Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201444040**
Release Date: 10/31/2014

CC:ITA:B05:FBoone
POSTS-112688-14

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 56.00-00

date: July 17, 2014

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subject: Effect of Section 56(g)(4)(G) ACE Adjustment on Bad Debt Deduction

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

<u>LEGEND</u>

Taxpayer =

Bank =

Date 1 =

Date 2 =

Date 3 =

$A =

Year 1 =

ISSUE

Is the basis reduction required under section 56(g)(4)(G) taken into account in determining the amount of a bad debt deduction for purposes of calculating adjusted current earnings?

CONCLUSION

The basis reduction required under section 56(g)(4)(G) is taken into account in determining the amount of a bad debt deduction for purposes of calculating adjusted current earnings.

FACTS

On Date 1 Taxpayer underwent an ownership change within the meaning of section 382(g) of the Code[1]. At that time, the aggregate adjusted basis of its assets exceeded the fair market value of those assets by a significant amount. Consequently, on the date of the ownership change, Taxpayer had a net unrealized built-in loss (NUBIL) within the meaning of section 382(h)(3)(A). A large portion of this NUBIL was attributable to loans held by Bank, a subsidiary of Taxpayer. Taxpayer and Bank file a consolidated return for federal income tax purposes. In the remainder of this memorandum, references to Taxpayer shall be understood to include all the corporations that file a consolidated return with Taxpayer.

Under Notice 2008-83, 2008-2 C.B. 905, Taxpayer was not required to treat post-ownership change charge-offs or write-downs of loans outstanding prior to the ownership change (pre-change loans) as recognized built-in losses within the meaning of section 382(h)(2)(B). Furthermore, no statute required Taxpayer to reduce the basis of those loans for regular tax and alternative minimum tax purposes (excluding the effect of any adjusted current earnings adjustment) as a result of the ownership change. Between Date 2 and Date 3, dates subsequent to the ownership change, Taxpayer claimed approximately $A in bad debt deductions in computing taxable income and alternative minimum taxable income (prior to taking into account any adjusted current earnings adjustment) for charge-offs and write downs of pre-change loans.

Because Taxpayer underwent an ownership change under section 382, and Taxpayer had a NUBIL, section 56(g)(4)(G) required Taxpayer to reduce the adjusted basis of the pre-change loans to their fair market value immediately before the ownership change. In computing the amount of its bad debt deduction attributable to the pre-change loans for purposes of computing its adjusted current earnings (ACE) for Year 1, Taxpayer initially took the section 56(g)(4)(G) basis reduction adjustment into account. However, Taxpayer now contends that although it was required to reduce the adjusted basis of

[1] Unless specifically provided otherwise, references to the Code refer to the Internal Revenue Code of 1986 as applicable to the taxable years at issue or under discussion.

the pre-change loans under 56(g)(4)(G), that basis reduction should be ignored in determining the amount of its bad debt deduction for purposes of calculating ACE.

LAW AND ANALYSIS

Section 55(b)(2) generally defines the term alternative minimum taxable income (AMTI) as the taxable income of the taxpayer for the taxable year--

(A) determined with the adjustments provided in section 56 and section 58, and
(B) increased by the amount of the items of tax preference described in section 57.

In addition, section 59 provides special rules for computing AMTI, some of which require further modifications in addition to those listed in sections 56 through 57.

For C corporations, one of the adjustments required in determining AMTI is the ACE adjustment. Section 56(g) provides that the AMTI of any corporation for any taxable year shall be increased by 75 percent of the excess (if any) of--

(1) the ACE of the corporation, over
(2) the AMTI determined without regard to the ACE adjustment and the alternative tax net operating loss deduction (pre-adjustment AMTI).

Section 56(g)(2) allows a negative ACE adjustment by providing that the corporation's AMTI for the taxable year shall be reduced by 75 percent of the excess (if any) of--

(1) pre-adjustment AMTI, over
(2) ACE.

Section 56(g)(2)(B) limits the negative ACE adjustment for any taxable year to the excess, if any, of cumulative positive ACE adjustments for prior taxable years over cumulative negative ACE adjustments for prior taxable years.

Section 56(g)(3) defines ACE as the AMTI for the taxable year—

(1) determined with the adjustments provided in section 56(g)(4), and
(2) determined without regard to this subsection and the alternative tax net operating loss deduction (ATNOL deduction).

One of the adjustments required by section 56(g)(4) pertains to ownership changes. Section 56(g)(4)(G) provides that If--

(1) there is an ownership change (within the meaning of section 382) in a taxable year beginning after 1989 with respect to any corporation, and
(2) there is a NUBIL (within the meaning of section 382(h)) with respect to such corporation,

then the adjusted basis of each asset of such corporation (immediately after the ownership change) shall be its proportionate share (determined on the basis of respective fair market values) of the fair market value of the assets of such corporation (determined under section 382(h)) immediately before the ownership change.

Section 56(g)(4)(H) provides that the adjusted basis of any property with respect to which an adjustment under this paragraph applies shall be determined by applying the treatment prescribed in this paragraph.

