What's New Supplement

December 18, 1999

Philip E. Harris
University of Illinois Extension and
Department of Agricultural and Consumer Economics
and
Department of Agricultural and Applied Economics
University of Wisconsin-Madison

Urbana, Illinois December 1999

Issued in furtherance of Cooperative Extension Work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Cooperative Extension Service, University of Illinois at Urbana-Champaign.

1999 Workbook

1999 Income Tax School

WHAT'S NEW SUPPLEMENT

1999 Workbook

CORRECTIONS

Page 9. Omit the heading "Effect of Student Financial Assistance" and the text below it to the bottom of the page. Worksheet B of the Free Application for Federal Student Financial Aid (FAFSA) allows applicants to exclude the Hope Scholarship Credit and the Lifetime Learning Credit from income when calculating the Expected Family Contribution (EFC). Therefore, these education credits will not increase the EFC and will not decrease the potential need-based financial assistance.

Page 12. Omit the heading "Effect on Student Financial Assistance" and the paragraph below it. See note 1 above.

Page 13. Line 3 should be 1,500.

Page 22. The I.R.C. section in the heading at the top of the page should be §72(t)(2)(E) [not §72(T)(2)(E)].

Page 57. The form should be a 1998 Schedule K-1 (not 1999).

Page 81. Practitioner Note. In the first line, "line 10" should be "line 9."

Page 113. Form 1040: Line 17 should be blank and line 18 should be 150,000.

Page 134. The grain elevator on the second line of the first table was acquired May 15, 1985 (not 1995). The total of the total column in the second table should be $1,222,410 (not $1,222,210).

Page 136. Under "Gradual Sale of Assets," the text should read as follows: "Bud could lease his assets to Dee and sell them only as necessary for the operation of her business. Bud is likely to owe self-employment tax on part or all of the rent he receives from Dee."

Page 155. Schedule F (Form 1040), line 6a should be 3,000.

Page 156. Fifth line from the bottom: "Buck" should be "Cream" each of the two times it appears.

Page 218. Paragraph above the example: The third sentence incorrectly states that the estate will be forced to use the same calendar year as all trusts. Replace that sentence with the following: "Another advantage is that the trust will use the same fiscal year as the estate."

Page 227. Line 21 should be 22,023 (not 22,900).

Page 249. The entries on lines other than line 15 are omitted because the example does not include the information needed to complete these lines.

Page 252. The $24,150 on line 12 should be moved to line 13.

Page 264. The date in column (c) of line 19A should be 12/02/99 (not 12/02/98).

Page 286. Schedule M-2, line 3, column (a) should be 5,820 (not 5,520).

Page 287. Line 5 should be $126,100 (not $126,000).

Page 288. In "b. Adjustment to Other Carryforward, Example 2 (continued)," second paragraph: The AMT credit reduction should be $3,000 (not $2,000), and the amount carried forward should be $22,000 (not $23,000).

Page 320. The letter from Coe College should be dated March 6, 1999 (not 1998). The heading in the letter should say "1999 Federal Income Tax Return" (not "1998"). The date of transfer in the letter should be March 5, 1999, (not 1998).

Page 321. The donation of used clothing should be reported on Form 8283 as follows: In Part I, line 1B, "Goodwill" should be entered in column (a); "used clothing" should be entered in column (b); "various" should be entered in column (c); and "Estimate from Goodwill" should be entered in column (h).

Page 349. Line 4e should be $1,250. Line 4f should be $2,850. Line 6 should be $2,850. Line 7 should be $3,150. Line 8 should be $2,850.

Page 354. Line 54 of the Schedule D at the bottom of the page should be $53,735 (not $636).

Page 365. In the first line, "(see page 44)" should be "(see page 358)."

Page 409. The heading at the top of the page should say "Unusual Issues" (not "Usual Issues").

Page 411. In the last line of text before the worksheet, "August 5, 1995" should be "August 5, 1994."

Page 412. In the fourth line of the example at the top of the page, "August 1, 1999" should be "November 1, 1999."

Page 414. In "Example A Facts," the second line should say, "more than three years" (not "more than two years"). In the fourth line, 2001 should be 2002.

Page 417. In the first line of item 3 at the bottom of the page, "four-year spread period. The remaining…" should be "four-year spread period, the remaining…".

Page 421. Item 2 near the top of the page: "Total amount of the 20% penalty" should be "Total amount of the 10% penalty."

Page 436. In the first line of Example 1, $690,000 should be $1,690,000.

Page 462. In the Practitioner Note near the top of the page, the code section in the second line should be §501(c)(7) [not §501(c)(4)].

Page 468. Under heading 2 at the bottom of the page: In item 2, "customers to clients" should be "customers or clients."

Page 477. In the first line of the computation of Nicole's 1999 inclusion amount in Example 3, the fair market value of the auto on the first day of the lease should be $42,500 (not $42,000).

NEW LEGISLATION

The Ticket to Work and Work Incentives Act of 1999 (Public Law 106-170), which includes some tax provisions, was signed by the president on December 17, 1999. Below is a brief summary of the tax provisions followed by edited excerpts from the committee reports.

DESCRIPTION OF THE REVENUE PROVISIONS IN THE CONFERENCE AGREEMENT ON THE "TICKET TO WORK AND WORK INCENTIVES ACT OF 1999"

Title I: Extension of Certain Expiring Tax Provisions

A. The conference agreement extends the research and experimentation tax credit through June 30, 2004, and expands the credit to Puerto Rico and U.S. possessions. The alternative incremental credit rates are increased by one percentage point.

B. The conference agreement extends the following provisions through December 31, 2001:

1. Minimum tax relief for individuals permitting full use of personal nonrefundable credits such as the child tax credit,
2. Exception under subpart F for active financing income,
3. Suspension of net income limitation on percentage depletion from marginal oil and gas wells,
4. Work Opportunity Tax Credit,
5. Welfare-to-Work Tax Credit,
6. Exclusion for employer-provided educational assistance,
7. Tax credit for electricity produced by wind and closed-loop biomass facilities (including an expansion to poultry waste),
8. Qualified zone academy bonds,
9. Tax credit for first-time D.C. homebuyers,
10. Extension of expensing for environmental remediation expenditures ("Brownfields"), and
11. Rum coverover for Puerto Rico and the Virgin Islands ($13.25 per proof gallon).

C. The conference agreement extends the Generalized System of Preferences through September 30, 2001.

Title II: Other Time-Sensitive Provisions

A. The conference agreement also contains the following five time-sensitive provisions, which:

1. Prohibit the disclosure of advanced pricing agreements (APAs) and APA background files,
2. Provide authority to postpone certain tax-related deadlines by reason of year 2000 failures,
3. Include certain vaccines against streptococcus pneumoniae to the list of taxable vaccines,
4. Delay implementing the requirement that registered motor fuels terminals offer dyed fuel as a condition of registration, and
5. Provide that federal production payments to farmers are not taxable until the year received.

Title III: Revenue Offsets

A. The conference agreement contains the following nine revenue offset provisions. It

1. Modifies individual estimated tax safe harbor (108.6% in 2000 and 110% in 2001), [Editor's note: this changes the rates reported on page 422 of the 1999 Income Tax Workbook}
2. Provides tax treatment of income and losses on derivatives,
3. Provides reporting of cancellation of indebtedness income by nonbank financial institutions,
4. Provides conversion of character of income from constructive ownership transactions,
5. Provides treatment of excess pension assets used for retiree health benefits,
6. Limits installment method for accrual method taxpayers,
7. Limits charitable contribution deduction for transfers associated with split-dollar insurance arrangements,
8. Provides distributions by a partnership to a corporate partner of stock in another corporation, and
9. Provides treatment of real estate investment trusts.

EXCERPTS FROM COMMITTEE REPORTS

I. EXTENSION OF EXPIRED AND EXPIRING TAX PROVISIONS

A. EXTEND MINIMUM TAX RELIEF FOR INDIVIDUALS (§§ 24 AND 26 OF THE CODE)

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum foreign tax credit. For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to the tentative minimum tax).

An individual's tentative minimum tax is an amount equal to (1) 26% of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income (AMTI) in excess of a phased-out exemption amount and (2) 28% of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit [§24(d)]. For taxable years beginning after 1998, the refundable child credit is reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

New Law

The act extends the provision that allows the nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds the tentative minimum tax) to taxable years beginning in 1999. For taxable years beginning in 2000 and 2001, the personal nonrefundable credits may offset both the regular tax and the minimum tax.

Under the act, the refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999, 2000, and 2001.

B. EXTEND RESEARCH AND EXPERIMENTATION TAX CREDIT AND INCREASE RATES FOR THE ALTERNATIVE INCREMENTAL RESEARCH CREDIT (§41 OF THE CODE) (FORM 6765)

Present Law

Section 41 provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1999.

