

Chapter 4: Individual Taxpayer Issues

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Please note. Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

PORTABILITY

Under the Code, individuals are allowed a certain amount that they can gift — either during their lifetimes or at their deaths — that is not subject to gift or estate tax. The amount of this tax-free transfer, referred to as the **basic exclusion amount**,¹ has varied considerably over the years.

Recent law has granted married persons the extra benefit of receiving their **deceased spouse's unused exclusion (DSUE) amount**.² This option, referred to as **portability**, is a helpful estate-planning tool. In many cases, electing portability has rendered traditional estate-planning techniques — such as the bypass trust³ — unnecessary.

To elect portability, a timely filed Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, must be filed.⁴ In addition, the Form 706 that is filed must be complete and properly prepared,⁵ which includes the requirement to calculate the DSUE amount for which portability is elected.⁶ A timely filed, complete, and properly prepared Form 706 is deemed to meet this requirement (unless the executor elects out of portability).⁷

Note. Portability elections are explained in more detail later in this chapter.

¹ IRC §2010(c)(3).

² IRC §2010(c)(5).

³ For some individuals, there are still good reasons to create a bypass trust. Moreover, if an individual has an estate plan in place with a bypass trust, they usually have no need to amend that plan in light of portability.

⁴ Treas. Reg. §20.2010-2(a).

⁵ Treas. Reg. §20.2010-2(a)(7)(i).

⁶ Treas. Reg. §20.2010-2(b).

⁷ Ibid.

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UNIFIED TRANSFER TAX CREDIT

Under the current unified estate and gift tax system, a decedent's estate tax liability is calculated based on the combined dollar value of their lifetime taxable gifts and their taxable estate. This amount is compared against the federal tax rate schedule to determine the decedent's **tentative** estate tax liability.

Certain credits — primarily, the unified transfer tax credit — are then applied against the taxable amount to determine the decedent's actual federal estate tax liability. The amount of the **unified transfer tax credit** is equal to the tentative tax that would be due for the corresponding "applicable exclusion amount."⁸ The **applicable exclusion amount** is the **basic exclusion amount** plus any DSUE amount.

BASIC EXCLUSION AMOUNT

The basic exclusion amount is the amount of an estate (including lifetime gifts) that is exempt from estate tax. The basic exclusion amount is set by statute at \$5 million. However, the law provides that each year after 2011, the amount is raised by a cost-of-living adjustment. The following chart shows the basic exclusion amounts and the corresponding unified credits for the past five years.⁹

Year	Basic Exclusion Amount	Unified Credit ¹⁰
2011	\$5,000,000	\$1,945,800
2012	5,120,000	1,993,800
2013	5,250,000	2,045,800
2014	5,340,000	2,081,800
2015	5,430,000	2,117,800

An estate is required to file a Form 706 if the value of the gross estate exceeds the filing threshold. Generally, the filing thresholds for 2011–2015 are the basic exclusion amounts shown above for each respective tax year.

Note. For further information regarding estate filing thresholds, see **uofi.tax/15b4x9** [www.irs.gov/instructions/i706/ch01.html].

⁸. IRC §2010.

⁹. Instructions for Form 706, p. 8; Rev. Proc. 2014-61, 2047-47 IRB 860.

¹⁰. IRC §2010.

Example 1. Tom died in 2014 with a \$4.8 million taxable estate. He had never been married and had made \$1 million in lifetime taxable gifts. The total of these two amounts (\$4.8 million + \$1 million = \$5.8 million) is compared against the following 2014 unified rate schedule¹¹ to determine the tentative estate tax liability.

Table A — Unified Rate Schedule

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A
\$0	\$10,000	\$0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	----	345,800	40%

The tax liability of Tom's estate is calculated as follows.