Taxpayer asserts that although section 56(g)(4)(G) requires Taxpayer to reduce the adjusted basis of its pre-change loans for ACE purposes, there is no provision in section 56(g) that specifically requires Taxpayer to take that basis reduction into account when determining Taxpayer's ACE bad debt deduction. Therefore, Taxpayer contends that the same amount of bad debt deduction that is allowable in computing taxable income and pre-adjustment AMTI also is allowable in determining ACE. Taxpayer points out that there are a number of specifically enumerated adjustments in section 56(g)(4) under which the adjusted basis of an asset is relevant to the amount of the allowable ACE deduction. For example, section 56(g)(4)(A) prescribes special rules in computing depreciation for ACE purposes. Section 56(g)(4)(F)(i) generally provides that in computing ACE, only section 611 cost depletion is allowable on property placed in service in a taxable year beginning after December 31, 1989. Taxpayer asserts that section 56(g)(4)(H) requires that the basis adjustments prescribed by section 56(g)(4)(G) are only taken into account in applying the other adjustment provisions of section 56(g)(4).

Taxpayer contends that AMTI is computed by starting with taxable income and then increasing or decreasing that number by the adjustments and preferences specifically listed in sections 56 through 59. Likewise, Taxpayer contends that ACE is computed by starting with pre-adjustment AMTI and then increasing or decreasing that number only by the specific items listed in section 56(g)(4). Under Taxpayer's approach, all Code sections that apply to the computation of taxable income are taken into account once in determining taxable income which is the starting point in computing AMTI. Once these Code sections are taken into account in determining taxable income, they are not taken into account again in modifying taxable income into AMTI unless such a reapplication is expressly required by the specific language used in sections 56 through 59.

Taxpayer rejects the position that to compute AMTI one must effectively recompute taxable income taking into account the adjustments and preferences listed in sections 56 through 59 (the separate but parallel approach). Likewise, Taxpayer rejects the position that ACE is computed by recomputing AMTI taking into account all the adjustments listed in section 56(g)(4) (the separate but parallel approach) under which the basis reduction of the pre-change loans would have to be taken into account in determining Taxpayer's ACE bad debt deduction. Taxpayer contends that its position, at least in the context of the computation of pre-adjustment AMTI, has been adopted by the Tax Court, the United States Court of Federal Claims, and the United States Court of Appeals for the Federal Circuit. Therefore, Taxpayer asserts that its bad debt deduction allowed in computing ACE must be the same as that allowed in computing taxable income and AMTI.

To determine if Taxpayer is correct, a brief history of the alternative minimum tax may prove helpful.

History of the Evolution of the AMT

A. Minimum Tax

Prior to enacting the first alternative minimum tax (AMT), Congress enacted the minimum tax (MT) in the Tax Reform Act of 1969. Congress enacted the MT to more equitably allocate the tax burden by imposing a tax on certain tax preference items in certain circumstances. See S. Rep. No. 552, 91st Cong., 1st Sess. 112 (1969). The MT tax base consisted of the sum of a taxpayer's preferences, less an applicable deduction, multiplied by a flat tax rate. It was imposed in addition to any regular tax liability that might be imposed on the taxpayer. A variation of this tax continued to apply to corporations until repealed in the Tax Reform Act of 1986. However, the MT failed to achieve its goal of preventing high income taxpayers from avoiding most or all of their tax liability through the use of tax preferences. Congress sought to improve upon the MT by transitioning to an AMT starting with the Tax Reform Act of 1978 (the 1978 Act).

B. 1978 Act AMT

The AMT, which has now completely replaced the MT, has evolved through three distinct stages beginning with the 1978 Act, continuing through the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and finally reaching its current basic structure in the Tax Reform Act of 1986 (the 1986 Act). For noncorporate taxpayers, in the 1978 Act Congress supplemented the MT with a limited scope AMT. In contrast to the MT, the first AMT was imposed on a tax base quite similar to regular taxable income, with a few notable exceptions. The most significant differences were that no long-term capital gain deduction was allowed in computing AMTI, and in certain cases some of a taxpayer’s itemized deductions were effectively disallowed in computing AMTI. The same net operating loss deduction was allowed in computing regular taxable income and AMTI. Basis of property was the same for both regular tax and AMT purposes.

Since its first incarnation in the 1978 Act, the AMT has functioned as an alternative to the regular tax. From a purely technical standpoint the Code has always imposed AMT on a taxpayer only to the extent the taxpayer’s taxable AMTI multiplied by the appropriate AMT tax rates, less certain credits, exceeded the taxpayer’s regular tax liability. However, a taxpayer essentially computes tax liability on AMTI and regular tax liability on taxable income and pays the higher amount.

C. TEFRA AMT

Post-1978 Act versions of the AMT reveal a trend toward greater differences between how AMTI and taxable income are computed. In TEFRA Congress repealed the MT for non-corporate taxpayers and replaced it with a revised AMT. Congress generally incorporated the old MT preferences into the computation of AMTI by causing such amounts to increase AMTI relative to taxable income, and Congress created new preferences either nondeductible or nonexcludable from gross income in computing AMTI. Congress also disallowed, in computing AMTI, certain itemized deductions allowable in computing taxable income.