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of 3%. Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5%. A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5% but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

New Law

The act extends the research tax credit for five years—that is, generally, for the period July 1, 1999, through June 30, 2004.

In addition, the provision increases the credit rate applicable under the alternative incremental research credit one percentage point per step, that is, from 1.65% to 2.65% when a taxpayer's current-year research expenses exceed a base amount of 1% but do not exceed a base amount of 1.5%; from 2.2% to 3.2% when a taxpayer's current-year research expenses exceed a base amount of 1.5% but do not exceed a base amount of 2%; and from 2.75% to 3.75% when a taxpayer's current-year research expenses exceed a base amount of 2%.

Research tax credits that are attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, may not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code prior to October 1, 2000. On or after October 1, 2000, such credits may be taken into account through the filing of an amended return, an application for expedited refund, an adjustment of estimated taxes, or other means that are allowed by the Code.

Effective Date. The extension of the research credit is effective for qualified research expenditures paid or incurred during the period July 1, 1999, through June 30, 2004. The increase in the credit rate under the alternative incremental research credit is effective for taxable years beginning after June 30, 1999. Estimated tax penalties will be waived for the period before July 1, 1999, with respect to any underpayment that is created by reason of the rule allocating research credits to a period based on the ratio of months in such period to the months in the taxable year.

C. EXTEND SUSPENSION OF NET INCOME LIMITATION ON PERCENTAGE DEPLETION FROM MARGINAL OIL AND GAS WELLS (§613A OF THE CODE)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that, for oil and gas properties, the amount deducted may not exceed 100% of the net income from that property in any year [§613(a)].

Special percentage depletion rules apply to oil and gas production from "marginal" properties [§613A(c)(6)]. Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property, substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit). Under one such special rule, the 100%-of-net-income limitation does not apply to domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

New Law

The act extends the present-law suspension of the 100%-of-net-income limitation with respect to oil and gas production from marginal wells to include taxable years beginning after December 31, 1999, and before January 1, 2002.

D. EXTEND THE WORK OPPORTUNITY TAX CREDIT (§51 OF THE CODE) (FORM 5884)

Present Law

In General. The work opportunity tax credit (WOTC), which expired on June 30, 1999, was available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40% (25% for employment of 400 hours or less) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40% of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40% of the first $3,000 of qualified first-year wages).

The employer's deduction for wages is reduced by the amount of the credit.

Targeted Groups Eligible for the Credit. The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (TANF) program, (2) high-risk youth, (3) qualified ex-felons, (4) vocational rehabilitation referrals, (5) qualified summer youth employees, (6) qualified veterans, (7) families receiving food stamps, and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

Minimum Employment Period. No credit is allowed for wages paid to employees who work less than 120 hours in the first year of employment.

Expiration Date. The credit is effective for wages paid or incurred to a qualified individual who began work for an employer before July 1, 1999.

New Law

The act extends the work opportunity tax credit for 30 months (through December 31, 2001) and clarifies the definition of first year of employment for purposes of the WOTC. H.R. 2923 also directs the Secretary of the Treasury to expedite procedures to allow taxpayers to satisfy their WOTC filing requirements (e.g., Form 8850) by electronic means.

Effective Date. The provision is effective for wages paid or incurred to qualified individuals who begin work for the employer on or after July 1, 1999, and before January 1, 2002.

E. EXTEND THE WELFARE-TO-WORK TAX CREDIT (§51A OF THE CODE) (FORM 8861)

Present Law

The Code provides to employers a tax credit on the first $20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit is 35% of the first $10,000 of eligible wages in the first year of employment and 50% of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either federal or state time limits, if they are hired within 2 years after the federal or state time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a §127 program (or that would be excludable but for the expiration of §127); (2) health plan coverage for the employee, but not more than the applicable premium defined under §4980B(f)(4); and (3) dependent care assistance excludable under §129.

The welfare-to-work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before July 1, 1999.

New Law

The act provides for a 30-month extension of the welfare-to-work tax credit.

Effective Date. The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999, and before January 1, 2002.

F. EXTEND EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE (§127 OF THE CODE)

Present Law

Educational expenses paid by an employer for the employer's employees are generally deductible to the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a §127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under §132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion expired with respect to graduate courses June 30, 1996. With respect to undergraduate courses, the exclusion for employer-provided educational assistance expires with respect to courses beginning on or after June 1, 2000.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5% of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more-than-5% owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the §127 exclusion may be excludable from income as a working-condition fringe benefit.

New Law

The act provides that the present-law exclusion for employer-provided educational assistance is extended through December 31, 2001.

Effective Date. The provision is effective with respect to courses beginning after May 31, 2000, and before January 1, 2002.

G. EXTEND EXPENSING OF ENVIRONMENTAL REMEDIATION EXPENDITURES (§198 OF THE CODE)

Present Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred (§198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called Brownfields). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February 1997 as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred before January 1, 2001.

New Law

The act extends the present-law expiration date for §198 to include those expenditures paid or incurred before January 1, 2002.

Effective Date. The provision to extend the expiration date is effective upon the date of enactment.

II. OTHER TIME-SENSITIVE PROVISIONS

A. AUTHORITY TO POSTPONE CERTAIN TAX-RELATED DEADLINES BY REASON OF YEAR 2000 FAILURES

Present Law

There are no specific provisions in present law that would permit the Secretary of the Treasury to postpone tax-related deadlines by reason of Year 2000 (also known as Y2K) failures. The Secretary is, however, permitted to postpone tax-related deadlines for other reasons. For example, the Secretary may specify that certain deadlines are postponed for a period of up to 90 days in the case of a taxpayer determined to be affected by a presidentially declared disaster. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. The provision does not apply for purposes of determining interest on any overpayment or underpayment.

The suspension of time applies to the following acts: (1) filing any return of income, estate, or gift tax (except employment and withholding taxes); (2) payment of any income, estate, or gift tax (except employment and withholding taxes); (3) filing a petition with the Tax Court for a redetermination of deficiency, or for review of a decision rendered by the Tax Court; (4) allowance of a credit or refund of any tax; (5) filing a claim for credit or refund of any tax; (6) bringing suit upon any such claim for credit or refund; (7) assessment of any tax; (8) giving or making any notice or demand for payment of any tax, or with respect to any liability to the United States in respect of any tax; (9) collection of the amount of any liability in respect of any tax; (10) bringing suit by the United States in respect of any liability in respect of any tax; and (11) any other act required or permitted under the internal revenue laws specified in regulations prescribed under §7508 by the Secretary.

New Law

The act contains a provision permitting the Secretary to postpone, on a taxpayer-by-taxpayer basis, certain tax-related deadlines for a period of up to 90 days in the case of a taxpayer that the Secretary determines to have been affected by an actual Y2K-related failure. In order to be eligible for relief, taxpayers must have made good-faith, reasonable efforts to avoid any Y2K-related failures. The relief will be similar to that granted under the presidentially declared disaster and combat zone provisions, except that employment and withholding taxes also are eligible for relief. The relief will permit the abatement of both penalties and interest.

The relief may apply to the following acts: (1) filing of any return of income, estate, or gift tax, including employment and withholding taxes; (2) payment of any income, estate, or gift tax, including employment and withholding taxes; (3) filing a petition with the Tax Court; (4) allowance of a credit or refund of any tax; (5) filing a claim for credit or refund of any tax; (6) bringing suit upon any such claim for credit or refund; (7) assessment of any tax; (8) giving or making any notice or demand for payment of any tax, or with respect to any liability to the United States in respect of any tax; (9) collection of the amount of any liability in respect of any tax; (10) bringing suit by the United States in respect of any liability in respect of any tax; and (11) any other act required or permitted under the internal revenue laws specified or prescribed by the Secretary. The provision is effective on the date of enactment.

B. PROVIDE THAT FEDERAL PRODUCTION PAYMENTS TO FARMERS ARE TAXABLE IN THE YEAR RECEIVED

Present Law

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR Act") provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient.

The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added §112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998.

These options potentially would have resulted in the constructive receipt (and thus inclusion in income) of the payments to which they relate at the time they could have been exercised, whether or not they were in fact exercised. However, §2012 of the Tax and Trade Relief Extension Act of 1998 provided that the time a production flexibility contract payment under the FAIR Act properly is includable in income is to be determined without regard to either option, effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

New Law

The act includes a provision to disregard any unexercised option to accelerate the receipt of any payment under a production flexibility contract that is payable under the FAIR Act, as in effect on the date of enactment of the provision, in determining the taxable year in which such payment is properly included in gross income. Options to accelerate payments that are enacted in the future are covered by this rule, providing the payment to which they relate is mandated by the FAIR Act as in effect on the date of enactment of this act.