Tax on \$1 million (from table)	\$ 345,800
Tax on balance of taxable estate (\$4.8 million × 40%)	1,920,000
Estate tax liability without unified credit	\$2,265,800
Less: unified transfer tax credit for 2014 ¹²	(2,081,800)
Estate tax liability	\$ 184,000

DECEASED SPOUSAL UNUSED EXCLUSION

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act (ATRA) of 2012.¹³ **ATRA made permanent the portability provisions** first enacted by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (Tax Relief Act) of 2010.¹⁴ The Tax Relief Act amended IRC §2010(c) to grant the right to **elect** portability to the estate of a decedent survived by a spouse. **If the executor of the decedent's estate makes this election, the decedent's estate transfers any DSUE to the surviving spouse.**

The DSUE of the **last deceased spouse** is added to the surviving spouse's own basic exclusion amount to determine the applicable exclusion amount. This applicable exclusion amount is then applied to transfers made during the surviving spouse's lifetime and to those made at their death.

¹¹ Instructions for Form 706.

¹² Ibid.

¹³ PL 112-240, HR 8, 126 Stat. 2313.

¹⁴ PL 111-312, 124 Stat. 3296, 3302 (2010).

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The DSUE is the **lesser** of:¹⁵

- The basic exclusion amount, or
- The amount by which the applicable exclusion amount of the surviving spouse's last deceased spouse exceeds the amount on which the tentative tax on the deceased spouse's estate is determined. (This includes the taxable estate and the amount of adjusted taxable gifts.)

Note. Generally, the estate of a nonresident alien spouse is not entitled to a DSUE unless a tax treaty provision states otherwise.¹⁶ However, if the surviving spouse obtains U.S. citizenship after the death of the last deceased spouse, the deceased spouse's DSUE becomes available to the surviving spouse on the date U.S. citizenship was obtained. This applies as long as the portability of the DSUE was timely elected or preserved by filing the necessary Form 706 for the estate of the deceased spouse.¹⁷

Example 2. Wanda died on June 14, 2014. She was survived by her husband, Edward. Both are U.S. citizens. Wanda's estate was valued at \$7.2 million, and she left \$5 million of her assets to Edward.

The \$5 million that Wanda left to Edward is excluded from her taxable estate. Therefore, her taxable estate is \$2.2 million (\$7.2 million – \$5 million). In addition, she made taxable gifts of \$1 million during her lifetime.

Because Wanda's gross estate of \$7.2 million exceeds the 2014 filing threshold (which is the 2014 basic exclusion amount of \$5.34 million), her executor must file an estate tax return. Wanda's executor files a timely, complete estate tax return. This return provides the required DSUE computation and therefore makes Wanda's DSUE available to Edward's estate at his subsequent death. The executor calculates the DSUE amount available to Edward is \$2.14 million. This is the lesser of the following amounts.

- The \$5.34 million basic exclusion amount for 2014
- The \$5.34 million exclusion amount – (\$2.2 million taxable estate + \$1 million adjusted taxable gifts) = **\$2.14 million**

The \$2.14 million DSUE from Wanda's estate will be added to Edward's basic exclusion amount upon his death.

Note. In the event Edward remarries, special rules apply. See Treas. Reg. §20.2010-3(a) and (b) for these rules.

Last Deceased Spouse

The last deceased spouse is the most recently deceased person who was married to the taxpayer at the time of their death. The identity of the last deceased spouse is determined:

1. When a lifetime gift is made, or
2. On the date of the taxpayer's death in the case of a transfer at death.

¹⁵ IRC §2010(c)(4).

¹⁶ Treas. Reg. §20.2010-3(e).

¹⁷ Treas. Reg. §20.2010-3(c)(2).

The identity of a taxpayer's last deceased spouse is not impacted by that taxpayer's remarriage unless or until that spouse also dies. At that time, the most recently deceased spouse becomes the last deceased spouse.

Note. The most recently deceased spouse is the last deceased spouse for purposes of the DSUE. This is true regardless of whether that deceased spouse's executor elects portability and regardless of whether the deceased spouse has an available DSUE.

