence. Residences financed through 2007 qualify. The provision also allows up to \$150,000 of loan proceeds to be used to repair Hurricane Katrina-damaged homes.

CHARITABLE CONTRIBUTIONS AND ACTIONS

Giving shelter to evacuees

Americans have opened their homes in unprecedented numbers to give shelter to evacuees. The new law rewards those generous homeowners (and renters) with a special tax deduction for tax years beginning in 2005 or 2006. Individuals who use their principal residence to provide housing free of charge to evacuees (referred to as Hurricane Katrina displaced individuals) for at least 60 consecutive days may claim a special \$500 deduction from taxable income for each evacuee residing in the taxpayer's home. The deduction is capped at \$2,000 total and may be claimed once for all tax years (which effectively limits it to providing shelter for four evacuees). The shelter also must be in the taxpayer's principal residence. In addition, the evacuee's principal place of abode must have been in the Hurricane Katrina disaster area as of August 28, 2005.

The income-based phase outs applicable to other exemptions do not apply to the special Hurricane Katrina exemption.

Example. *Kim lives in Memphis. She opens her home to five evacuees from New Orleans, Antonio, Isabel, and their three children. Antonio, Isabel, and their children arrive at Kim's home on September 29 and stay rent free with Kim until December 26. Kim may claim the special \$500 deduction for four of her*

evacuee-houseguests, up to the maximum \$2,000.

Caution. *A Hurricane Katrina displaced individual for purposes of the deduction does not include the spouse or any dependent of the taxpayer providing shelter. A non-dependent cousin, aunt, or other relative, however, can qualify. This deduction may be taken whether or not the taxpayer itemizes deductions. The evacuee's taxpayer identification number must be included on the return of the taxpayer claiming the deduction.*

Comment *Although a charitable deduction generally cannot be taken when donations are given directly to a person rather than a charitable organization, many individuals are opening their homes to strangers selected and sent by a particular charitable organization. Those individuals may be able to take a charitable deduction for rental value and food given to their houseguests as a donation to the organized charity. In that case, the charity must complete the proper substantiation paperwork needed for a deduction. The double benefit of a charitable deduction and a \$500 exemption, however, is unlikely, based on legislative language that denies the exemption if the taxpayer receives any rent or other amount "from any source" in connection with providing the housing.*

Charitable contributions

Generally, for individuals, contributions to tax-exempt charitable organizations are limited to 50 percent of the taxpayer's contribution base (adjusted gross income) for the tax year. Any excess amount may be carried over for a period of up to five years. The new law removes the 50 percent limitation for all cash donations to a charitable organization described in Code Sec. 170(b)(1)(A) (other than a supporting organization described

in Code Sec. 509(a)(3)) for the period beginning on August 28, 2005, and ending on December 31, 2005. Under the provision, an individual's deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding tax years. The provision also exempts those donations from the application of the phase-out of itemized deductions for high-AGI taxpayers. A taxpayer must also elect to have contributions treated as qualified contributions under these provisions.

Comment *This provision is one of the few that does not require a connection with Hurricane Katrina. Any and all cash contributions made by an individual taxpayer made after August 27th through the end of the year qualify for exemption from the contribution base rule.*

Mileage reimbursement

Taxpayers using a personal vehicle for any charity work may claim a tax deduction of 14 cents per mile in lieu of a deduction based on actual expenses. The new law raises the statutory standard mileage rate for charity work related to Hurricane Katrina to 70 percent of the standard business mileage rate for the period beginning on August 25, 2005, and ending on December 31, 2006, rounded up to the next highest cent. The standard business mileage rate is 40.5 cents-per-mile through August 31, 2005. The standard business mileage rate is 48.5 cents-per-mile for the September 1 to December 31, 2005 period. Therefore, the new mileage rate for charity work related to Hurricane Katrina is 29 cents-per-mile during the period of August 25, 2005, through August 31, 2005. The new mileage rate for charity work, therefore, is 34 cents-per-mile from September 1 to the end of the year. It will be adjusted for 2006 once the IRS releases the 2006 mileage rates later this year.

