

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Karl Blake
Tax Law Specialist (Reviewer)
Wage & Investment
Tax Forms & Publications
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subject: Effect of KETRA Housing Exemption on Capital Loss Carryover Computation

You raised this issue in connection with the preparation of Schedule D. We have also considered a closely-related issue, the effect of this Hurricane Katrina-related exemption on the calculation of a net operating loss.

ISSUES

1. In computing the amount of a capital loss that is carried over to future years under I.R.C. § 1212(b), is the \$500 exemption added by § 302 of the Katrina Emergency Tax Relief Act of 2005, for housing individuals displaced by Hurricane Katrina, treated as a deduction "in lieu of" the personal exemption deduction in § 151?
2. Is the Katrina housing exemption treated as a deduction "in lieu of" the personal exemption deduction for purposes of computing a net operating loss deduction under § 172?

CONCLUSIONS

1. The Katrina housing exemption is not a deduction in lieu of the personal exemption deduction that would reduce the amount of a capital loss carryover under § 1212.

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2. The Katrina housing exemption is not a deduction in lieu of the personal exemption deduction that would reduce a net operating loss, under § 172(d)(3), or the amount of an NOL carryback or carryover, under § 172(b)(2)(A).

DISCUSSION

Issue 1. Capital Loss Carryover Computation

The Katrina Emergency Tax Relief Act of 2005, PL 109-73, or KETRA, added, as § 302, a special provision authorizing a one-time \$500 exemption for providing free housing for at least 60 days for up to four people who were displaced by Hurricane Katrina.

Specifically, KETRA § 302(a) provides that in the case of tax years of a natural person beginning in 2005 or 2006, for purposes of the Internal Revenue Code, "taxable income shall be reduced by \$500" for each Hurricane Katrina displaced individual of the taxpayer for the tax year. Certain limitations, and a definition of a Hurricane Katrina displaced individual, are set out in KETRA § 302(b) and (c).

In determining taxable income, an individual reduces adjusted gross income ("AGI") by any personal exemptions and either the standard deduction or itemized deductions. Under § 151, a deduction for personal exemptions is generally allowed for the taxpayer, his or her spouse if filing jointly, and any dependents. Under § 151(d)(3), the benefit of the deduction is phased out for taxpayers with AGI above a certain amount. Personal exemptions are not allowed for purposes of determining a taxpayer's alternative minimum taxable income. § 56(b)(1)(E).

Section 1211(b) limits an individual's deduction for capital losses to capital gains plus up to \$3000 (\$1500, if married filing separately). Section 1212(b) provides rules for determining the amount of an individual's excess net capital loss that can be carried over to future years as a capital loss carryover (CLCO). Section 1212(b) operates by computing, each year, a deemed short-term and long-term capital loss for the following year. Generally, under § 1212(b)(1), the excess of this year's short-term capital loss over long-term capital gain is a short-term capital loss in the next year, and the excess of long-term capital loss over short-term capital gain is a long-term capital loss in the next year. Under § 1212(b)(2), however, for purposes of the computation, this year's short-term capital gain is limited to taxable income (even if negative) increased by the amount of this year's capital loss deduction, plus "the deduction allowed .. under section 151 or any deduction in lieu thereof" (emphasis added).

In addition to affecting the short-term versus long-term character of carryovers, to the extent a capital loss is deducted against ordinary income, § 1212(b)(2) generally preserves the carryover to the extent the deduction did not produce an actual tax

benefit because there was insufficient ordinary income available for offset and taxable income was actually negative. However, in this calculation, in effect, capital losses are always deemed to have produced a tax benefit to the extent of the personal exemption deduction. This generally reduces the benefit of the personal exemption deduction when a taxpayer has a capital loss carryover and negative taxable income.¹

The issue here is whether, in such a situation, the capital loss carryover is reduced under § 1212(b)(2) to the extent of the Katrina housing exemption, as well as the personal exemption, because the Katrina housing exemption is a "deduction in lieu of" the personal exemption deduction. We conclude that there is no reduction.

First, as a technical matter, the Katrina housing exemption is not part of the § 151 deduction, and may not be a deduction at all. KETRA § 302(a) simply provides that "taxable income shall be reduced," leaving open whether it is a deduction, an exclusion, or simply a "reduction."

More significantly, even if the Katrina housing exemption is considered a deduction, as you point out it is clearly provided *in addition to*, not "in lieu of," the personal exemption deduction in § 151. Contrast, for example, the Katrina housing exemption with provisions that actually take the place of the personal exemption deduction, such as the deduction for trusts and estates in § 642(b)(3). See § 153(1); § 1.1211-1(b)(6)(i) of the Income Tax Regulations (under prior law).

Additional evidence that Congress did not generally intend the benefit of the Katrina housing exemption to be eliminated or diluted in the same manner as the personal exemption deduction is found in the structure of KETRA § 302 and in its legislative history. Instead of treating the Katrina housing exemption as part of the personal exemption deduction under § 151, KETRA § 302 provides direct, independent, "free-standing" authority for the reduction it describes. This has the effect of freeing the Katrina housing exemption from the phase-out provision in § 151(d)(3), as well as ensuring that, unlike the personal exemption deduction, the Katrina housing exemption is deductible for purposes of computing the alternative minimum tax. See § 56(b)(1)(E). Both of these effects were intentional, as evidenced by the Joint Committee's technical explanation for KETRA, which provides:

The *additional exemption* is not subject to the income-based phaseouts applicable to personal exemptions, and is allowed as a deduction in computing alternative minimum taxable income.

Joint Committee on Taxation Staff, Technical Explanation of H.R. 3768 (JCX-69-05), 109th Cong., 1st Sess. (2005), at 20 (emphasis added).

¹ Generally, the overall benefit of the personal exemption deduction is not completely eliminated since, among other factors, the effect of the offsetting CLCO reduction is felt in a future year.

In conclusion, from both a technical and a policy standpoint, the Katrina housing exemption provided by KETRA § 302 should not be treated as a deduction "in lieu of" the personal exemption deduction, for purposes of the computation of a capital loss carryover in § 1212(b).

Issue 2. Net Operating Loss Computations.

Section 172 provides generally for the carryback and carryover (carryforward) of "net operating losses" to other years. Technically, it operates in three steps: (1) computation of a net operating loss, see § 172(c), (d); (2) computation of the years to which the NOL may be carried and the amount of the NOL "absorbed" in each year in which it is deducted, see § 172(b); and (3) computation of the "net operating loss deduction" by combining the carrybacks and carryovers to a particular year, see § 172(a).

In the first step, computing a net operating loss, § 172(d) makes certain modifications to taxable income for the "loss year." Among the modifications is that no deduction under § 151 or "in lieu of" that deduction is allowed. § 172(d)(3). The same adjustment is made in the second step, in which the taxable income deemed to have reduced the NOL carryback or carryover in an "intervening year" is computed. See § 172(b)(2)(A).

As in the case of the capital loss carryover, the effect of these adjustments is to reduce the amount of an NOL carryback or carryover to the extent the taxpayer was entitled to the personal exemption deduction in the loss year and/or intervening years.

For the same reasons discussed under Issue 1 above, we conclude that the Katrina housing exemption in KETRA § 302 is not a "deduction in lieu of" the personal exemption deduction, for purposes of computing an NOL deduction under § 172.

This advice has been coordinated with the group in IT&A with jurisdiction over §§ 151 and 172. It is restricted to the two issues considered. We express no opinion with respect to other contexts, if any, in which characterization of the Katrina housing exemption might be relevant. If you have questions, please contact Sandy Irving, at (202) 622-5020.