Finley v. Commissioner, 54 T. C. 1730 (1970)

The alternative tax on capital gains must be computed in strict accordance with the statutory formula, without deviation or fragmentation.

Summary

In Finley v. Commissioner, the taxpayers attempted to split their income into "fragments" to minimize their tax liability under the alternative tax provisions of section 1201(b) of the Internal Revenue Code. They argued that this method, which applied different tax rates to different portions of their income, was consistent with congressional intent to impose the lowest possible tax on capital gains. The Tax Court rejected this approach, holding that the alternative tax must be computed strictly according to the statutory formula. The court found no support for the taxpayers' method in the statute, regulations, or legislative history, and upheld the Commissioner's computation as consistent with the law.

Facts

George and Elizabeth Finley reported a total taxable income of $81,401 for 1965, consisting of $24,707 in ordinary income and $56,694 in taxable income from net long-term capital gains (after applying a section 1202 deduction). In calculating their tax under section 1201(b), they divided their income into three "fragments": the first representing ordinary income ($24,707), the second representing a portion of their capital gains ($19,293), and the third representing the remaining capital gains ($37,401). They applied different tax rates to each fragment, resulting in a lower total tax than would have been computed under section 1.

Procedural History

The Commissioner determined a deficiency of $1,925. 11, rejecting the Finleys' method of computing the alternative tax. The Finleys petitioned the Tax Court for a redetermination of the deficiency. The Tax Court upheld the Commissioner's determination, finding it consistent with the statute and regulations.

Issue(s)

1. Whether the taxpayers' method of computing the alternative tax under section 1201(b) by dividing their income into "fragments" and applying different tax rates to each fragment is permissible under the statute.

Holding

1. No, because the taxpayers' method of computing the alternative tax is not supported by the statute, regulations, or legislative history. The court upheld the Commissioner's method as consistent with the statutory formula.

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Court’s Reasoning

The Tax Court rejected the Finleys’ argument that their method of computing the alternative tax was consistent with congressional intent to impose the lowest possible tax on capital gains. The court found no support for this approach in the plain language of section 1201(b), which requires computing the alternative tax as “the sum of (1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and (2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss. ” The court noted that the taxpayers’ method of splitting their income into “fragments” and applying different tax rates to each was not contemplated by the statute or any regulation. The court also rejected the taxpayers’ constitutional arguments, finding that the Commissioner’s method, which followed the statutory formula exactly, could not be considered “discriminatory, arbitrary, and capricious. “

Practical Implications

Finley v. Commissioner clarifies that the alternative tax on capital gains under section 1201(b) must be computed strictly according to the statutory formula, without any deviation or fragmentation. Taxpayers and tax professionals must adhere to this formula when calculating the alternative tax, even if doing so results in a higher tax liability than other methods might. The case also demonstrates the importance of following the plain language of the tax code and regulations, rather than attempting to infer congressional intent from the overall purpose of a provision. Taxpayers seeking to minimize their tax liability on capital gains should look to other provisions of the code, such as the section 1202 deduction, rather than attempting to manipulate the alternative tax computation.

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