The provision in the act does not delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

Effective Date. The provision is effective on the date of enactment.

III. REVENUE OFFSET PROVISIONS

A. MODIFICATION OF INDIVIDUAL ESTIMATED TAX SAFE HARBOR (§ 6654 OF THE CODE)

Present Law

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 90% of the tax shown on the current year's return or (2) 100% of the prior year's tax. For taxpayers with a prior year's AGI above $150,000 ($75,000 for married taxpayers filing separately), however, the rule that allows payment of 100% of the prior year's tax is modified. Those taxpayers with AGI above $150,000 generally must make estimated payments based on either (1) 90% of the tax shown on the current year's return or (2) 110% of the prior year's tax.

For taxpayers with a prior year's AGI above $150,000, the prior year's tax safe harbor is modified for estimated tax payments made for taxable years through 2002. For such taxpayers making estimated tax payments based on prior year's tax, payments must be made based on 105% of the prior year's tax for taxable years beginning in 1999, 106% of the prior year's tax for taxable years beginning in 2000 and 2001, and 112% of the prior year's tax for taxable years beginning in 2002.

New Law

The act provides that taxpayers with prior-year AGI above $150,000 who make estimated tax payments based on the prior year's tax must do so based on 108.6% of the prior year's tax for estimated tax payments made for taxable year 2000. Taxpayers with prior-year AGI above $150,000 who make estimated tax payments based on the prior year's tax must do so based on 110% of the prior year's tax for estimated tax payments made for taxable year 2001. The modified safe harbor percentage is not changed for estimated tax payments made for any taxable years other than 2000 and 2001.

Effective Date. The provision is effective for estimated tax payments made for taxable years beginning after December 31, 1999, and before January 1, 2002.

B. EXPAND REPORTING OF CANCELLATION OF INDEBTEDNESS INCOME (§6050P OF THE CODE) (FORM 1099-C)

Present Law

Under §61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the Internal Revenue Service (IRS) regarding any discharge of indebtedness of $600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged; the amount of debt discharged; the date on which the debt was discharged; and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution as described in §581 (relating to banks) or §591(a) (relating to savings institutions); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a federal or state agency regulating such entities; and (5) an executive, judicial, or legislative agency [as defined in 31 U.S.C. §3701(a)(4)].

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

New Law

The act requires information reporting on indebtedness discharged by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Effective Date. The provision is effective with respect to discharges of indebtedness after December 31, 1999.

C. MODIFY INSTALLMENT METHOD AND PROHIBIT ITS USE BY ACCRUAL-METHOD TAXPAYERS (§§453 AND 453A OF THE CODE)

Present Law

An accrual-method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income, and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under §453(l)(2)(B) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under §453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

New Law

The act generally prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for federal income tax purposes using an accrual method of accounting. It also modifies the installment sale pledge rule to provide that entering into any arrangement giving the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note.

Prohibition on the Use of the Installment Method for Accrual-Method Dispositions. The act generally prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for federal income tax purposes using an accrual method of accounting. The provision does not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The provision also does not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under §453(l).

The provision does not change the ability of a cash-method taxpayer to use the installment method. For example, a cash-method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a 10-year note, and a percentage of the gross revenues of the company for the next 10 years. The provision does not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

Modifications to the Pledge Rule. The act modifies the pledge rule to provide that entering into any arrangement giving the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer recognizes gain only as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the provision, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not apply to (1) installment-method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under §453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

Effective Date. The provision is effective for sales or other dispositions entered into on or after the date of enactment.

IV. MISCELLANEOUS AND TECHNICAL AMENDMENTS

A. EARNED INCOME TAX CREDIT

For tax years beginning after 1999, the definition of foster child is simplified for EITC purposes. Under the change, a foster child is defined as a child who meets the following requirements:

1. is cared for by the taxpayer as if he or she were the taxpayer's own child,
2. has the same principal place of abode as the taxpayer for the taxpayer's entire tax year, and
3. either is the taxpayer's brother, sister, stepbrother, stepsister, or descendant (including an adopted child) of any such relative, or was placed in the taxpayer's home by an agency of a state or one of its political subdivisions or by a tax-exempt child placement agency licensed by a state.

B. SOCIAL SECURITY

Beginning January 1, 2000, members of the clergy have two years to revoke their exemption from social security. If a taxpayer joins under this rule, the decision is irrevocable, and he or she has to pay self-employment taxes, and his or her subsequent earnings are credited for social security (and Medicare) benefit purposes.

PROPOSED REGULATIONS

Farm Income Averaging (Schedule J)

The Treasury issued Prop. Reg. §1.1301-1 on October 8, 1999. The proposed regulations are fairly consistent with the discussion at pages 112 through 123 of the *1999 Income Tax Workbook*. The most notable new information in the proposed regulations is that gain from the sale of improvements is included in eligible income. See Prop. Reg. §1.1301-1(e)(1)(ii)(A) below.

Following is the full text of the proposed regulations.

Proposed Regulation §1.1301-1

(a) Overview. An individual engaged in a farming business may elect to compute his or her current year (election year) income tax liability under §1 by averaging, over the prior three-year period (base years), all or a portion of the individual's current year electible farm income (as defined in paragraph (e), of this section. To average farm income, the individual

1. Designates all or a portion of his or her electible farm income for the election year as elected farm income,
2. Allocates one-third of the elected farm income to each of the three base years, and
3. Determines the election year §1 tax by determining the sum of

i. The election year §1 tax without regard to the elected farm income, plus

ii. For each base year, the increase in §1 tax attributable to the elected farm income allocated to such year.

(b) Individual Engaged in a Farming Business. Farming business has the same meaning as provided in §263A(e)(4) and the regulations thereunder. An individual engaged in a farming business includes a sole proprietor of a farming business, a partner in a partnership engaged in a farming business, and a shareholder of an S corporation engaged in a farming business. An individual is not required to have been engaged in a farming business in any of the base years in order to make a farm income averaging election.

(c) Making, Changing, or Revoking an Election

1. *Making an election.* A farm income averaging election is made by filing Schedule J, Farm Income Averaging, with an individual's timely filed (including extensions) Federal income tax return for the election year.
2. Making a late election, or changing or revoking an election

   i. Adjustments in an election or base year. An individual who has an adjustment for an election year or for any base year may make a late farm income averaging election, change the amount of elected farm income in a previous election, or revoke a previous election, if the period of limitation on filing a claim for credit or refund has not expired for the election year. For purposes of this paragraph (c)(2), an adjustment is any change in taxable income or tax liability that is permitted to be made by filing an amended Federal income tax return or a change in taxable income or tax liability made as the result of an IRS examination.

   ii. No adjustment. If an individual does not have an adjustment as described in paragraph (c)(1)(i) of this section, the individual may not make a late farm income averaging election, change the amount of elected farm income in a previous election, or revoke a previous election, without the consent of the Commissioner.

(d) Calculation of §1 Tax

1. *In general.* The §1 tax for the election year is determined by allocating elected farm income to the base years only after all other adjustments and determinations have been made. For example, any net operating loss (NOL) carryover or net capital loss carryover is applied to an election year before allocating elected farm income to the base years. Similarly, the determination of whether there is a net §1231 gain or loss in the election year and the determination of the character of the §1231 items are made before allocating elected farm income to the base years. The allocation of elected farm income to the base years does not affect any determination (other than the calculation of the §1 tax attributable to the elected farm income) with respect to the election year or the base years. Thus, for example, in applying the §68 overall limitation on itemized deductions to the election year, adjusted gross income for the election year includes any elected farm income allocated to the base years. Similarly, the §68 limitation for a base year is not recomputed to take into account any allocation of elected farm income to such base year. The calculation of the §1 tax on elected farm income allocated to a base year is made without any additional adjustments or determinations with respect to such year. For example, if a base year had a partially used capital loss, the remaining capital loss may not be applied to reduce the elected farm income allocated to such year. Similarly, if a base year had a partially used credit, the remaining credit may not be applied to reduce the §1 tax attributable to the elected farm income allocated to such year.
2. *Base year was previously an election year or another base year.* If a base year for a current farm income averaging election was previously an election year for another farm income averaging election, the base year's §1 tax is determined after reducing the base year's taxable income by the elected farm income for that prior election year. If a base year for a current farm income averaging election was previously a base year for another farm income averaging election, the base year's §1

tax is determined after increasing the base year's taxable income by the elected farm income allocated to that year by that prior election.