A surviving spouse may apply the full amount of the DSUE of the last deceased spouse to offset the tax liability of any lifetime gifts. The DSUE amount is applied before any basic exclusion amount to which the surviving spouse is entitled. If the surviving spouse remarries and the new spouse also predeceases the surviving spouse, the surviving spouse may then apply the full amount of the DSUE of the most recently deceased spouse to any taxable transfers. This means that a **surviving spouse can potentially apply two or more successive DSUEs** — each in the full amount of the basic exclusion. However, a surviving spouse **cannot use the sum** of DSUE amounts from multiple predeceased spouses at one time. Moreover, the DSUE amount of a predeceased spouse cannot be applied after the death of a subsequent spouse.¹⁸

Example 3. Mary and Richard married in 1962. Richard died in 2011, leaving \$3 million to Mary and \$1 million to his children. Richard made no taxable gifts during his lifetime.

Richard's executor made a portability election. Because Richard used only \$1 million of his basic exclusion amount (his transfer to Mary does not count against the DSUE¹⁹), a \$4 million DSUE is available to Mary (\$5 million basic exclusion amount for 2011 – \$1 million transfer to the children).

Mary married George in 2014 and gifted \$3 million to her children after the remarriage. She applied \$3 million of Richard's \$4 million DSUE to eliminate any gift tax liability.

George dies in 2015, and his executor also elects portability. George's estate transfers a \$5 million DSUE to Mary. This \$5 million DSUE represents the 2015 basic exclusion amount of \$5.43 million, adjusted for the previous taxable gifts George made. George is now Mary's last deceased spouse. If Mary dies later in 2015 and leaves a \$10 million estate to her children, her estate will not have any estate tax liability. This is because George's DSUE eliminates liability for \$5 million of the transfer, and Mary's own basic exclusion amount offsets the tax liability for the rest.

Mary's lifetime taxable gifts		\$ 3,000,000
Less: Richard's DSUE		(4,000,000)
Amount subject to gift tax		\$ 0
Mary's taxable estate at death		\$10,000,000
George's DSUE	\$ 5,000,000	
Mary's basic exclusion amount	5,430,000	
Less: applicable exclusion amount	\$10,430,000	(10,430,000)
Amount subject to estate tax liability		\$ 0

Note. For additional guidance about the calculation of the DSUE amount, see Treas. Reg. §20.2010-2(c). Special rules apply to qualifying domestic trusts (QDOTs). For these special QDOT rules, see Treas. Reg. §§20.2010-3(c)(3) and 20.2010-2(c)(4).

¹⁸ Instructions for Form 706.

¹⁹ IRC §2056.

ELECTING PORTABILITY

Time to File

To take advantage of portability, **the executor of the decedent's estate must complete and file a timely Form 706.** Form 706 is due nine months after the decedent's date of death. An executor who is unable to file Form 706 by the due date may receive an automatic 6-month extension by filing Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*, on or before the original due date. If a portability election is not made on a timely filed (including an extension, if applicable) Form 706, the surviving spouse cannot take the decedent's DSUE into account.²⁰

Final portability regulations²¹ issued June 12, 2015, do allow estates without a Form 706 filing requirement (because the gross value of the estate does not exceed the threshold amount) to request a regulatory extension²² if they miss the Form 706 filing deadline.²³ The relief is not automatic and must be requested through a private letter ruling. Executors must generally show that they acted reasonably and in good faith to obtain the relief.

The statute of limitations for assessing additional amounts with respect to an estate tax return is generally the later of three years from the date of filing or two years from the date the tax was paid. However, the IRS has the power to examine the DSUE amount at any time after the period of the limitations has expired. This means that the IRS may examine the estate and gift tax returns of each of the decedent's predeceased spouses.²⁴ Any materials that are relevant to the calculation of the DSUE amount of each deceased spouse can be examined (including the estate and gift tax returns). Accordingly, a surviving spouse must retain appraisals and other documentation substantiating the executor's good-faith estimate, along with any intervening estate and gift tax returns to substantiate the DSUE amount.

