Breakell v. Commissioner, 97 T. C. 282 (1991)

The tax benefit rule under section 58(h) does not permit a reduction of tax preference items to the extent they have contributed to negative adjusted gross income when calculating the alternative minimum tax.

Summary

In Breakell v. Commissioner, the Tax Court addressed the calculation of the alternative minimum tax (AMT) for taxpayers with negative adjusted gross income (AGI). The petitioners, who reported a negative AGI, argued for a reduction in their tax preference items by the amount of these items that provided no tax benefit in their regular income tax calculation. The court held that while the tax benefit rule under section 58(h) allows for adjustments, it does not permit a further reduction of preference items already accounted for in the negative AGI. The ruling emphasized that using negative AGI as the starting point for AMT calculations inherently includes offsets from preference items, preventing a double deduction. This decision impacts how taxpayers with negative AGI calculate their AMT and underscores the importance of understanding the interplay between regular tax and AMT calculations.

Facts

Walter J. Breakell, III and Dorothy Breakell filed their 1986 federal income tax return showing a negative adjusted gross income of $158,895. This negative AGI included deductions from preference items such as a $112 dividend exclusion and a $427,534 capital gain deduction under section 1202. The petitioners computed their alternative minimum tax using this negative AGI and sought to reduce their tax preference items by the amount of these items that did not provide a tax benefit in calculating their regular income tax. The Commissioner of Internal Revenue challenged this computation, arguing that the preference items should not be reduced by the amount already reflected in the negative AGI.

Procedural History

The petitioners filed a timely joint federal income tax return for 1986 and subsequently contested the Commissioner’s determination of a $34,346 deficiency in their 1986 federal income tax, along with an addition to tax. The case was heard by the United States Tax Court, which reviewed the issue of the proper calculation of the alternative minimum tax based on the petitioners’ negative adjusted gross income and the treatment of tax preference items.

Issue(s)

1. Whether the tax benefit rule under section 58(h) permits taxpayers with negative adjusted gross income to reduce their tax preference items by the amount of those items that did not provide a tax benefit in calculating their regular income tax.

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Holding

1. No, because the tax benefit rule does not allow for a further reduction of preference items that have already contributed to the negative adjusted gross income used as the starting point for calculating the alternative minimum tax.

Court's Reasoning

The court reasoned that section 58(h) requires adjustments to tax preference items when they do not result in a reduction of regular tax. However, the court emphasized that the change to using adjusted gross income as the base for AMT calculations, as established by the Tax Equity and Fiscal Responsibility Act of 1982, means that negative AGI already includes offsets from preference items. Therefore, allowing a further reduction of these items would result in a double deduction. The court supported its analysis with reference to prior cases like First Chicago Corp. v. Commissioner and Occidental Petroleum Corp. v. Commissioner, which established principles for implementing section 58(h). The court concluded that while a small portion of the unutilized preference deductions could be adjusted to avoid taxing non-beneficial amounts, the majority of the preference items could not be further reduced due to their inclusion in the negative AGI.

Practical Implications

This decision clarifies that taxpayers with negative adjusted gross income must carefully calculate their alternative minimum tax, recognizing that preference items contributing to negative AGI cannot be further reduced under section 58(h). Legal practitioners should advise clients on the proper method for computing AMT when dealing with negative AGI, ensuring that no double deductions are claimed. The ruling also highlights the need for clear regulations from the IRS regarding the application of the tax benefit rule to deductions, as existing regulations primarily address credits. Businesses and individuals should be aware of this ruling when planning tax strategies that involve generating negative AGI, as it affects the calculation of their alternative minimum tax liability. Subsequent cases may need to distinguish Breakell when dealing with different types of income or deductions.

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