The TEFRA AMT expressly took adjusted gross income, an intermediate step in the computation of regular taxable income, as its starting point in the computation of AMTI. To determine AMTI, adjusted gross income was generally simply increased by specified preferences and only certain itemized deductions were allowable in computing AMTI[2].

Like its 1978 Act predecessor, the differences between TEFRA AMTI and taxable income remained permanent in nature, serving primarily to increase AMTI relative to taxable income. This held true even for preferences attributable to accelerated deductions. For example, in computing TEFRA AMTI the Code required a taxpayer to treat as a preference the excess of allowable accelerated depreciation on each section 1250 property over the amount that would have been allowable on the property using the straight-line method. However, the Code did not provide a taxpayer a later negative adjustment in computing AMTI when the depreciation on the property that would have been allowable under the straight-line method exceeded that allowable under the accelerated method.

Consistent with the permanent difference scheme, TEFRA continued to use the regular tax basis of property as the basis for computations affecting AMTI. Thus, if a taxpayer sold a piece of section 1250 property, the basis of which had previously been reduced by accelerated depreciation deductions, TEFRA required the taxpayer to use the property's regular tax basis in computing gain or loss for purposes of computing AMTI. TEFRA required this result even though, because of the preference for accelerated depreciation deductions, some of the depreciation allowed in computing taxable income had been disallowed in computing AMTI.

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[2] The primary exception to this rule was the alcohol fuel credit. Although the amount of this credit was required to be included in gross income in determining taxable income, it was not includible in AMTI. Also, throwback trust distributions were not taken into account in determining the tentative tax imposed on AMTI. However, as a practical matter in almost all circumstances the modifications to adjusted gross income and disallowance of certain itemized deductions made AMTI greater relative to taxable income.

Finally, in computing TEFRA AMTI, Congress provided for a separate alternative tax net operating loss (ATNOL) deduction. In determining the amount of the ATNOL, the TEFRA AMT started with the regular NOL and then decreased that number by items not deductible in computing AMTI. Consequently, the ATNOL could not be greater than the regular NOL but could be less, making the TEFRA ATNOL a subset of the NOL.

In summary, by greatly increasing the number of items treated differently in computing taxable income and AMTI, Congress, in TEFRA, further delineated the separateness of AMTI from taxable income. Nevertheless, for the most part TEFRA AMTI could be described as regular taxable income increased by items deductible in computing taxable income but not deductible in computing AMTI.

D. 1986 Act AMT

In the Tax Reform Act of 1986 (the 1986 Act), Congress repealed the MT for corporate taxpayers and first subjected them to the AMT. Congress also made major modifications to the computation of AMTI completing its transformation to a type of taxable income "separate from but parallel to" regular taxable income.

While still providing for permanent differences between AMTI and taxable income, in the 1986 Act Congress for the first time provided for differences regarding when items of income or deductions are taken into account in computing taxable income and AMTI (timing differences), a difference of paramount importance in properly resolving the issue in this case. For example, in computing AMTI the depreciation allowable on an item of tangible property placed in service after December 31, 1986, in the early years of the property's recovery period generally will be less than the depreciation allowable on such property in computing taxable income. This difference, however, will reverse in subsequent taxable years when the depreciation allowable in computing AMTI exceeds that allowable on the property in computing taxable income. To truly reflect differences between when items of income or deduction are taken into account in computing AMTI and taxable income, in the 1986 Act Congress also provided that the basis of the same property could be different for AMT and regular tax purposes.

In addition, with regard to the portion of the AMT attributable to timing items[3], Congress provided for a minimum tax credit. This credit could be used to reduce regular tax liability to the extent it exceeded the amount of tax tentatively imposed on a taxpayer's AMTI as reduced by the AMT foreign tax credit (tentative minimum tax or TMT). The credit generally becomes allowable when, as a result of the reversal of prior timing differences, the deductions and exclusions from gross income taken into account in computing AMTI exceed those allowable in computing taxable income and this reversal results in regular tax liability exceeding TMT. The net effect of the MT credit system is

[3] Congress subsequently changed the law to allow corporations a MT credit for all of their AMT. Non-corporate taxpayers for the most part are still limited to MT credits for AMT attributable to items other than certain specified "exclusion items". Thus, if an item is not specifically defined as an exclusion item, a MT credit would be allowable for any AMT attributable to that item.

that AMT attributable to timing items does not result in a permanent tax increase relative to a tax regime that just included the regular tax. Rather, AMT attributable to timing items simply results in an acceleration of some portion of the regular tax liability.

With the enactment of the 1986 Act AMT, one may classify items of income and deduction in one of three ways regarding how such items are taken into account in computing taxable income and AMTI: (1) items treated the same under both systems, (2) items with permanent different treatment under both systems, and (3) items taken into account under both systems but with timing differences.

