Private Letter Ruling 8404004

ISSUE:

Whether, in determining a taxpayer's alternative minimum tax liability under section 55 of the Internal Revenue Code, the tax benefit rule of section 58(h) requires an adjustment when the taxpayer has both the capital gains preference item and the adjusted itemized deductions preference item.

FACTS:

In reporting their income for the 1980 taxable year, Taxpayers claimed a net capital gains deduction allowed by section 1202 of the Code. Taxpayers also claimed various itemized deductions for this year and the sum of these itemized deductions exceeded 60% of adjusted gross income. Taxpayers incurred a liability for the alternative minimum tax imposed by section 55.

APPLICABLE LAW AND RATIONALE:

Section 55 of the Code imposes the alternative minimum tax on the alternative minimum taxable income of noncorporate taxpayers to the extent that it produces a higher tax than the taxpayer's regular tax liability. For taxable years beginning after 1978 and before 1983, alternative minimum taxable income is defined in section 55(b) as gross income reduced by deductions allowed for and used in the taxable year (including deductions in excess of gross income) and by amounts included in income under section 86 (relating to alcohol fuel credits) or 667 (relating to accumulation distributions from trusts) and increased by the amount of the taxpayer's adjusted itemized deductions and capital gains preference items.

In the case of a noncorporate taxpayer, section 57(a)(9) of the Code defines the capital gains preference as an amount equal to the net capital gain deduction for the taxable year determined under section 1202.

For the taxable year under examination, section 57(b) of the Code defines adjusted itemized deductions as the amount by which all the taxpayer's allowable itemized deductions except certain excepted ones (medical expenses, casualty losses, and others) exceeds 60 percent of adjusted gross income (less the same excepted itemized deductions).

Because the capital gains preference item is deducted in arriving at adjusted gross income, the determination of the adjusted itemized deductions preference is a direct function of the capital gains preference item. If a taxpayer has both the adjusted itemized deductions preference and the capital gains preference, a dollar of capital gains preference will generate more than one dollar of total tax preferences and hence, increase alternative minimum taxable income.

Taxpayers contend that the tax benefit rule of section 58(h) of the Code must be invoked in this situation to mitigate the effects of this interaction between the two items of tax preference subject to the alternative minimum tax. Section 58(h) provides that items of tax preference are to be adjusted when the tax treatment giving rise to such items does not result in a reduction of the taxpayer's tax liability for any taxable year.

An automatic tax benefit rule is incorporated in the computation of the alternative minimum taxable income set out in section 55(b) of the Code to the extent that preference deductions which do not reduce a taxpayer's regular tax liability but merely increase negative taxable income are applied to reduce alternative minimum taxable income. See S. Rep. No. 95-1263, 95th Cong., 2d Sess. 204 (1978), 1978-3 (vol. 1) C.B. 502. This automatic tax benefit rule, however, resolves only the problem of negative taxable income. It does not resolve the problem created when the amount of one tax preference item (adjusted itemized deductions) is influenced by the amount of another tax preference item (capital gains deduction).

A method for alleviating the problem caused by the interaction of two preference items is set forth in Rev.Rul. 80-226, 1980-2 C.B. 26. This revenue ruling outlines the steps to be followed in computing the minimum tax imposed by section 56 of the Code when a taxpayer has preference items that do not produce a tax benefit. The tax benefit a taxpayer receives from preference deductions is measured by the excess of gross income over the preference exclusion. The preference exclusion equals the sum of (1) nonpreference deductions used in computing adjusted gross income, (2) personal exemptions, (3) those itemized deductions excepted from the computation of the adjusted itemized deductions preference, and (4) all other itemized deductions to the extent of 60% of adjusted gross income computed without regard to preference deductions. By computing adjusted gross income without regard to preference items for purposes of computing the preference exclusion, the taxpayer is allowed to reduce income with those deductions which, but for the presence of preference items deducted in arriving at adjusted gross income, would be nonpreference itemized deductions. This approach reflects the theory behind the tax benefit rule; the actual benefit received by a taxpayer from tax preference items is measured by the excess of (1) the taxpayer's taxable income computed without regard to preference items over (2) the taxpayer's taxable income computed with regard to tax preference items.

Although Rev.Rul. 80-226 only applies to the computation of the minimum tax under section 56 of the Code, the method it provides for eliminating the influence of tax preference items deducted in arriving at adjusted gross income upon the adjusted itemized deductions preference may also be applied in computing the alternative minimum tax under section 55. For purposes of the alternative minimum tax, the tax benefit received from preference items will be equal to the excess of taxable income computed without regard to preference deductions (i.e., gross income minus the preference exclusion) over taxable income computed with regard to preference deductions. Because deductions in excess of gross income are allowed in determining alternative minimum taxable income, these deductions provide a tax benefit to the extent they lower the tax base upon which the alternative minimum tax is imposed. Therefore, negative taxable income figures must be considered in comparing taxable income computed without regard to preference deductions and taxable income computed with regard to preference deductions. For example, consider a situation in which a taxpayer has $300x of tax preference items subject to the alternative minimum tax. If this taxpayer's taxable income computed without regard to preference items is $100x and taxable income computed with regard to preference items is

negative $100x, the amount of tax benefit produced by preference items is $200x. The amount of preference items included in the computation of alternative minimum taxable income would be limited to $200x.

The limitation of preference items outlined above is consistent with the statutory definition of adjusted itemized deductions set out in section 57(b) of the Code. The preference item must be computed in strict compliance with section 57(b), including the use of the section 62 definition of adjusted gross income. An adjustment is made only after the total amount of preference items is computed to limit the preference items used in the computation of alternative minimum taxable income to those preference items that produce a tax benefit. Therefore, the use of a modified form of adjusted gross income in the computation of the preference exclusion does not conflict with the preference item computation, but rather is authorized for tax benefit purposes by section 58(h).

CONCLUSION:

In determining a taxpayer's alternative minimum tax liability, section 58(h) of the Code requires an adjustment when the taxpayer has both the capital gains preference item and the adjusted itemized deductions preference item.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the memorandum. See section 11.03 of Rev.Proc. 83-2, 1983-1 I.R.B. 28. However, a technical advice memorandum involving a continuing transaction generally is not revoked or modified retroactively if the taxpayer can demonstrate that the criteria in section 11.04 of Rev.Proc. 83-2 are satisfied.