***McCarthy Trust v. Commissioner, 86 T. C. 781 (1986)***

Interest paid by a trust cannot be offset by interest received when calculating adjusted itemized deductions for alternative minimum tax purposes.

**Summary**

In McCarthy Trust v. Commissioner, the U. S. Tax Court ruled on the calculation of a trust's alternative minimum taxable income (AMTI). The McCarthy Trust had deducted interest payments without offsetting them against interest income received in the same year, leading to a dispute over the calculation of "adjusted itemized deductions" for AMT purposes. The court held that the interest paid by the trust must be included in the AMTI calculation without any offset for interest income, as the tax code did not provide for such an offset. This decision clarified that for AMT calculations, interest deductions are treated as tax preference items to the extent they exceed 60% of adjusted gross income, regardless of corresponding interest income.

**Facts**

In 1976, Richard P. McCarthy created irrevocable trusts for his children, including the McCarthy Trust. The trust purchased Southdown, Inc. , stock and notes from McCarthy, financed by a note payable to McCarthy. In 1977, the trust sold the notes and McCarthy repurchased the stock, issuing a note to the trust. In 1979, the trust received interest income from McCarthy's note and paid interest on its note to McCarthy. On its 1979 tax return, the trust included the interest income and deducted the interest paid without offsetting them, resulting in a dispute over the calculation of the alternative minimum tax (AMT).

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in the McCarthy Trust's 1979 federal income tax, asserting that the trust's interest payments should be included in the calculation of adjusted itemized deductions for AMT purposes without offset. The McCarthy Trust petitioned the U. S. Tax Court, which upheld the Commissioner's determination.

**Issue(s)**

1. Whether interest paid by the McCarthy Trust can be offset by interest income received when calculating "adjusted itemized deductions" for purposes of the alternative minimum tax.

**Holding**

1. No, because the Internal Revenue Code does not provide for the offsetting of interest paid by interest received in determining adjusted itemized deductions for

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AMT purposes.

**Court’s Reasoning**

The court applied section 55 of the Internal Revenue Code, which imposes an alternative minimum tax on noncorporate taxpayers. The trust’s alternative minimum taxable income is calculated by including certain tax preference items, such as adjusted itemized deductions. Section 57(b)(2) defines adjusted itemized deductions for trusts as deductions exceeding 60% of adjusted gross income, and interest paid under section 163 is not excluded from this calculation. The court rejected the trust’s argument for offsetting interest received against interest paid, noting that the tax code does not provide for such an offset in determining AMT. The court emphasized that the AMT focuses on deductions rather than income and that allowing an offset would contravene the statutory language. The court also cited Commissioner v. Lo Bue and Commissioner v. National Alfalfa Dehydrating & Milling Co. to support the principle that taxpayers cannot restructure transactions to avoid tax consequences.

**Practical Implications**

This decision has significant implications for trusts and estates in calculating their alternative minimum tax. Trusts must include interest payments in their adjusted itemized deductions without offsetting them against interest income received, potentially increasing their AMT liability. Tax practitioners advising trusts should carefully consider the impact of interest deductions on AMT calculations. This ruling underscores the importance of understanding the distinct treatment of deductions for AMT purposes and may influence how trusts structure their financial arrangements to minimize tax exposure. Subsequent cases, such as Rhude v. United States and Riley v. Commissioner, have reinforced this principle, indicating a consistent judicial approach to AMT calculations.

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