E. 1986 Act Bluebook

The “Bluebook” to the 1986 Act contains the following passage regarding the nature of the 1986 Act AMT:

> Structure of minimum tax as an alternative system.--For most purposes, the tax base for the new alternative minimum tax is determined as though the alternative minimum tax were a separate and independent income tax system. Thus, for example, where a Code provision refers to a “loss” of the taxpayer from an activity, for purposes of the alternative minimum tax the existence of a loss is determined with regard to the items that are includable and deductible for [alternative] minimum tax, not regular tax, purposes.
>
> In certain instances, the operation of the alternative minimum tax as a separate and independent tax system is set forth expressly in the Code. With respect to the passive loss provision, for example, section 58 provides expressly that, in applying the limitation for [alternative] minimum tax purposes, all [alternative] minimum tax adjustments to income and expense are made and regular tax deductions that are items of tax preference are disregarded.
>
> In other instances, however, where no such express statement is made, Congress did not intend to imply that similar adjustments were not necessary. Thus, for example, for [alternative] minimum tax purposes it was intended that section 1211 (limiting capital losses) be computed using [alternative] minimum tax basis, that section 263A (requiring the capitalization of certain depreciation deductions to inventory) apply with regard to [alternative] minimum tax depreciation deductions, and that section 265 (relating to expenses of earning tax-exempt income) apply with regard only to items excludable from alternative minimum taxable income.

Staff of the Joint Committee on Taxation*, General Explanation of the Tax Reform Act of 1986*, 99th Cong., 1st Sess. 438 (Comm. Print 1987).

The phrase “separate from but parallel to” does not appear in the explanation section of any of the official committee reports to the1986 Act. It appears twice in the “present law" sections of the conference report to the 1986 Act. The conferees used the phrase to explain the pre-1986 Act treatment of the carryover of ATNOLs and AMT foreign tax credits.

Allen v. Commissioner

In *Allen v. Commissioner*, 118 T.C. 1 (2002), the petitioners, shareholders in an S corporation, claimed targeted jobs credits under section 51(a) for 1994 and 1995 for wages paid to the S corporation's employees. As required by section 280C(a), the amount of the wage deductions claimed in determining taxable income for each of the taxable years was reduced by the amount of targeted jobs credit generated for that year. Although no provision in sections 56 through 59 provided for a different treatment in computing AMTI, the petitioners contended that under the separate but parallel method of computing AMTI no wage deduction reduction applied. They reasoned that the purpose of the section 280C(a) wage deduction reduction was to prevent the taxpayers from getting a double tax benefit from the same expenditure, once as a tax credit, and again as a deduction. Because the targeted jobs credit was not allowable in determining AMT liability, they asserted that no double tax benefit was possible in the context of the AMT and therefore in determining AMTI no section 280C(a) wage deduction reduction applied.

The Commissioner agreed that the computation of the 1986 Act version of AMTI required a separate but parallel approach. That is, rather than determining AMTI simply by adding to or subtracting items from taxable income, determining 1986 Act AMTI requires that taxable income be recomputed taking into account the adjustments and preferences specified in sections 56 through 59. However, because the petitioners had claimed targeted jobs credits, and because no provision of sections 56 through 59 allowed section 280C(a) to be applied differently in computing AMTI than in computing taxable income, the Commissioner contended that the wage reduction limitation also applied in determining AMTI.

The Commissioner pointed out that in another context involving a credit allowable against the regular tax but not the AMT, Congress had provided a special rule for computing AMTI. In section 232 of the Crude Oil Windfall Profit Tax Act of 1980 (the 1980 Act) Congress first provided tax credits for certain uses of alcohol (alcohol fuel credits). Congress required the amount of any alcohol fuel credit earned to be included in gross income. However, in the 1980 Act Congress amended section 55(b)(1) to exclude the amount of alcohol fuel credit earned from inclusion in AMTI. Like the targeted jobs credit, under the 1986 Act version of the AMT the alcohol fuel credit could be used to reduce regular tax liability but not AMT.

Since the adoption of alcohol fuel credits in the 1980 Act, in subsequent amendments to the Code, taking retroactive technical corrections into account, Congress had continued to include the amount of such credits earned in gross income for purposes of computing taxable income but not AMTI. For the taxable years at issue section 56(a)(8) had specifically excluded the amount of alcohol fuel credit earned from gross income for purposes of computing AMTI. Requiring the amount of a credit to be included in gross income is quite similar to reducing the amount of a deduction by the amount of credit earned. That Congress, for the 1986 Act version of the AMT, continued to provide a statutory rule eliminating the amount of alcohol fuel credit earned from AMTI while providing no special AMT rule for purposes of applying section 280C(a), in the Commissioner's view, provided additional evidence that Congress intended for the section 280C(a) wage deduction reduction to also be applied in computing AMTI.[4]

In *Allen*, the petitioners essentially argued that a separate but parallel computation of AMTI should be performed as if the AMT were the only tax that applied, that is, as if the regular tax did not even exist (completely independent tax systems). In such a universe it would be absurd to reduce a taxpayer's wage deduction by a "credit" that did not exist. The Commissioner asserted that a separate but parallel computation of AMTI did not require such an approach. Rather, separate but parallel simply required that taxable income be recomputed taking into account those preferences and adjustments specifically set forth in sections 56 through 59, taking into account the actual facts. The petitioners had actually claimed entitlement to a targeted jobs credit that would either reduce their regular tax liability as a credit or be allowed as a deduction in the future in computing both AMTI and taxable income. Because there was no provision in sections 56 through 59 that allowed section 280C(a) to be applied any differently in determining AMTI than it applied in determining taxable income, the wage deduction reduction also applied in determining AMTI.