3. *Example*. The rules of paragraph (d)(2) of this section are illustrated by the following example:

   i. *Example* In each of years 1996, 1997 and 1998, T had taxable income of $20,000. In 1999, T had taxable income of $30,000 (prior to any farm income averaging election) and electible farm income of $10,000. T makes a farm income averaging election with respect to $9,000 of his electible farm income for 1999. Thus, $3,000 of elected farm income is allocated to each of years 1996, 1997 and 1998. T's 1999 tax liability is the sum of

      A. The §1 tax on $21,000 (1999 taxable income minus elected farm income); plus

      B. For each of years 1996, 1997, and 1998, the §1 tax on $23,000 minus the §1 tax on $20,000 (the increase in §1 tax attributable to the elected farm income allocated to such year).

   ii. In 2000, T has taxable income of $50,000 and electible farm income of $12,000. T makes a farm income averaging election with respect to all $12,000 of his electible farm income for 2000. Thus, $4,000 of elected farm income is allocated to each of years 1997, 1998 and 1999. T's 2000 tax liability is the sum of

      A. The §1 tax on $38,000 (2000 taxable income minus elected farm income); plus

      B. For each of years 1997 and 1998, the §1 tax on $27,000 minus the §1 tax on $23,000 (the increase in §1 tax attributable to the elected farm income allocated to such years after increasing such years' taxable income by the elected income allocated to such year by the 1999 farm income averaging election); plus

      C. For year 1999, the §1 tax on $25,000 minus the §1 tax on $21,000 (the increase in §1 tax attributable to the elected farm income allocated to such year after reducing such year's taxable income by the 1999 elected farm income).

(e) Electible Farm Income

1. *Identification of items attributable to a farming business.*

   i. In general. Farm income includes items of income, deduction, gain, and loss attributable to the individual's farming business. Farm losses include an NOL carryover or carryback, or a net capital loss carryover, to an election year that is attributable to a farming business. Income, gain or loss from the sale of development rights, grazing rights, and other similar rights are not treated as attributable to a farming business. Farm income does not include wages.

   ii. Gain or loss on sale or other disposition of property.

      A. In general. Gain or loss from the sale or other disposition of property (other than land, but including a structure affixed to the land) that was regularly used in the individual's farming business for a substantial period of time is treated as attributable to a farming business. Whether property was "regularly used for a substantial period of time" depends on all of the facts and circumstances.

      B. Cessation of a farming business. If gain or loss described in paragraph (e)(1)(ii)(A) of this section is realized after cessation of a farming business, such gain or loss is treated as attributable to a farming business if the property is sold within a reasonable time after cessation of the farming business. A sale or other disposition within one year of cessation of the farming business is presumed to be within a reasonable time. Whether a sale or other disposition that occurs more than one year after cessation of the farming business is "within a reasonable time" depends on all of the facts and circumstances.

2. *Determination of amount that may be elected farm income.*

   i. Electible farm income. The maximum amount of income that an individual may elect to average (electible farm income) is the sum of any farm income and gain minus any farm deductions or losses (including loss carryovers and carrybacks) that are allowed as a deduction in computing the individual's taxable income. However, electible farm income may not exceed taxable income. In addition, electible farm income from net capital gain attributable to a farming business cannot exceed total net capital gain. An individual who has both ordinary and net capital gain farm income may elect (up to electible farm income) any combination of such ordinary and net capital gain farm income.

   ii. Examples. The rules of paragraph (e)(2)(i) of this section are illustrated by the following examples:

   Example (1). A has farm gross receipts of $200,000 and farm ordinary deductions of $50,000. A's taxable income is $150,000 ($200,000 – $50,000). A's electible farm income is $150,000, all of which is ordinary income.

   Example (2). B has ordinary farm income of $200,000 and nonfarm losses of $50,000. B's taxable income is $150,000 ($200,000 – $50,000). B's electible farm income is $150,000, all of which is ordinary income.

   Example (3). C has a farm capital gain of $50,000 and a nonfarm capital loss of $40,000. C also has ordinary farm income of $60,000. C has taxable income of $70,000 ($50,000 – $40,000 + $60,000). C's electible farm income is $70,000. C can elect up to $10,000 of farm capital gain and up to $60,000 of farm ordinary income.

   Example (4). D has a nonfarm capital gain of $40,000 and a farm capital loss of $30,000. D also has ordinary farm income of $100,000. D has taxable income of $110,000 ($40,000 – $30,000 + $100,000). D's electible farm income is $100,000 ordinary farm income minus $30,000 farm capital loss, or $70,000, all of which is ordinary income.

   Example (5). E has a nonfarm capital gain of $20,000 and a farm capital loss of $30,000. E also has ordinary farm income of $100,000. E has taxable income of $97,000 ($20,000 – $23,000 + $100,000). E has a farm capital loss carryover of $7,000 ($30,000 § $23,000 allowed as a deduction). E's electible farm income is $100,000 ordinary farm income minus $23,000 farm capital loss, or $77,000, all of which is ordinary income.

(f) Miscellaneous Rules

1. *Short taxable year.*

   i. In general. If a base year or an election year is a short taxable year, the rules of §443 and the regulations thereunder apply for purposes of calculating the §1 tax.

   ii. Base year is a short taxable year. If a base year is a short taxable year, the increase in §1 tax attributable to the elected farm income allocated to such year is determined after the taxable income for such year has been annualized.

   iii. Election year is a short taxable year. If an election year is a short taxable year, any elected farm income is first annualized before being allocated to the base years. The increase in §1 tax attributable to the elected farm income allocated to the base years is the same part of the tax computed on an annual basis as the number of months in the short election year is of 12 months.

2. *Changes in filing status.* An individual is not prohibited from making a farm income averaging election solely because the individual's filing status is not the same in an election year and the base years. For example, an individual who files married filing jointly in the election year, but filed as single in all of the base years, may still elect to average farm income.

3. *Employment tax.* A farm income averaging election has no effect in determining the amount of wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (Federal income tax withholding), or the amount of net earnings from self-employment for purposes of the Self-Employment Contributions Act (SECA).

4. *Alternative minimum tax*. A farm income averaging election does not apply for purposes of determining the §55 alternative minimum tax in the election year or any base year. However, an election will apply for purposes of determining the regular tax under §§53(c) and 55(c).
5. *Unearned income of minor child*. In an election year, if a minor child's investment income is taxable under §1(g) and a parent makes a farm income averaging election, the tax rate used for purposes of applying §1(g) is the rate determined after application of the election. With respect to a base year, however, the tax on a minor child's investment income is not affected by a farm income averaging election.

(g) Effective Date. The rules of this section apply to taxable years ending on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

RECENT RULINGS AND CASES

Rev. Rul. 99-56
[I.R.C. §§165, 611 and 1231]

> ☞ **Basis for limiting a timber casualty loss deduction is the basis in the block of timber affected, not the basis in the units rendered unfit for use.**

Issue. The Internal Revenue Service has reconsidered Rev. Rul. 66-9, 1966-1 C.B. 39, and Rev. Rul. 73-51, 1973-1 C.B. 75, in light of the decisions in *Westvaco Corp. v. United States*, 639 F.2d 700 [47 AFTR 2d 81-406] (Ct. Cl. 1980), and *Weyerhaeuser v. United States*, 92 F.3d 1148 [78 AFTR 2d 96-5823] (1996), rev'g in part and aff'g in part, 32 Fed. Cl. 80 (1994), cert. denied, 519 U.S. 1091 (1997).

Law and Analysis. Section 1.165-7(b)(2) of the Income Tax Regulations provides that a casualty loss must be determined by reference to a single, identifiable property (SIP) damaged or destroyed by casualty. Rev. Rul. 66-9 holds that, in the case of a casualty loss to timber, the SIP damaged or destroyed by casualty is the quantity of timber–the units (board feet, log scale, cords, or other units) of wood in standing trees that are available and suitable for exploitation and use by forest industries–rendered unfit for use by casualty (in that case, a hurricane). Rev. Rul. 66-9 articulates two interrelated concepts. One is the definition of SIP; the other is the sufficiency of damage giving rise to a casualty loss. It defines SIP to be the quantity of timber destroyed by the casualty. It regards only total destruction of the timber to be legally sufficient to trigger a casualty loss. The revenue ruling holds that the loss from the sale or other disposition of the timber that was not destroyed by the hurricane should be determined at the time of sale or other disposition by subtracting the adjusted basis of the quantity of timber disposed of from the amount received for that timber.

Rev. Rul. 73-51, in considering the allowance of a §165 casualty loss on account of an ice storm, repeats the SIP definition of Rev. Rul. 66-9 and holds that the physical damage (in that case, broken crowns or root damage that stunted tree growth) to the merchantable trees did not result in any of the existing timber being rendered unfit for use.