Under the regulations, if the executor files a properly completed, timely estate return that includes a DSUE amount that is uncertain at the time of filing, the estate return is sufficient to make a subsequently recalculated DSUE amount available to the surviving spouse. IRC §2053 lists certain amounts (such as administration expenses and foreign taxes) that may be deducted by an estate. If such deductible amounts are not known at the time the estate tax return is completed, the executor may file a protective claim for the refund of tax after the deduction is allowed at a later date. Although such deductions may reduce the estate's tax liability and increase the DSUE amount, no protective election is necessary to ensure a surviving spouse benefits from the increased DSUE.²⁵

Example 4. After Bob's death, his executor completes an estate tax return in connection with Bob's estate. The complete, properly prepared estate return shows that Bob's DSUE amount is zero. However, the estate has a claim against it for foreign taxes and the executor files a protective claim for a refund in connection with a potential deduction for these foreign taxes. After the filing of the estate return, the foreign taxes are paid by the estate. The estate is permitted to deduct these foreign taxes. This deduction reduces the estate tax and triggers a DSUE amount that is greater than zero. The executor's timely, complete, and properly prepared estate tax return is considered a proper election of this DSUE amount and it can be used by Bob's surviving spouse. The executor need not file a protective election in connection with this later-recomputed DSUE amount.

Filing Requirement

Filing Form 706 is deemed to make a portability election as long as there is a DSUE and a surviving spouse. If an executor of the estate of a decedent with a surviving spouse does not file a Form 706, there is no portability election and the surviving spouse does not have a DSUE to apply to future transfers.

²⁰ IRC §2010(c)(5)(A).

²¹ TD 9725, 2015-26 IRB 1094.

²² Treas. Reg. §301.9100-3. This is often called "9100 relief."

²³ Estates with a filing requirement because their gross value is equal to or exceeds the threshold amount may not request this relief.

²⁴ Treas. Regs. §§20.2010-2(d) and 3(d).

²⁵ Treas. Reg. §20.2010-2(b); TD 9725, 2015-26 IRB 1094.

Once made, the portability election **is irrevocable** unless an adjustment or amendment to the election is made on a subsequent Form 706 that is filed on or before the due date.

Note. All executors of estates in which the decedent leaves a surviving spouse should consider filing a Form 706 as a matter of course, even if the couple currently has a low combined net worth. The surviving spouse may acquire wealth after the decedent's death and thus benefit from a DSUE. An estate attorney or decedent's tax preparer should give the executor the option to file Form 706 to protect the surviving spouse. Failing to file the form and therefore causing the surviving spouse to lose the DSUE and any related applicable tax savings could be malpractice. This could be true even if at the time of the decedent's death it did not appear that the surviving spouse would need the DSUE to avoid estate or gift tax liability.

Caution. If an executor chooses not to file a Form 706, the tax practitioner or estate attorney should obtain a signed statement from the executor stating that they have chosen not to file the form after full disclosure of the risks involved.

Nonresident Decedents

An executor may not make a portability election for a nonresident decedent who was not a United States citizen at the time of their death.

Filing Form 706 Without Portability

If the executor of an estate files a Form 706 but does not want to elect portability, they must check the box in section A of part 6. Checking the box indicates that the estate opts **not** to elect portability of the DSUE amount. **Otherwise, the filing of Form 706 acts as an automatic portability election.**

Form 706 (Rev. 8-2013)

Estate of:

Decedent's social security number

Part 6—Portability of Deceased Spousal Unused Exclusion (DSUE)

Portability Election

A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount.

Section A. Opting Out of Portability

The estate of a decedent with a surviving spouse may opt out of electing portability of the DSUE amount. Check here and do not complete Sections B and C of Part 6 only if the estate opts **NOT** to elect portability of the DSUE amount. ☒

NO **Yes**

Simplified Reporting Method

An executor who is not otherwise required to file an estate tax return **except for the purpose of electing portability** may be able to take advantage of a simplified reporting method.²⁶ For property included in the gross estate that is marital deduction property²⁷ or charitable deduction property,²⁸ the executor may be able to omit the value of the property from the corresponding Form 706 schedule. **Marital deduction property** is property transferred to a spouse. It is excluded from the value of the taxable estate. **Charitable deduction property** is property the decedent has instructed the executor to devise to a charity. It is also excluded from the value of the decedent's taxable estate.