Despite the litigating parties' agreement that determining 1986 Act AMTI required a separate but parallel approach, albeit disagreeing regarding what that approach entailed, the Tax Court, *sua sponte,* took a different tack to resolve the case in favor of the Commissioner. After quoting the statutory definition of taxable income and then AMTI, the Tax Court stated:

> From this text, we understand explicitly that the base of AMTI is "taxable income", and that this base may be affected by the items described in sections 56, 57, and 58. Sec. 55(b)(2). See generally section 59, which, although not specifically mentioned in section 55, provides definitions and special rules that apply in the setting of AMT. As to the meaning of the term "taxable income", Congress has provided unambiguously and with sweeping breadth that "*for purposes of this subtitle*, the term 'taxable income' means gross income [see sec.

[4] The Commissioner also cited *Hightower v. Commissioner*, T.C. Memo. 1982-559, a case involving the issue of whether, in computing income subject to self-employment tax, section 280C requires a taxpayer to reduce its deduction for wages by the amount of new jobs credit earned. New jobs credit reduces a taxpayer's regular tax but cannot be used to reduce a taxpayer's self-employment tax. The court noted that deductions are a matter of legislative grace, *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934), and concluded that the language of the applicable statutes required the taxpayer to reduce its deduction for wages in computing income subject to self-employment tax by the amount of new jobs credit earned.

> 61(a) for the applicable meaning of the term “gross income”] minus the deductions allowed by this chapter (other than the standard deduction).” Sec. 63(a) (emphasis added). We conclude on the basis of our plain reading of the unambiguous text of sections 55 and 63(a) that a computation of AMTI requires that a taxpayer first compute its taxable income and then alter that amount (by way of an adjustment or an increase) to reflect the items described in the remainder of part. VI, subchapter A, chapter 1, subtitle A (part VI) [sections 55-59]. …
>
> Because section 280C is a wage-expense limitation that enters into the computation of taxable income for purposes of section 63(a), and section 280C(a) is not referenced in part VI, we conclude naturally that the limitation is reflected in the calculation of AMTI. …
>
> Respondent does not disagree with the parallel tax regime rationale advanced by petitioners. Respondent invites the Court to hold that the systems are “parallel” in the sense that a taxpayer who has calculated taxable income must start from scratch in a separate computation of AMTI. Both respondent and petitioners rely extensively upon the Staff of Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986* (J. Comm. Print 1987) (General Explanation of the 1986 Act), in arguing that the legislative history under the current AMT regime supports the treatment of that regime as a system that is parallel to the regular tax regime. …
>
> We decline to adopt the parties’ parallel system contention, however, because, as discussed herein, the plain and unambiguous text of the statutes (and the related legislative history) disproves that contention.

118 T.C. at 10-11. Subsequent to *Allen*, the United States Court of Federal Claims, affirmed by the United States Court of Appeals for the Federal Circuit, also held that in computing 1986 Act AMTI a taxpayer’s AMT wage deduction had to be reduced by the amount of targeted jobs credit generated by such wages. See *Ventas v. United States*, 57 Fed. Cl. 411 (2003), *aff”d*, 381 F.3d 1156 (Fed. Cir. 2004).

According to Taxpayer, these cases establish that taxable income constitutes the starting point in computing 1986 Act AMTI. That number is then mechanically increased or decreased only as precisely specified in sections 56 through 59. This mechanical process does not involve the reapplication of any Code section previously applied in determining taxable income but taking into account the adjustments and preferences specified in sections 56 through 59. If taxable income is to be increased or decreased as a result of a provision in sections 56 through 59, that increase or decrease must be directly required by that provision without reference to any statutory provision not specified in sections 56 through 59. For example, if some provision of section 56 requires that the adjusted basis of an asset be determined differently for AMT and regular tax purposes, that different basis is taken into account only for purposes of applying the other provisions of sections 56 through 59.

Taxpayer applies a similar analysis in determining ACE. The starting point in determining ACE is pre-adjustment AMTI. That number is then mechanically increased or decreased as precisely specified in section 56(g)(4) without regard to any Code sections other than section 56(g)(4).

Notwithstanding *Allen* and the other cases cited by Taxpayer, AMTI should be determined by recomputing taxable income taking into account the adjustments and preferences specified in sections 56 through 59. Likewise, the proper way to determine ACE is to recompute pre-adjustment AMTI taking into account the section 56(g)(4) ACE adjustments. In both cases the process will involve the application of Code sections other than those specified in the AMT or ACE provisions.