Planning tip. *The IRS has indicated that it will hold off setting the standard mileage rates for 2006 until close to January 2006. Next year's rate could be lower than 48.5 cents per miles, thus reducing the rate for charitable work related to Hurricane Katrina.*

If the taxpayer is a volunteer and he or she is reimbursed for the costs of using a passenger automobile in connection with providing relief to Hurricane Katrina victims, the reimbursement received from an organization described in Code Sec. 170(c) is excluded from his or her income up to the amount that equals the full standard business mileage rate. This exclusion provision applies to automobile usage during the period beginning on August 25, 2005, and ending on December 31, 2006.

Reminder. *Parking fees and tolls may also be deducted separately by taxpayers claiming the statutory standard mileage rate for charity work. Volunteers who drive from their home states to the Katrina disaster area presumably are covered for that leg of their journey as well as for vehicle use while in the disaster area.*

Planning tip. *The JCT explanation of the new law indicates that taxpayers deducting vehicle expenses must substantiate that expenses were incurred in providing relief related to Hurricane Katrina. At minimum, substantiation encompasses reliable written records regarding the number of miles driven, the dates on which the taxpayer incurred the mileage, the name of the charitable organization for which services were provided, the locations where the taxpayer provided services to the charitable organization, and the charitable purposes of the services, that must relate to providing relief related to Hurricane Katrina.*

Corporate donations

The charitable contribution deduction for a corporation is generally limited to 10 percent of its taxable income for the year in which the contribution was made. Excess amounts may be carried over for up to five years, but deductions in those years are also subject to the maximum limitation. The new law waives the 10 percent limitation for Hurricane Katrina only cash donations made by corporate donors to a charitable organization described in Code Sec. 170(b)(1)(A) (other than supporting organizations described in Code Sec. 509(a)(3)) during the period beginning on August 28, 2005, and ending on December 31, 2005. The corporation's qualified contributions must be for relief efforts related to Hurricane Katrina and the corporation must elect to have the provisions apply. The JCT explanation notes that the corporation must substantiate that the contribution is made for Hurricane Katrina relief efforts. (This is not required for individual taxpayers.)

Impact *This additional incentive would cover, for example, corporate employers that are matching donations made by employees to relief organizations.*

Food and book inventory donations

Food. C corporations may claim an enhanced deduction for contributions of inventory to 501(c)(3) organizations (except private nonoperating foundations) that are:

- Used consistent with the donee's exempt purpose solely for the care of the ill, needy or infants;
- Not transferred in exchange for money, other property, or services; and
- Substantiated by a written statement that their use will be consistent with such requirements.

Donated property that meets these Code Sec. 170(e)(3) requirements is deductible in an amount that is the lesser of:

- The basis of the property, plus one half of the excess of fair market value over the basis; or
- Two times the basis.

The new law extends these provisions to S corps, partnerships and sole proprietorships. Under the Act, any taxpayer, whether or not a C corporation, engaged in a trade or business, is eligible to claim the enhanced deduction for contributions of food inventory to an organization described in Code Sec. 501(c)(3). For taxpayers other than C corporations, the total deduction for food inventory contributions in a tax year generally may not exceed 10 per cent of the taxpayer's net income for such tax year for all trades or businesses, including sole proprietorships, S corporations, partnerships, or other entities, from which such contributions were made.

Caution. *The deduction for contributions of food inventory applies only to "food that is apparently wholesome" defined as food intended for human consumption that meets all quality and labeling standards imposed by applicable law, even though it may not be readily marketable for various reasons.*

This provision for food inventory applies to contributions made on or after August 28, 2005, in tax years ending after such date and will not apply to contributions made after December 31, 2005.

Books. The new law also extends the present-law enhanced deduction for contributions of inventory by C corporations under Code Sec. 170(e)(3) to qualified book contributions. For contributions made after August 28, 2005, and before January 1, 2006, a C corporation may claim an enhanced deduction equal to the lesser of:

- The basis of the property, plus one half of the excess of fair market value over the basis; or
- Two times the basis.

A qualified book contribution is a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten

through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The deduction is only allowed if the donee school certifies in writing that:

- The books are suitable, in terms of currency, content, and quantity for use in the school's educational programs and
- The school will use the books in its educational programs.

The deduction for qualified book contributions applies to contributions made after August 28, 2005, and before December 31, 2005.