The Court of Claims, in Westvaco, decided that the SIP damaged or destroyed by storms and fires included all of the taxpayer's standing timber in the district (block) directly affected by each casualty and not just the units of timber contained in the trees suffering mortal injury. The court enunciated the standard that the appropriate SIP is any unit of property that has an identifiable adjusted basis and that is reasonable and logical and identifiable in relation to the area affected by the casualty. The court also held that the allowable loss for casualty is not limited to merchantable units of timber totally destroyed.

In Weyerhaeuser, the United States Court of Appeals for the Federal Circuit held that the SIP damaged or destroyed by several forest fires and a volcanic eruption affecting taxpayer's timber property was the block, that subdivision of a taxpayer's forest holdings selected by the taxpayer as a means of tracking the adjusted basis in the timber pursuant to §1.611-(3)(d)(1). Consistent with Westvaco, a casualty loss was allowed for trees that were damaged but not rendered worthless.

Holding. In light of the court decisions in Westvaco and Weyerhaeuser the Service is revoking Rev. Rul. 66-9 and Rev. Rul. 73-51.

Effect on Other Revenue Rulings. Rev. Rul. 66-9, 1966-1 C.B. 39, and Rev. Rul. 73-51, 1973-1 C.B. 75, are revoked.

Drafting Information. The principal author of this revenue ruling is Richard T. Probst of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Richard T. Probst on (202) 622-3120 (not a toll-free call).

[Rev. Rul. 99-56, 1999-51 IRB]

Rev. Proc. 99-42
[I.R.C. §1]

☞ **Inflation adjusted tax rates, deductions and credits are released for 2000.**

IRS provided 2000 cost-of-living adjustments to tax rate tables, earned income credit, standard deduction amounts, personal exemption, and other inflation-adjusted items. Adjusted for the first time in 2000 is limitation in Code §132(f) on exclusion from gross income for qualified transportation fringes, and value of property exempt from levy under Code §6334(a)(2) and Code §6334(a)(3). Other adjustments relating to excise taxes and estate and gift taxes were also made.

Summary. Tax Rate Tables. For tax years beginning in 2000, the tax rate tables under §1 are as follows:

TABLE 1: MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not over $43,850	15% of the taxable income
Over $43,850 but not over 105,950	$6,577.50 plus 28% of the excess over $43,850
Over $105,950 but not over $161,450	$23,965.50 plus 31% of the excess over $105,950
Over $161,450 but not over $288,350	$41,170.50 plus 36% of the excess over $161,450
Over $288,350	$86,854.50 plus 39.6% of the excess over $288,350

TABLE 2: SECTION 1(b). HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not over $35,150	15% of the taxable income
Over $35,150 but not over $90,800	$5,272.50 plus 28% of the excess over $35,150
Over $90,800 but not over $147,050	$20,854.50 plus 31% of the excess over $90,800
Over $147,050 but not over $288,350	$38,292 plus 36% of the excess over $147,050
Over $288,350	$89,160 plus 39.6% of the excess over $288,350

TABLE 3: SECTION 1(c). UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not over $26,250	15% of the taxable income
Over $26,250 but not over $63,550	$3,937.50 plus 28% of the excess over $26,250
Over $63,550 but not over $132,600	$14,381.50 plus 31% of the excess over $63,550
Over $132,600 but not over $288,350	$35,787 plus 36% of the excess over $132,600
Over $288,350	$91,857 plus 39.6% of the excess over $288,350

TABLE 4: SECTION 1(d). MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not over $21,925	15% of the taxable income
Over $21,925 but not over $52,975	$3,288.75 plus 28% of the excess over $21,925
Over $52,975 but not over $80,725	$11,982.75 plus 31% of the excess over $52,975
Over $80,725 but not over $144,175	$20,585.25 plus 36% of the excess over $80,725
Over $144,175	$43,427.25 plus 39.6% of the excess over $144,175

TABLE 5: SECTION 1(e). ESTATES AND TRUSTS RETURNS

If Taxable Income Is:	The Tax Is:
Not over $1,750	15% of the taxable income
Over $1,750 but not over $4,150	$262.50 plus 28% of the excess over $1,750
Over $4,150 but not over $6,300	$934.50 plus 31% of the excess over $4,150
Over $6,300 but not over $8,650	$1,601 plus 36% of the excess over $6,300
Over $8,650	$2,447 plus 39.6% of the excess over $8,650

Unearned Income of Minor Children Taxed as if Parent's Income (the "Kiddie Tax"). For tax years beginning in 2000, the amount in §1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $700. (This amount is the same as the $700 standard deduction amount provided in §3.05(2) of this revenue procedure.) In the alternative, the same $700 amount is used for purposes of §1(g)(7) (that is, determining whether a parent may elect to include a child's gross income in the parent's gross income and for calculating the "kiddie tax").

Earned Income Credit

1. In general. For tax years beginning in 2000, the following amounts are used to determine the earned income credit under §32(b). The "earned income amount" is the amount of earned income at or above which the maximum amount of the earned income credit is allowed. The "threshold phaseout amount" is the amount of modified adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The "completed phaseout amount" is the amount of modified adjusted gross income (or if greater, earned income) at or above which no credit is allowed.

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Threshold Phaseout Amount	Completed Phaseout Amount
1	$2,353	$6,920	$12,690	$27,413
2 or more	$3,888	$9,720	$12,690	$31,152
None	$ 353	$4,610	$ 5,770	$10,380

The Internal Revenue Service, in the instructions for the Form 1040 series, provides tables showing the amount of the earned income credit for each type of taxpayer.

2. Excessive investment income. For tax years beginning in 2000, the earned income credit is denied under §32(i) if the aggregate amount of certain investment income exceeds $2,400.

Alternative Minimum Tax Exemption for a Child Subject to the "Kiddie Tax." For tax years beginning in 2000, in the case of a child to whom the §1(g) "kiddie tax" applies, the exemption amount under §55 and §59(j) for purposes of the alternative minimum tax under §55 may not exceed the sum of

a. such child's earned income for the taxable year, plus

b. $5,200.

Standard Deduction

(1) In General. For tax years beginning in 2000, the standard deduction amounts under §63(c)(2) are as follows:

Filing Status	Standard Deduction
Marrried individuals filing joint returns and surviving spouses (§1 (a))	$7,350
Heads of households (§1(b))	$6,450
Unmarried Individuals (other than surviving spouses and heads of households) (§1(c))	$4,400
Married individuals filing separate returns (§1(d))	$3,675

(2) Dependent. For tax years beginning in 2000, the standard deduction amount under §63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $700, or the sum of $250 and the individual's earned income.

(3) Aged and Blind. For tax years beginning in 2000, the additional standard deduction amounts under §63(f) for the aged and for the blind are $850 for each. These amounts are increased to $1,100 if the individual is also unmarried and not a surviving spouse.

Overall Limitation on Itemized Deductions. For tax years beginning in 2000, the "applicable amount" of adjusted gross income under §68(b), above which the amount of otherwise allowable itemized deductions is reduced under §68, is $128,950 (or $64,475 for a separate return filed by a married individual).

Qualified Transportation Fringe. For tax years beginning in 2000, the monthly limitation under §132(f)(2)(A), regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass, is $65. The monthly limitation under §132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $175.

Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.
For tax years beginning in 2000, the exclusion under §135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modi-

fied adjusted gross income above $81,100 for joint returns and $54,100 for other returns. This exclusion completely phases out for modified adjusted gross income of $111,100 or more for joint returns and $69,100 or more for other returns.

Personal Exemption

(1) Exemption Amount. For tax years beginning in 2000, the personal exemption amount under §151(d) is $2,800.

Filing Status	Threshold Phaseout Amount	Completed Phaseout Amount
Married filing jointly	$193,400	$315,900
Heads of households	$161,150	$283,650
Unmarried individuals	$128,950	$251,450
Married filing separately	$ 96,700	$157,950

(2) Phaseout. For tax years beginning in 2000, the personal exemption amount begins to phase out at, and is completely phased out after, the following adjusted gross income amounts

Eligible Long-Term Care Premiums. For tax years beginning in 2000, the limitations under §213(d), regarding eligible long-term care premiums includable in the term "medical care," are as follows

Attained Age Before the Close of the Taxable Year	
40 or less	$ 220
More than 40 but not more than 50	$ 410
More than 50 but not more than 60	$ 820
More than 60 but not more than 70	$2,200
More than 70	$2,750

Valuation of Qualified Real Property in Decedent's Gross Estate. For an estate of a decedent dying in calendar year 2000, if the executor elects to use the special use valuation method under §2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use §2032A that is taken into account for purposes of the estate tax may not exceed $770,000.