The Service's Position

In *Allen*, the Tax Court relied in large part on the "unambiguous" statutory language defining AMTI. To reiterate, section 55(b) generally defines the term AMTI as the taxable income of the taxpayer for the taxable year--

(A) determined with the adjustments provided in section 56 and section 58, and
(B) increased by the amount of the items of tax preference described in section 57.

Contrary to the view expressed by the Tax Court in *Allen*, we do not regard the above language to be free from ambiguity. The language could be interpreted to mean (1) taxable income is computed de novo taking into account the specified preferences and adjustments, or (2) taxable income as determined for regular tax purposes is simply increased or decreased by the specified preferences and adjustments, much as adjusted gross income was simply increased by the specified items in determining TEFRA AMTI.

The 1986 Act's introduction of differences between when items of income or deduction are taken into account in computing AMTI versus taxable income require that interpretation (1) be applied. Consider the 1986 Act provisions that define the 1986 Act ATNOL. Section 56(a)(4) provides that in computing AMTI the ATNOL deduction shall be allowed in lieu of the net operating loss deduction allowed under section 172. Section 56(d)(2)(A) generally defines an ATNOL as follows:

(A) Post-1986 loss years. In the case of a loss year beginning after December 31, 1986, the net operating loss for such year under section 172(c) shall--

(i) be determined with the adjustments provided in this section and section 58 and

(ii) be reduced by the items of tax preference determined under section 57 for such year.

An item of tax preference shall be taken into account under clause (ii) only to the extent such item increased the amount of the net operating loss for the taxable year under section 172(c).

With the exception of the flush language, the language used to define an ATNOL is remarkably similar to the language used in section 55(b)(2) to define AMTI. Both statutes provide that a well-defined item under the regular tax system, in one case the NOL, and in the other taxable income, (1) is to be determined with the adjustments provided in section 56 and section 58 and (2) is to be reduced (in the case of the NOL, increased in the case of taxable income) by the items of tax preference determined under section 57 for such year. If the "unambiguous text " of section 55(b)(2) requires that AMTI be computed by mechanically increasing or decreasing taxable income as specified in sections 56 through 59, it also follows that the ATNOL is computed by mechanically increasing or decreasing the NOL as specified in sections 56 through 59.

Consider the results this approach can produce. For example, assume that Corporation A and Corporation B have the following gross income and deductions:

	Corporation A	Corporation B
Gross income	$100,000	$50,000
Depreciation Allowed for Regular Tax Purposes	(50,000)	(50,000)
Taxable Income	$ 50,000	$(0)

Section 172(c) defines a "net operating loss" as the excess of the deductions allowed by chapter 1 of the Code over the gross income, computed with certain modifications specified in section 172(d). Assume that none of those modifications apply in the example. Neither taxpayer's regular tax deductions exceed the taxpayer's regular tax gross income. Thus, neither taxpayer has an NOL, or stated differently each taxpayer's NOL is $ 0.

Assume that under section 56(a)(1)(A) each taxpayer is entitled to an AMT depreciation deduction of $150,000. If the ATNOL is computed by starting with the NOL (zero) and subtracting the additional $100,000 of AMT depreciation allowed by section 56(a)(1)(A), both A and B will have the same ATNOL ($100,000). This would be the case even though A and B have the same deductions and A's gross income is $50,000 greater than B's.

Although under the stipulated facts the result achieved for B makes sense, this method produces a nonsensical result for A. A's ATNOL should be $50,000 (AMT gross income of $100,000 less AMT depreciation of $150,000). Such a result properly reflects economic reality which includes the $50,000 difference in their gross incomes. A proper result in all possible scenarios can only be achieved by a "start from scratch" approach under which the ATNOL is calculated in the same manner used to calculate the NOL modified by taking into account the adjustments and preferences set forth in sections 56 through 59.

Likewise, assume that Corporation C has the following gross income and deductions:

Gross Income	$200,000
Depreciation Allowed in Computing Taxable Income	(100,000)
Taxable Income	100,000
Additional Depreciation Allowed in Computing AMTI	(50,000)
AMTI	$50,000

Once again, for regular tax purposes C's NOL is zero because C's regular tax deductions do not exceed its gross income. If C's ATNOL is computed by starting with the NOL ($0) and subtracting from that number the additional $50,000 AMT depreciation allowed by section 56(a)(1)(A), C with have both positive AMTI of $50,000 and an ATNOL of $50,000, an absurd result.

We recognize that the goal in interpreting statutes is to determine the true intent of Congress and "[t]here is no invariable rule for the discovery of that intention." *United States v. American Trucking Ass'n*, 310 U.S. 534, 542 (1940). In *American Trucking*, the Supreme Court made the following observations on statutory construction:

> There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one "plainly at variance with the policy of the legislation as a whole" this Court has followed that purpose, rather than the literal words.

Id. at 543. However, there must be unequivocal evidence that Congress intended a different result than that given by the plain meaning of words used in a statute before it is appropriate to override the plain meaning of those words. *Segel v. Commissioner*, 89 T.C. 816, 841 (1987).