²⁶ Treas. Reg. §20.2010-2(a)(7)(ii)(A).

²⁷ The marital deduction allows the decedent to transfer property to their surviving spouse free of any estate tax liability. See IRC §2056(a).

²⁸ IRC §2055(a).

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If the simplified reporting method applies, the executor must report only the following information for charitable deduction and marital deduction property.

- Description
- Ownership
- Beneficiary
- Other information necessary to establish the right of the estate to the deduction²⁹

Marital deduction property information is reported on Form 706, Schedule M. **Under the simplified reporting method, the value of the assets is not required to be entered on Schedule M.**

Charitable deduction property information is reported on Form 706, Schedule O. If the simplified method is applicable, the value of the assets need not be entered on the schedule.

Although the value need not be reported for the marital deduction and charitable deduction property, the **executor must use due diligence to estimate the fair market value of the aggregated deductible property (rounded up to the nearest \$250,000).** This value should be entered on Form 706, part 5, lines 10 and 23 (shown later).³⁰

The simplified reporting method is available only for marital deduction and charitable deduction property when a Form 706 need not be filed except for the purpose of electing portability. The simplified method is **unavailable** if any of the following conditions apply.³¹

1. The value of the property relates to, affects, or is needed to determine the value passing from the decedent to another recipient.
2. The value of the property is needed to determine the estate's eligibility for alternate valuation,³² special-use valuation,³³ estate tax deferral,³⁴ or another Code provision.
3. Less than the entire value of an interest in property includable in the decedent's gross estate is marital deduction property or charitable deduction property.
4. A partial disclaimer or partial qualifying terminable interest property (QTIP) election is made regarding a bequest, devise, or transfer of property includable in the gross estate, part of which is marital deduction or charitable deduction property.

Example 5. Courtney Blount died in 2014. The value of her estate was less than the basic exclusion amount of \$5.34 million. Nonetheless, the executor of her estate filed Form 706 for the purpose of electing portability. In accordance with the rules for the simplified procedure, the executor estimated the value of the marital deduction property.

Courtney had a CD in her name with her spouse (Bob) listed as POD (paid on death). The amount in this CD must be entered on Schedule M because the CD was not jointly owned with her spouse.

Relevant portions of the Form 706 follow.

²⁹ For the marital deduction, this would include that (1) the decedent was survived by a spouse, (2) the surviving spouse was a U.S. citizen, (3) the property interest passed from the decedent to the surviving spouse, and (4) the property interest was a deductible interest. Treas. Reg. §20.2056(a)-1(b)(1)(i)-(iii).

³⁰ Instructions for Form 706; Treas. Reg. §20.2010-2(a)(7)(ii)(A),(B).

³¹ Treas. Reg. §20.2010-2(a)(7)(ii)(A).

³² IRC §2032.

³³ IRC §2032A.

³⁴ IRC §6166.