Annual Exclusion for Gifts

(1) For calendar year 2000, the first $10,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §2503 made during that year.
(2) For calendar year 2000, the first $103,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §§2503 and 2523(i)(2) made during that year.

Generation-Skipping Transfer Tax Exemption. For calendar year 2000, the generation-skipping transfer tax exemption under §2631, which is allowed in determining the "inclusion ratio" defined in §2642, is $1,030,000.

Luxury Automobile Excise Tax. For calendar year 2000, the excise tax under §§4001 and 4003 is imposed on the first retail sale of a passenger vehicle (including certain parts or accessories installed within six months of the date after the vehicle was first placed in service), to the extent the price exceeds $38,000.

Property Exempt from Levy. For calendar year 2000, the value of property exempt from levy under §6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) may not exceed $6,360. The value of property exempt from levy under §6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) may not exceed $3,180.

Interest on a Certain Portion of the Estate Tax Payable in Installments. For an estate of a decedent dying in calendar year 2000, the dollar amount used to determine the "2% portion" (for purposes of calculating interest under §6601(j)) of the estate tax payable in installments under §6166 is $1,030,000.

Periodic Payments Received under Qualified Long-Term Care Insurance Contracts or under Certain Life Insurance Contracts. For calendar year 2000, the stated dollar amount of the per diem limitation under §7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is $190.

Effective Date. General Rule. Except as provided in §4.02, this revenue procedure applies to tax years beginning in 2000.

[Rev. Proc. 99-42, 1999-46 IRB]

Social Security Administration
[Fact Sheet 10/19/99]

☞ **The Social Security wage base for 2000 is $76,200.**

The Social Security Administration has announced that the wage base for computing the Social Security tax (OASDI) in 2000 is $76,200. That is a $3,600 increase from the $72,600 wage base in 1999.

Rev. Proc. 99-38
[I.R.C. §61]

☞ **Optional standard mileage rates for 2000 are released.**

For expenses incurred on or after 1/1/2000, optional mileage rates are as follows: for business use, 32.5 cents per mile; for charitable use, 14 cents per mile; for medical or moving use, 10 cents per mile. Rev. Proc. 98-63, 1998--52 IRB 25, as modified by Announcement 99-7, 19999-2 IRB 45, is superseded for allowances paid and transportation expenses paid or incurred after 1999.

For owned automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 12 cents per mile for 1996, 1997, 1998, and 1999, and 14 cents per mile for 2000, for those years in which the business standard above will not apply to any year in which such costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by §1016.

[Rev. Proc. 99-38, 1999-43 IRB]

Announcement 99-104
[I.R.C. §408A]

☞ **The deadline for recharacterizing 1998 IRA contributions, including Roth conversions, is extended to December 31, 1999.**

Purpose. The first year for which Roth IRAs could be established was 1998. It has come to the attention of the Internal Revenue Service and Treasury that taxpayers have experienced particular difficulty in properly applying the rules governing Roth IRA conversion contributions and recharacterizations. In view of the tax consequences of excess IRA contributions, the Service and Treasury believe that additional time should be provided for taxpayers who made 1998 Roth IRA conversion contributions or other 1998 IRA contributions and who would like to recharacterize those contributions.

This announcement provides relief to taxpayers who would like to recharacterize 1998 IRA contributions, including amounts contributed to Roth IRAs as conversions when the taxpayers were not eligible. Pursuant to this announcement, these taxpayers have until the end of 1999 to recharacterize their 1998 IRA contributions.

Background. Section 408A(d)(6) of the Internal Revenue Code and §1.408A-5 of the regulations provide that, except as otherwise provided by the Secretary, a taxpayer may elect to recharacterize an IRA contribution made to one type of IRA as having been made to another type of IRA by making a trustee-to-trustee transfer of the IRA contribution, plus earnings, to the other type of IRA. In a recharacterization, the IRA contribution is treated as having been made to the transferee IRA and not the transferor IRA. Under §408A(d)(6) and §1.408A-5, this recharacterization election generally must occur on or before the date prescribed by law, including extensions, for filing the taxpayer's Federal income tax return for the year of the contribution.

Section 1.408A-5, Q&A-6, describes how a taxpayer makes the election to recharacterize an IRA contribution. To recharacterize an amount that has been converted from a traditional IRA to a Roth IRA:

1. the taxpayer must notify the Roth IRA trustee of the taxpayer's intent to recharacterize the amount,
2. the taxpayer must provide the trustee (and the transferee trustee, if different from the transferor trustee) with specified information that is sufficient to effect the recharacterization transfer, and
3. the trustee must make the transfer.

Section 301.9100-2(b) of the regulations generally provides for an automatic extension of 6 months from the due date of a return, excluding extensions, to make elections that otherwise must be made by the due date of the return or the due date of the return plus extensions, provided

1. the taxpayer's return was timely filed for the year the election should have been made and
2. the taxpayer takes appropriate corrective action within this 6-month period.

Announcement 99-57, 1999-24 I.R.B. 50 (June 14, 1999) describes the application of §301.9100-2(b) to recharacterization elections.

Extension of Time to Recharacterize 1998 IRA Contributions

Pursuant to §408A(d)(6), a taxpayer will be deemed to have timely made an otherwise valid recharacterization of a 1998 IRA contribution, including a Roth IRA conversion for which the taxpayer was not eligible, if

1. the recharacterization occurs on or before December 31, 1999,
2. the taxpayer timely filed his or her 1998 Federal income tax return, and
3. the taxpayer files an amended 1998 return if the recharacterization is not properly reflected on the previously filed return.

Effect on Other Documents. Announcement 99-57 is modified.
[Announcement 99-104, 1999-44 IRB]

Noticw 99-53
[I.R.C. §6045]

☞ **The effective date of regulation pertaining to reporting of gross proceeds paid to attorneys is delayed one year.**

This notice informs taxpayers that the Internal Revenue Service intends to delay for one year the effective date of the regulations proposed under §6045 of the Internal Revenue Code (relating to the reporting of payments of gross proceeds to attorneys). The notice of proposed rulemaking (NPRM) was published in the Federal Register on May 21, 1999 (64 FR 27730), 1999-23 I.R.B. 14 (REG-105312-98). Section 1.6045-5(h) of the proposed Income Tax Regulations provides that the rules in §1.6045-5 apply to payments made after December 31, 1999.

The Service has received many comments requesting that the effective date of the regulations be delayed and believes that a delayed effective date for the regulations is appropriate under the circumstances. Accordingly, when finalized, the rules in §1.6045-5 will apply to payments made after December 31, 2000. Nevertheless, payments of gross proceeds to attorneys made after December 31, 1997, are and continue to be reportable on Form 1099-MISC pursuant to §6045(f).

The principal author of this notice is A. Katharine Jacob Kiss, of the Office of the Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice contact Ms. Kiss at (202) 622-4920 (not a toll-free number).

[Notice 99-53, 1999-46 IRB]

Kikalos v. Commissioner
[I.R.C. §§ 61, 163, 165, 446, and 6662]

☞ **Interest owed on individual income tax deficiencies is not deductible as a business expense.**

Facts. In 1992, the Commissioner made substantial adjustments to the gross income that Nick and Helen Kikalos had reported receiving from Nick's Liquors for the 1986 and 1987 tax years. As a result, the couple owed an additional $286,147.50 in taxes for the 1986 tax year and another $272,146 for the 1987 tax year. The Kikaloses were also required to pay interest on those deficiencies in the total amount of $393,024. On the Schedule C submitted with their 1992 tax return, they claimed that amount as a business expense and deducted it from their income.

In 1994, the Kikaloses were required to pay additional income tax and penalties of $458,230.43 for the 1988 tax year and $441,669.22 for 1989, again due to adjustments in the gross income that they reported for Nick's Liquors. The interest that they owed on the income tax deficiencies for those years amounted to another $499,895.11. As they had on their 1992 return, the Kikaloses deducted that interest from their income on their 1994 tax return.

The Internal Revenue Service disallowed the deduction pursuant to a temporary regulation that deems interest owed on tax underpayments to be nondeductible personal interest, even if the income giving rise to the tax liability derives from the taxpayer's business. See Temp. Treas. Reg. §1.163-9T(b)(2)(i)(A), 26 C.F.R. §1.163-9T(b)(2)(i)(A). Following its decision in *Redlark v. Commissioner,* 106 T.C. 31 (1996), rev'd, 141 F.3d 936 [81 AFTR 2d 98-1483] (9th Cir. 1998), which by a divided vote held that regulation invalid, the tax court concluded that the tax underpayments were properly allocable to Nick Kikalos' unincorporated business, see 26 U.S.C. §163(h)(2)(A), and that the interest on the underpayments was therefore deductible as a business expense. *Kikalos v. Commissioner,* 75 T.C.M. (CCH) 1924, 1932-33 (1998).