As the above examples illustrate, even if the statutory language defining an ATNOL literally required the ATNOL to be determined simply by increasing or decreasing the amount of the NOL, the absurdity of some of the results produced by following that approach most likely would justify an interpretation that deviated from the literal wording of the statute. Because the provisions defining an ATNOL may be fairly interpreted as requiring a separate computation of the ATNOL, using the same method as that employed in determining the NOL taking into account preferences and adjustments, and because to do otherwise can produce absurd results, a separate but parallel computation should be employed in determining the amount of the ATNOL.

The scenarios discussed above provide the clearest illustrations of how adopting Taxpayer’s theory of statutory interpretation may lead to absurd results in determining AMTI. We will not attempt here to illustrate every instance of how Taxpayer’s restrictive interpretation would lead to results clearly at odds with the purposes of the AMT provisions. However, Taxpayer has focused on the interpretation of an ACE provision concerning adjusted basis. Therefore, we will also focus on adjusted basis.

Section 56(a)(1) provides special rules to determine AMT depreciation on tangible property. Section 56(a)(6) provides in part that the adjusted basis of any property to which section 56(a)(1) applies shall be determined based on the treatment prescribed in section 56(a)(1). Taxpayer would concede that to determine the amount of AMT depreciation on tangible property, that property’s AMT adjusted basis must be used. This is because section 56(a)(6), in conjunction with section 56(a)(1), expressly requires this result.

However, gain or loss on the sale or other disposition of property is determined under section 1001(a). There is no statutory provision (assuming that the general definition of AMTI is applied in the manner contended for by Taxpayer) in sections 56 through 59 that expressly requires section 1001(a) to be applied separately from its regular tax application to determine AMT gain or loss on depreciable tangible property. Therefore, if Taxpayer is correct, as was the case under the TEFRA AMT, gain or loss on the sale or other disposition of depreciable property is the same for both regular tax and AMT purposes. This would be true notwithstanding that prior to the sale substantially more depreciation may have been taken on such property for regular tax purposes than that deducted in determining AMTI.

The Senate report to the 1986 Act provides as follows:

> For all depreciable property to which minimum tax adjustments apply, adjusted basis is determined for minimum tax purposes with reference to the amount of

> depreciation allowed for minimum tax purposes under the alternative system. Thus, the amount of gain on the disposition of such property will differ for regular and minimum tax purposes.

S. Rep. No. 313, 99th Cong., 2d Sess. 524 (1986). The House report to the 1986 Act provides as follows:

> For all depreciable property to which minimum tax adjustments apply, adjusted basis is determined for minimum tax purposes with reference to the amount of depreciation claimed for minimum tax purposes under the nonincentive system. Thus, the amount of gain on the disposition of such property will differ for regular and minimum tax purposes.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 310 (1985). Both the 1986 Act House and Senate reports run counter to Taxpayer's restrictive view of the definition of AMTI. To get the result specified in the legislative history, section 1001(a) with respect to gain or loss on the sale or other disposition of depreciable tangible property must be applied once for regular tax purposes and again for AMT purposes taking into account the AMT adjusted basis of the property. The intent of Congress, as expressed in the above-cited legislative history, is statutorily expressed in section 56(a)(6), which provides that the adjusted basis of any property to which certain specified AMT adjustments apply, shall be determined on the basis of the treatment prescribed by those adjustments.

Similarly, in calculating ACE, taxpayers must determine gain or loss under section 1001(a) using the ACE adjusted basis of an asset. Section 56(g)(4)(H) is worded similarly to section 56(a)(6) and seems to require that the basis of an asset, as determined by applying the adjustments under section 56(g)(4), be used for all purposes in calculating ACE. For the same reasons set forth above regarding the calculation of AMTI, Taxpayer's restrictive view makes no sense in light of the statutory language and legislative history of the 1986 Act.

Furthermore, Taxpayer's restrictive interpretation also frustrates the purpose of the minimum tax credit. That purposes is to ensure that any AMT imposed attributable to timing differences results in a temporary rather than a permanent increase in tax liability vis-à-vis the cumulative amount of tax imposed under the regular tax system.

The House report to the 1986 Act provides as follows:

> [T]he committee believes that the present law structure of the alternative minimum tax requires modification in certain respects. In particular, to the extent that tax preferences reflect deferral, rather than permanent avoidance of tax liability, some adjustment is required with respect to years after the taxpayer has been required to treat an item as a minimum tax preference, and potentially to incur minimum tax liability with respect to the item. Absent such an adjustment, taxpayers could lose the benefit of certain deductions altogether.

Id. at 307-08. The report goes on to make clear that the adjustment being referred to is the minimum tax credit:

> When a taxpayer pays alternative minimum tax, the amount of such tax paid (i.e. the net minimum tax) is allowed as a credit against the regular tax liability of the taxpayer in subsequent years. However, this credit (known as the minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years. For individuals, the minimum tax credit applies only to minimum tax liability incurred due to deferral preferences (such as depreciation) i.e. preferences for which the timing, rather than the amount, of a deduction gives rise to its treatment as a tax preference.

Id. at 308-09.