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For Example 5

Form 706 (Rev. August 2013) Department of the Treasury Internal Revenue Service		United States Estate (and Generation-Skipping Transfer) Tax Return ▶ Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2012. ▶ Information about Form 706 and its separate instructions is at www.irs.gov/form706 .			OMB No. 1545-0015	
Part 1—Decedent and Executor	1a Decedent's first name and middle initial (and maiden name, if any) Courtney S. (Blythe)	1b Decedent's last name Blount		2 Decedent's social security no. 123 99 9999		
	3a City, town, or post office; county; state or province; country; and ZIP or foreign postal code. 1354 State St., Magnum, IA 50987	3b Year domicile established 1952	4 Date of birth 04/02/1952	5 Date of death 09/06/2014		
	6a Name of executor (see instructions) James F. Blount	6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code) and phone no. 1354 State St. Magnum, IA 50987 Phone no. 555-345-0987				
	6c Executor's social security number (see instructions) 999 99 1234					
	6d If there are multiple executors, check here <input type="checkbox"/> and attach a list showing the names, addresses, telephone numbers, and SSNs of the additional executors.					
	7a Name and location of court where will was probated or estate administered Magnum County District Court				7b Case number ECV-0987	
	8 If decedent died testate, check here <input checked="" type="checkbox"/> and attach a certified copy of the will. 9 If you extended the time to file this Form 706, check here <input type="checkbox"/>					
	10 If Schedule R-1 is attached, check here <input type="checkbox"/> 11 If you are estimating the value of assets included in the gross estate on line 1 pursuant to the special rule of Reg. section 20.2010-2T(a)(7)(ii), check here <input checked="" type="checkbox"/>					
Part 2—Tax Computation	1 Total gross estate less exclusion (from Part 5—Recapitulation, item 13)			1	2,740,989	
	2 Tentative total allowable deductions (from Part 5—Recapitulation, item 24)			2	2,740,989	
	3a Tentative taxable estate (subtract line 2 from line 1)			3a	0	
	b State death tax deduction			3b		
	c Taxable estate (subtract line 3b from line 3a)			3c	0	
	4 Adjusted taxable gifts (see instructions)			4	0	
	5 Add lines 3c and 4			5	0	
	6 Tentative tax on the amount on line 5 from Table A in the instructions			6	0	
	7 Total gift tax paid or payable (see instructions)			7	0	
	8 Gross estate tax (subtract line 7 from line 6)			8	0	
	9a Basic exclusion amount	9a	5,340,000			
	9b Deceased spousal unused exclusion (DSUE) amount from predeceased spouse(s), if any (from Section D, Part 6—Portability of Deceased Spousal Unused Exclusion).	9b	0			
	9c Applicable exclusion amount (add lines 9a and 9b)	9c	5,340,000			
	9d Applicable credit amount (tentative tax on the amount in 9c from Table A in the instructions)	9d	2,081,800			
	10 Adjustment to applicable credit amount (May not exceed \$6,000. See instructions.)	10				
	11 Allowable applicable credit amount (subtract line 10 from line 9d)	11	2,081,800			
	12 Subtract line 11 from line 8 (but do not enter less than zero)	12	0			
	13 Credit for foreign death taxes (from Schedule P). (Attach Form(s) 706-CE.)	13				
	14 Credit for tax on prior transfers (from Schedule Q)	14				
	15 Total credits (add lines 13 and 14)	15				
16 Net estate tax (subtract line 15 from line 12)	16					
17 Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)	17					
18 Total transfer taxes (add lines 16 and 17)	18					
19 Prior payments (explain in an attached statement)	19					
20 Balance due (or overpayment) (subtract line 19 from line 18)	20	0				
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than the executor) is based on all information of which preparer has any knowledge.						
Sign Here	Signature of executor _____		Date _____			
	Signature of executor _____		Date _____			
Paid Preparer Use Only	Print/Type preparer's name _____		Preparer's signature _____		Date _____	
	Firm's name ▶ _____		Check <input type="checkbox"/> if self-employed		PTIN _____	
	Firm's address ▶ _____		Firm's EIN ▶ _____		Phone no. _____	

For Privacy Act and Paperwork Reduction Act Notice, see instructions.

Cat. No. 20548R

Form **706** (Rev. 8-2013)

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For Example 5

Form 706 (Rev. 8-2013)

Estate of: Courtney S. Blount	Decedent's social security number		
	123	99	9999

Part 4—General Information (continued)