Issue. Is the regulation that treats all interest paid on individual income tax deficiencies as nondeductible personal interest consistent with the Internal Revenue Code?

Analysis. The court applied a two-step analysis. First, it considered whether I.R.C. §163(h) speaks clearly to the deductibility of interest on income tax deficiencies emanating from the taxpayer's sole proprietorship and concluded that it does not. Given the statutory ambiguity, there is an implicit delegation of authority to the Commissioner to clarify whether income tax deficiency interest is properly allocable to a trade or business.

The second step of the analysis is whether the Commissioner has filled the statutory gaps reasonably. Ultimately, the Kikaloses must lean on the cases pre-dating the statute in the effort to show that the temporary regulation is unreasonable, and those cases simply cannot carry the weight of the challenge. Because they were decided long before Congress enacted the provision at issue here, these cases simply do not speak to the question of whether the interest business owners must pay on income tax deficiencies is non-deductible "personal interest" under §163(h)(1) or deductible interest accrued on a debt that is "properly allocable" to a trade or business under §163(h)(2)(A). Congress has assigned that task to the Commissioner, without supplying any guidance of its own on the subject and without any indication that it meant to codify the case law on which the Kikaloses now rely. The reasoning of the older cases might have guided the Commissioner to a different regulatory interpretation of the statute, but without a more express command from the legislature, we cannot say that the judicial rationale dictated any one treatment of income tax deficiency interest. In that regard, it is worth noting that in years since the Commissioner promulgated the temporary regulation, Congress has not seen fit to overrule the Commissioner (Allen, 173 F.3d at 538; Miller, 65 F.3d at 690).

Holding. In accord with every other circuit that has addressed the issue, the Seventh Circuit Court of Appeals sustained the Commissioner's determination that interest owed on individual income tax deficiencies is not deductible as a business expense, irrespective of the source of the income giving rise to the tax liability.

[*Kikalos v. Commissioner*, 190 F.3d 791 (7th Cir. 1999)]

Rev. Rul. 99-53
[I.R.C. §6621(a)(1)]

☞ **Quarterly interest rates for the first quarter of 2000 are announced.**

The rate of interest determined under §6621 of the Code for the calendar quarter beginning January 1, 2000, will be 8% for overpayments (7% in the case of a corporation), 8% for underpayments, and 10% for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 is 5.5%.

Rev. Rul. 99-45
[I.R.C. §1274]

☞ **Applicable federal rates for November 1999 are announced.**

TABLE 1: REV. RUL. 99-45. APPLICABLE FEDERAL RATES (AFR) FOR NOVEMBER 1999

	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
Short-Term AFR	5.57%	5.49%	5.45%	5.43%
Mid-Term AFR	6.08%	5.99%	5.95%	5.92%
Long-Term AFR	6.39%	6.29%	6.24%	6.21%

[Rev. Rul. 99-45,1999-48 IRB]

Rev. Rul. 99-48
[I.R.C. §1274]

☞ **Applicable federal rates for December 1999 are announced.**

TABLE 2: REV. RUL. 99-48. APPLICABLE FEDERAL RATES (AFR) FOR DECEMBER 1999

	Period for Compounding			
	Annual	**Semiannual**	**Quarterly**	**Monthly**
Short-Term AFR	5.74%	5.66%	5.62%	5.59%
Mid-Term AFR	6.20%	6.11%	6.06%	6.03%
Long-Term AFR	6.47%	6.37%	6.32%	6.29%

[Rev. Rul. 99-48, 1999-49 IRB]

Hennen v. Commissioner
[I.R.C. §1402]

☞ **Rent received by landowner who is employed in the farming business that rents the land is subject to self-employment tax.**

Facts. During the taxable years at issue, Mr. Hennen operated the farm as a sole proprietorship. Mr. Hennen owned about 320 acres, and Mrs. Hennen owned 200 acres. The other acreage is rented from others. Mr. Hennen rented the 200 acres of farmland from Mrs. Hennen for $16,000 per year under an oral agreement. Mr. Hennen paid her $80 an acre, which is comparable to the amount he paid to others. Mr. Hennen used the land rented from Mrs. Hennen in the farming operations to produce agricultural commodities such as livestock and crops.

Mrs. Hennen owned the 200 acres in her own name. She purchased the 200 acres from her Uncle in 1972. Mr. Hennen then entered into an oral arrangement to lease the acreage from Mrs. Hennen. Mrs. Hennen deposits the rent received from her husband in her farm account, which is separate from his account. When petitioners entered into the oral agreement, petitioners expected that Mrs. Hennen would perform the duties she had been performing in the farming operations.

Since Mr. and Mrs. Hennen began farming, Mrs. Hennen has provided general farming services to the endeavor. She bought cattle, loaded cattle, and vaccinated cattle. She cleaned shop. She also sprayed weeds, picked up parts, unloaded grain, and drove a tractor. In addition, Mrs. Hennen performed the farm bookkeeping. Mrs. Hennen carried on these duties prior to renting the land to her husband. Mrs. Hennen did whatever it took to make the farm run more smoothly and had done so ever since Mr. Hennen and Mrs. Hennen were married 38 years ago. Mrs. Hennen worked on the farm approximately 1,000 hours per year.

Mrs. Hennen did not participate in making decisions as to the type of crop to plant, nor did she participate in other management decisions. Mr. Hennen made the management decisions.

In each of the years in issue, Mrs. Hennen entered into a purported Employment Agreement (Agreement) with Mr. Hennen. The Agreement said that with respect to Mr. Hennen's business of farming, Mrs. Hennen was to perform bookkeeping, run errands for the business, and help with livestock chores and field work. In essence, the Agreement memorialized almost the same duties that Mrs. Hennen had been performing since Mr. and Mrs. Hennen began farming together. The Agreement also said Mrs. Hennen could participate in her husband's Health and Accident Insurance Plan, according to the terms and provisions of that plan. Mrs. Hennen would have continued to do the same farming jobs even if there had been no Agreement.

For all 3 years in issue, petitioners filed their Forms 1040 income tax returns on a married, filing jointly basis. On their Schedules E, Supplemental Income and Loss, petitioners reported that they received net rental income for 1994, 1995, and 1996, from "FARM AND HOUSE", "FARMS", and "FARMS", respectively, in the amounts of $14,322, $12,940, and $12,766, respectively. On line 7, Wages, salaries, tips, etc., of their Forms 1040, petitioners reported that Mrs. Hennen received wages from Mr. Hennen in the amounts of $3,137.11, $3,250, and $3,487 for 1994, 1995, and 1996, respectively, and, in 1994, petitioners also reported that Mrs. Hennen received wages from World Book, Inc. in the amount of $221.45. The amounts deducted as labor hired on the respective Schedules F, Profit or Loss From Farming, for the 3 years in issue exceeded the amounts purportedly paid to Mrs. Hennen. Mr. Hennen failed to withhold Federal income taxes, State income taxes, Federal Insurance Contribution Act taxes, and Medicare tax for all 3 years.

In the notice of deficiency, respondent, inter alia, determined that the real estate rental payments Mrs. Hennen received from Mr. Hennen during the taxable years at issue are includable in Mrs. Hennen's net earnings from self-employment under §1402(a)(1), and thus subject to self-employment tax. Respondent also allowed petitioners a deduction for one-half of the self-employment taxes imposed for the taxable years at issue.

Issue. Does I.R.C. §1402(a)(1) require Mrs. Hennen to pay self-employment tax on her rental income?

Analysis. Section 1401 provides that a tax shall be imposed on the self-employment income of every individual. Generally, rentals from real estate are excluded from the computation of net earnings from self-employment [§1402(a)(1)]. However, §1402(a)(1) also provides that rentals derived by the owner or tenant of land are not excluded from the computation of net earnings from self-employment if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural commodities (including livestock) on such land, and that there shall be material participation by the owner or tenant in the production or the management of the production of such agricultural commodities, and (B) there is material participation by the owner or tenant with respect to any such agricultural commodity.

In light of all the facts and circumstances, we must decide whether Mrs. Hennen received rental income from Mr. Hennen pursuant to an "arrangement" between the parties to produce agricultural commodities on the farm within the meaning of §1402(a)(1)(A).

