T.C. Memo. 1982-26

For income averaging calculations, negative taxable income in base period years must be adjusted to zero before adding the zero bracket amount, consistent with IRS regulations and statutory interpretation.

Summary

This Tax Court case addresses the proper calculation of base period income for income averaging under pre-1977 tax law when taxpayers have negative taxable income in those base period years. The petitioners argued that the zero bracket amount should be added to the negative taxable income, and only the resulting sum should be adjusted to zero if still negative. The IRS contended, and the court agreed, that negative taxable income must first be adjusted upward to zero before adding the zero bracket amount. This interpretation, based on the plain language of the statute, existing regulations, and legislative intent, resulted in a higher average base period income for the petitioners and upheld the IRS's deficiency determination.

Facts

Petitioners elected income averaging on their 1977 joint federal income tax return. In calculating their base period income for 1973 and 1974, they had negative taxable income. Petitioners computed their base period income by adding the zero bracket amount ($3,200) to these negative taxable income figures. They then treated the result as zero if the sum was negative. The IRS recalculated their base period income, first adjusting the negative taxable income for 1973 and 1974 to zero, and then adding the zero bracket amount. This method resulted in a higher average base period income and a tax deficiency.

Procedural History

The Internal Revenue Service (IRS) determined a deficiency in the petitioners' federal income tax for 1977. The petitioners challenged this determination in the United States Tax Court.

Issue(s)

1. Whether, for the purpose of income averaging in 1977, base period income for pre-1977 tax years with negative taxable income should be calculated by first adjusting the negative taxable income to zero and then adding the zero bracket amount.
2. Whether the IRS's interpretation, requiring negative taxable income to be adjusted to zero before adding the zero bracket amount, is consistent with the relevant statute, regulations, and legislative intent.

Holding

1. Yes, the base period income for pre-1977 tax years with negative taxable income should be calculated by first adjusting the negative taxable income to zero and then adding the zero bracket amount because this is consistent with the statutory language and existing regulations.
2. Yes, the IRS's interpretation is consistent with the relevant statute, regulations, and legislative intent, as the statute plainly directs the determination of base period income under section 1302(b)(2) before the addition of the zero bracket amount, and regulations under 1302(b)(2) stipulate that base period income may never be less than zero.

Court's Reasoning

The court relied on the plain language of section 1302(b)(3) of the Internal Revenue Code, which states that base period income is to be determined under section 1302(b)(2) before adding the zero bracket amount. Section 1.1302-2(b)(1) of the Income Tax Regulations, interpreting section 1302(b)(2), explicitly states that "Base period income for any taxable year may never be less than zero." The court cited its prior decision in *Tebon v. Commissioner*, 55 T.C. 410 (1970), which upheld the validity of this regulation. The court rejected the petitioners' argument that legislative history suggested a different interpretation, stating that the legislative history aimed to ensure comparability between pre- and post-1977 tax years due to the change from standard deductions to zero bracket amounts. The court found that the petitioners' reliance on potentially conflicting instructions in Schedule G of Form 1040 was unpersuasive, as the statute and regulations clearly supported the IRS's position. The court concluded, "From the foregoing, we conclude that petitioners are required to adjust their negative taxable income figures of ($1,738) and ($7,955) for 1973 and 1974, respectively, to zero in order to compute their base period incomes for these years, and then to add their $3,200 zero bracket amount to each such zero."

Practical Implications

This case clarifies the method for calculating base period income for income averaging, particularly when dealing with pre-1977 tax years and negative taxable income. It reinforces the principle of statutory interpretation that prioritizes the plain language of the statute and existing regulations. For tax practitioners and taxpayers, this decision highlights that when calculating base period income for income averaging, negative taxable income in base period years must be adjusted to zero before adding the zero bracket amount. This interpretation can lead to a higher average base period income and potentially affect the tax benefits of income averaging. The case underscores the importance of adhering to established regulations and the IRS's interpretation when those interpretations are consistent with the statutory text.