HELPING BUSINESSES RECOVER

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) encourages employers to hire economically-challenged individuals. The credit generally equals 40 percent of the first \$6,000 of wages (\$3,000 for summer youth employees) paid to each targeted group member during the first year of employment.

The new law creates a new target group for the WOTC, "Hurricane Katrina employees." A Hurricane Katrina employee is an individual whose principal place of abode was in the core disaster area on August 28, 2005. If a business employed a particular worker on August 28, however, it is ineligible for a WOTC for that worker.

Impact *Under the new law, employers can take the credit for an individual hired to work in a core disaster area by August 27, 2007; employers can take the credit for a displaced individual hired by December 31, 2005, regardless of where the employee works. The December 31, 2005, expiration date of the WOTC is waived for these employees.*

Employee retention credit

A new tax credit is created to encourage small employers to keep employees on their payrolls. The credit is 40 percent of the first \$6,000 in wages paid to each eligible employee after August 28, 2005, and before January 1, 2006, by employers located in the core disaster area, for the period the business is rendered inoperable as a result of damage caused by Hurricane Katrina.

Impact *This credit, unlike the enhanced WOTC, is only available to small employers. The new law defines "small employer" as a business that employed an average of no more than 200 employees during the tax year.*

Excise and employment tax deadlines

The new law further extends deadlines previously extended by the IRS through administrative rulemaking. Deadlines for filing tax returns and making payments for income, estate and gift, excise, and employment taxes have all been extended until February 28, 2006 for affected taxpayers (victims and volunteers). The law clarifies that the IRS has the authority to extend employment and excise tax deadlines.

IRS RESPONDS TO KATRINA

In a series of rapid-fire announcements immediately after Katrina, the IRS has:

- Extended filing and payment deadlines;
- Allowed employees to donate leave to help victims;
- Set up a toll-free number for taxpayer assistance;
- Partnered with tax professionals to help victims;
- Extended Form 5500 qualified plan deadlines;
- Extended minimum funding plan contribution deadlines;
- Raised the standard mileage rate;
- Given relief workers some help;

- Expedited charity applications;
- Given tax-exempt bond issuers more time to file information returns;
- Waived certain fuel excise tax rules; and
- Suspended some low-income housing credits.

Extended deadlines and penalty relief

The IRS administratively extended deadlines for filing returns and making payments after Hurricane Katrina. The new law codifies the IRS’s action and extends the deadlines to February 28, 2006. The IRS will abate any penalties for late filing or late payments that would otherwise apply.

Caution Relief is automatic in areas designated by FEMA as “individual assistance areas.” These are the hardest-hit areas. “Taxpayers will not have to do anything to obtain the exten-

TIME LINE FOR KATRINA ACT BENEFITS

- 2005 deadlines:**
- Qualified contributions paid through 12/31/05
 - Contributions of food/book inventory after 8/28/05 through 12/31/05
 - Employment retention credit for displaced employees hired on or before 12/31/05
- 2006 deadlines:**
- Housing displaced individuals 60 day period, through 2006
 - Charitable use standard mileage rate ending 12/31/06
 - Vehicle expense reimbursement for volunteers ending 12/31/06
 - Home purchase recontributions for distributions after 2/28/05 and before 8/29/05
 - Qualified distributions from retirement savings before 1/1/07
 - Plan loans before 1/1/07
 - Nonbusiness debt forgiveness before 1/1/07
- 2007 deadlines:**
- Work opportunity tax credit within core areas hired on or before 8/28/07

sions and other relief available,” the IRS explained. In areas designated by FEMA as “public assistance areas,” taxpayers must identify themselves as Hurricane Katrina victims. Taxpayers outside of the disaster area that qualify for exten-

sions and other relief also must identify themselves as Hurricane Katrina victims. The IRS is encouraging all affected taxpayers to write “Hurricane Katrina” in red across the top of tax forms so its employees can act quickly.

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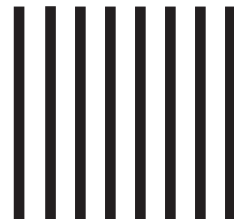
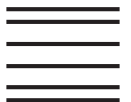
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