The parties stipulated that Mr. Hennen used the land rented from Mrs. Hennen in the farming operations to produce agricultural commodities such as livestock and crops. With respect to whether under the arrangement Mrs. Hennen was to materially participate in the farming operations, we look not only to the obligations imposed upon Mrs. Hennen by the oral lease, "but to those obligations that existed within the overall scheme of the farming operations which were to take place" on Mrs. Hennen's property. *Mizell v. Commissioner*, T.C. Memo. 1995-571. These include Mrs. Hennen's obligations as a longstanding participant in the farming business as well as the "general understanding between [Mr. Hennen and Mrs. Hennen] with respect to the production of agricultural products." Id. Viewed in this light, the arrangement between Mr. and Mrs. Hennen provided, or contemplated, that Mrs. Hennen materially participate in the production of agricultural commodities on the farmland.

Although petitioners contend that the purported oral lease agreement did not require Mrs. Hennen to participate materially in the farming operations, the record supports a finding that Mrs. Hennen played a material role in the production of agricultural commodities under an arrangement with her husband.

The regulations provide in pertinent part that if the rental income is derived under an arrangement between the owner of land and another person who provides that such other person shall produce agricultural commodities on such land, and that there shall be material participation by the owner in the production or the management of the production of such agricultural commodities, and there is such material participation by the owner, then the rental income received by the owner pursuant to the arrangement is considered earnings from self-employment [§1.1402(a)-4(b), Income Tax Regs].

Holding. The court found that the rental income is includable farm rental income that is part of Mrs. Hennen's net earnings from self-employment under §1402(a)(1) for each of the taxable years at issue.

This is the same conclusion the court reached in a similar case, decided after this case was heard. *Bot v. Commissioner,* T.C. Memo. 1999-256 [1999 RIA TC Memo ¶99,256].

[*Hennen v. Commissioner,* TC Memo 1999-306]

McNamara v. Commissioner

[I.R.C. §1402]

☞ **Rent paid by corporation to sole owner and his wife who are employed by the corporation for land used by the corporation for agricultural production is subject to self-employment tax.**

Facts. Mr. McNamara operated the farm as a joint venture with his wife until he incorporated the farm on January 17, 1992. Mr. McNamara is the sole shareholder, officer, and director of McNamara Farms. McNamara Farms rents land from Mr. and Mrs. McNamara and two other landowners. During the taxable years at issue, McNamara Farms rented 460 acres of farmland, including a house, from petitioners under a lease characterized as a Cash Rent Farm Lease. Petitioners owned the 460 acres of farmland equally as joint tenants. McNamara Farms paid petitioners rent in the amounts of $45,620, $56,168, and $57,000 in 1993, 1994, and 1995, respectively.

McNamara Farms used the land rented from petitioners in its farming operation to produce agricultural commodities such as corn, soybeans, seed corn, sweet corn, and sugar beets.

On February 1, 1992, Mrs. McNamara also entered into a purported Employment Agreement with McNamara Farms, signed by Mr. McNamara as President. The Employment Agreement provided that Mrs. McNamara was to perform the following duties for the farming business: Bookkeeping, preparation of meals for employees, field work, assistance in providing security for machinery and inventory, and such other usual and customary duties as may be delegated by the employer from time to time. In essence, the Agreement memorialized almost the same duties that Mrs. McNamara had been performing since Mr. and Mrs. McNamara began farming together. The Employment Agreement further provided that any portion of compensation not paid in kind (e.g., grain crops) "will be subject to required FICA social security tax and income tax withholding." The Agreement also provided that Mrs. McNamara could participate in the McNamara Farms medical reimbursement plans and that she would be provided medical insurance coverage for herself and her dependents.

For all 3 years in issue, petitioners filed their Forms 1040 income tax returns as married individuals filing joint returns. Mr. McNamara stated his occupation was "farmer" and Mrs. McNamara stated her occupation was "bookkeeper". On their Schedules E, Supplemental Income and Loss, petitioners reported that they received net rental income in the amounts of $19,180, $24,442 and $22,671 in 1993, 1994, and 1995, respectively. On line 7, Wages, salaries, tips, etc., of their Forms 1040, petitioners reported that they received wages in the amounts of $30,603, $30,466, and $31,252 for 1993, 1994, and 1995, respectively. Elsewhere on their 1993, 1994, and 1995 returns, Mr. McNamara and Mrs. McNamara reported earnings from McNamara Farms of $28,019 and $2,584, respectively (total of $30,603), $27,775 and $2,691, respectively (total of $30,466), and $28,561 and $2,691, respectively (total of $31,252). Contrary to the terms of the Employment Agreements, McNamara Farms failed to withhold Federal income taxes and State income taxes from their earnings. McNamara Farms withheld Federal Insurance Contribution Act taxes and Medicare tax for all 3 years from their earnings.

Respondent determined deficiencies in petitioners' Federal income taxes in the amounts of $2,507, $3,191, and $2,963, for the taxable years 1993, 1994, and 1995, respectively. In the notice of deficiency, respondent determined that the real estate rental payments petitioners received from McNamara Farms during the taxable years at issue are includable in petitioners' net earnings from self-employment under §1402(a)(1), and thus subject to self-employment tax income. Respondent divided the amounts equally between petitioners with respect to self-employment income and self-employment tax. Respondent also allowed petitioners a deduction for one-half of the self-employment taxes imposed for the taxable years at issue.

Issue. The sole issue for decision is whether rental payments received by petitioners from McNamara Farms, Inc. (McNamara Farms), a corporation solely owned by petitioner Michael McNamara (Mr.

McNamara), are includable in petitioners' net earnings from self-employment under §1402(a)(1) and thus subject to self-employment taxes.

Analysis. Section 1401 provides that a tax shall be imposed on the self-employment income of every individual. Generally, rentals from real estate are excluded from the computation of net earnings from self-employment [§1402(a)(1)]. However, §1402(a)(1) also provides that rentals derived by the owner or tenant of land are not excluded from the computation of net earnings from self-employment if:

> (A) such income is derived under an arrangement between the owner or tenant and another individual, which provides that such other individual shall produce agricultural commodities on such land, and that there shall be material participation by the owner or tenant in the production or the management of the production of such agricultural commodities, and (B) there is material participation by the owner or tenant with respect to any such agricultural commodity;

In determining whether compensation is includable in self-employment income under §§1401-1403 such provisions are to be broadly construed so as to favor coverage for Social Security purposes. *Braddock v. Commissioner,* 95 T.C. 639, 644 (1990). The rental exclusion in §1402(a)(1) is to be strictly construed to prevent this exclusion from interfering with the congressional purpose of effectuating maximum coverage under the Social Security umbrella. *Johnson v. Commissioner,* 60 T.C. 829, 832 (1973); *Gill v. Commissioner,* T.C. Memo. 1995-328.

Petitioners contend that the written lease agreement does not require material participation by petitioners in the farming operations. Petitioners further contend that the rental income that petitioners received from McNamara Farms was cash rent from real estate, and therefore should be excluded in determining whether petitioners had any net earnings from self-employment as that term is used in §1402(a)(1).

In light of all the facts and circumstances, we must decide whether petitioners received rental income from McNamara Farms pursuant to an "arrangement" between the parties to produce agricultural commodities on the farm within the meaning of §1402(a)(1)(A).

McNamara Farms used the farmland to produce agricultural commodities such as corn, soybeans, seed corn, sweet corn, and sugar beets. With respect to whether under the arrangement petitioners were to materially participate in the farming operations, we look not only to the obligations imposed upon them by the written lease, "but to those obligations that existed within the overall scheme of the farming operations which were to take place" on their property. *Mizell v. Commissioner,* T.C. Memo. 1995-571. These include petitioners' obligations as longstanding participants in the farming business as well as the "general understanding between [petitioners and McNamara Farms] with respect to the production of agricultural products." Id. Viewed in this light, the arrangement between petitioners and McNamara Farms provided, or contemplated, that petitioners materially participate in the production of agricultural commodities on the farmland.

For about 21 years through the taxable years at issue, Mr. McNamara performed general farming services on the farm on a regular and intermittent basis, as we detailed in the findings of fact. Mrs. McNamara failed to testify, but it is clear that for a good number of years she did the same. In our view, these "regularly performed services are material to the production of an agricultural commodity, and the intermittent services performed are material to the production operations to which they relate" [§1.1402(a)-4(b)(6), Example (1), Income Tax Regs.].

The regulations provide in pertinent part that if the rental income is derived under an arrangement between the owner of land and another person who provides that such other person shall produce agricultural commodities on such land, and that there shall be material participation by the owner in the production or the management of the production of such agricultural commodities, and there is such material participation by the owner, then the rental income received by the owner pursuant to the arrangement is considered earnings from self-employment. §1.1402(a)-4(b), Income Tax Regs.

Holding. Accordingly the court found that the rental income is includable farm rental income that is part of petitioners' net earnings from self-employment under §1402(a)(1) for each of the taxable years at issue.

[*McNamara v. Commissioner*, TC Memo 1999-333]