If you answer "Yes" to any of the following questions, you must attach additional information as described.		Yes	No
10	Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which (a) one or more of the other joint tenants was someone other than the decedent's spouse, and (b) less than the full value of the property is included on the return as part of the gross estate? If "Yes," you must complete and attach Schedule E		X
11a	Did the decedent, at the time of death, own any interest in a partnership (for example, a family limited partnership), an unincorporated business, or a limited liability company; or own any stock in an inactive or closely held corporation?		X
b	If "Yes," was the value of any interest owned (from above) discounted on this estate tax return? If "Yes," see the instructions on reporting the total accumulated or effective discounts taken on Schedule F or G		
12	Did the decedent make any transfer described in sections 2035, 2036, 2037, or 2038? (see instructions) If "Yes," you must complete and attach Schedule G		X
13a	Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?		X
b	Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?		X
c	Was the decedent receiving income from a trust created after October 22, 1986, by a parent or grandparent? If "Yes," was there a GST taxable termination (under section 2612) on the death of the decedent?		X
d	If there was a GST taxable termination (under section 2612), attach a statement to explain. Provide a copy of the trust or will creating the trust, and give the name, address, and phone number of the current trustee(s).		
e	Did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in lines 13a or 13b? If "Yes," provide the EIN for this transferred/sold item. ►		X
14	Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H		X
15	Did the decedent have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?		X
16	Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I or a private annuity? If "Yes," you must complete and attach Schedule I		X
17	Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a predeceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation		X

Part 5—Recapitulation. Note. If estimating the value of one or more assets pursuant to the special rule of Reg. section 20.2010-2T(a)(7)(ii), enter on both lines 10 and 23 the amount noted in the instructions for the corresponding range of values. (See instructions for details.)

Item no.	Gross estate	Alternate value	Value at date of death
1	Schedule A—Real Estate	1	
2	Schedule B—Stocks and Bonds	2	
3	Schedule C—Mortgages, Notes, and Cash	3	490,989
4	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712)	4	
5	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance)	5	
6	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance)	6	
7	Schedule G—Transfers During Decedent's Life (att. Form(s) 712 for life insurance)	7	
8	Schedule H—Powers of Appointment	8	
9	Schedule I—Annuities		
10	Estimated value of assets subject to the special rule of Reg. section 20.2010-2T(a)(7)(ii)	Rounded up to Nearest \$250,000 → 2,250,000	
11	Total gross estate (add items 1 through 10)		2,740,989
12	Schedule U—Qualified Conservation Easement Exclusion	12	
13	Total gross estate less exclusion (subtract item 12 from item 11). Enter here and on line 1 of Part 2—Tax Computation	13	2,740,989
Item no.	Deductions	Amount	
14	Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims	14	
15	Schedule K—Debts of the Decedent	15	
16	Schedule K—Mortgages and Liens	16	
17	Total of items 14 through 16	17	
18	Allowable amount of deductions from item 17 (see the instructions for item 18 of the Recapitulation)	18	
19	Schedule L—Net Losses During Administration	19	
20	Schedule L—Expenses Incurred in Administering Property Not Subject to Claims	20	
21	Schedule M—Bequests, etc., to Surviving Spouse	21	490,989
22	Schedule O—Charitable, Public, and Similar Gifts and Bequests	22	
23	Estimated value of deductible assets subject to the special rule of Reg. section 20.2010-2T(a)(7)(ii)	23	2,250,000
24	Tentative total allowable deductions (add items 18 through 23). Enter here and on line 2 of the Tax Computation	24	2,740,989

Page 3

HIGH-INCOME TAXPAYERS

High-income clients face a number of complex tax-planning issues. Recent changes in tax law implemented by the Affordable Care Act (ACA) and ATRA have greatly increased the potential tax liability of this group of taxpayers. Provisions important to high-income taxpayers include the following.

Provisions	Rate	2015 Threshold	
		Single	MFJ
Highest marginal rate	39.6%	\$413,200	\$464,850
Capital gains rate	20%	413,200	464,850
Beginning of personal exemption phaseout range	NA	258,250	309,900
Beginning of itemized deductions phaseout range	NA	258,250	309,900
Additional Medicare tax	0.9%	200,000	250,000
Net investment income tax	3.8%	200,000	250,000

This section reviews each of these provisions. It concludes with a brief overview of some planning opportunities that high-income taxpayers may wish to consider.