Taxpayers generally are able to use the minimum tax credit to reduce their regular tax liability when the net amount of deductions attributable to timing items allowed for AMT purposes exceeds the amount of such deductions allowed in determining taxable income. Thus, the minimum tax credit generally is allowable when the timing differences reverse. For depreciable tangible property this reversal takes place when the amount of depreciation allowed in determining AMTI exceeds that allowable in determining taxable income. However, if the property is sold prior to being fully depreciated, the depreciation timing difference reversal will be incomplete. If, consistent with Taxpayer's theory, the adjusted basis for gain or loss on the sale of the property for both AMT and regular tax purposes is the regular tax adjusted basis, then gain or loss from the sale of the property will be the same in determining both taxable income and AMTI. In such a case, contrary to congressional intent, there will be permanent tax increases imposed on the taxpayer as a result of a timing difference. Although such permanent tax increases can occur if, for example, an individual taxpayer dies without using all of the taxpayer's minimum tax credits, in other circumstances where the statutes imposing AMT may be fairly interpreted to avoid such a result, that interpretation should apply.

Moreover, notwithstanding *Allen*, since that case was decided the Tax Court has not interpreted the provisions defining AMTI as restrictively as advocated by Taxpayer. In *Merlo v. Commissioner*, 126 T.C. 205 (2006), *aff'd*, 492 F.3d 618 (5th Cir 2007), the taxpayer exercised incentive stock options (ISOs). Under section 421(a)(1) the taxpayer was not required to recognize any income on the exercise for regular tax purposes. However, for AMT purposes section 56(b)(3) required the taxpayer to recognize income equal to the difference between the exercise price and the fair market value of the stock acquired on the date of exercise. The last sentence of section 56(b)(3) provides that in determining AMTI the adjusted basis of any stock acquired by the exercise of an ISO shall be determined taking the required income recognition into account. So under section 56(b)(3) the AMT adjusted basis of the stock acquired upon the exercise of the ISOs was the fair market value of the stock.

Section 165(g)(1) generally provides that if any security (including stock in a corporation) which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year. This loss is determined under section 1001(a) treating the sales price as zero. The stock acquired in *Merlo* became worthless causing the taxpayer to sustain a loss. One issue was whether the capital loss limitations of section 1211(b) applied for both regular tax and AMT purposes. A second issue was whether the loss that the taxpayer realized on the worthlessness of the shares generated an ATNOL.

There is no provision in sections 56 through 59 that expressly requires that section 1001(a) be applied separately from how it is applied in determining taxable income for purposes of determining AMT gain or loss from the sale or exchange of stock. However, the Tax Court took it as a given that the AMT loss on the worthlessness of the stock was based on the much greater AMT adjusted basis of the stock. See also *Palahnuk v. Commissioner* 127 T.C. 118 (2006), *aff'd*, 544 F.3d 471 (2d Cir. 2008) (different gain or loss for regular tax and AMT purposes on sale of stock acquired pursuant to ISOs); *Kadillak v. Commissioner*, 127 T.C. 184 (2006), *aff'd*, 534 F.3d 1197 (9th Cir. 2008) (nondeductible AMT capital loss). The only way to achieve this result is to separately apply section 1001(a) (a separate but parallel approach) in determining AMTI taking into account the AMT adjusted basis as prescribed under section 56(b)(3).

We also note that the ACE regulations specifically require a separate but parallel approach in determining ACE. Section 1.56(g)-1(a)(5) provides as follows:

> General rule for applying Internal Revenue Code provisions in determining adjusted current earnings -- (i) In general. Except as otherwise provided by regulations or other guidance issued by the Internal Revenue Service, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining adjusted current earnings. For example, the rules of part V of subchapter P (relating to original issue discount and similar matters) of the Code apply in determining the amount (and the timing) of any interest income included in adjusted current earnings under this section. In applying Code provisions, however, the adjustments of section 56(g) and this section are also taken into account. For example, in applying the capitalization provisions of section 263A, the amount of depreciation to be capitalized is based on the amount of depreciation allowed in computing adjusted current earnings.

Finally, the example of the application of section 56(g)(4)(G) contained in the ACE regulations, Treas. Reg. 1.56(g)-1(k)(4), requires that gain or loss on the disposition of assets for purposes of determining ACE must be based on the adjusted basis of the assets as determined under section 56(g)(4)(G). After setting forth the facts in the example and illustrating how the section 56(g)(4)(G) basis modification applies, the regulation includes the following sentence: "L must use these new adjusted bases for all purposes in determining adjusted current earnings, including computing depreciation and any gain or loss on disposition." Thus, notwithstanding that there is no provision in section 56(g)(4) that expressly requires section 1001(a) to be applied separately in determining gain or loss for ACE purposes, such a computation is required under the regulations. Likewise, in determining the amount of its bad debt deduction in determining ACE, a taxpayer must use the adjusted basis of the loans as determined under section 56(g)(4)(G).

Based on the preceding analysis, we conclude that to determine the amount of its bad debt deduction for purposes of computing ACE, Taxpayer must take the basis reduction required under section 56(g)(4)(G) into account.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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