Note. This section does not include a detailed discussion of the alternative minimum tax (AMT). The AMT was originally implemented to ensure that high-income taxpayers were not lowering their tax liabilities through excessive tax deductions. Now, however, the AMT is generally more likely to affect taxpayers with incomes between \$200,000 and \$500,000. For more information about the AMT, see the 2011 *University of Illinois Federal Tax Workbook*, Chapter 6: AMT for Individuals, which is available at uofi.tax/arc [www.taxschool.illinois.edu/taxbookarchive]. Other useful information is provided by the instructions for Form 6251, *Alternative Minimum Tax—Individuals*.

INCOME TAX MARGINAL RATE

ATRA permanently lowered the marginal tax rates for many middle-income taxpayers. **However, it permanently increased the highest marginal tax rate for high-income earners from 35% to 39.6%.** This increase affects single taxpayers with 2015 taxable incomes greater than \$413,200 and married filing jointly (MFJ) taxpayers with taxable incomes greater than \$464,850.³⁵

ADDITIONAL MEDICARE TAX

Beginning January 1, 2013, the ACA³⁶ implemented an additional Medicare tax of 0.9% for taxpayers whose wages, compensation, and self-employment (SE) income exceeds threshold amounts. **The threshold amounts, which are not annually adjusted for inflation, are shown in the following table.**³⁷

Filing Status	Threshold Amount
Married Filing Jointly (MFJ)	\$250,000
Married Filing Separately (MFS)	125,000
Single, Head of Household (HoH), and Qualifying Widow(er) (QW)	200,000

³⁵ Rev. Proc. 2014-61, 2014-47 IRB 860.

³⁶ Section 9015 of the Patient Protection and Affordable Care Act, PL 111-148 (124 Stat. 119) (2010), and as amended by section 10906 of the PPACA and section 1402(b) of the Health Care and Education Reconciliation Act of 2010, PL 111-152 (124 Stat. 1029) (2010).

³⁷ IRC §§1401(b)(2)(A) and 3101(b)(2).

Income Subject to Additional Medicare Tax

The additional Medicare tax applies to the following income categories.

- Wages and other compensation subject to Medicare
- Compensation subject to the Railroad Retirement Tax Act (RRTA)
- SE net income (an SE net loss **is not considered** for purposes of this tax)
- Taxable wages not paid in cash, such as noncash fringe benefits
- Tips

Employer Withholding Requirement

An employer is required to withhold an additional 0.9% on the portion of an employee's wages that exceeds \$200,000 per year.³⁸ The employer is to disregard the employee's filing status and other income, including income paid to the employee's spouse. Accordingly, withholding often does not cover the full amount of tax due. The employee is responsible for paying any additional Medicare tax that is not withheld by the employer. The employee may, however, ask the employer to withhold additional income tax to compensate for the underpayment.³⁹

The employer may withhold more than the employee owes for the additional Medicare tax, particularly for MFJ taxpayers. However, an employer **cannot** honor an employee's request to stop withholding additional Medicare tax if the employee's compensation exceeds the \$200,000 withholding threshold. The employee must claim a credit for any withheld additional Medicare tax against the total tax liability shown on their individual income tax return.⁴⁰

Filing Form 8959

The additional Medicare tax is calculated using Form 8959, *Additional Medicare Tax*. The individual also reports the additional Medicare tax withheld by their employer on their individual income tax return. This amount is applied against all taxes shown on the individual's income tax return.

Example 6. In 2014, George, who is single, earns \$145,000 of SE income and \$130,000 of wages as an employee. Because his wages do not exceed \$200,000, his employer does not withhold the additional Medicare tax on any portion of his wages. The employer did withhold \$1,885 in regular Medicare tax on the \$130,000 of wages.

George is liable for the additional Medicare tax on \$75,000 of his income (\$145,000 SE income + \$130,000 wages – \$200,000 threshold). For 2014, George owes \$675 in additional Medicare tax ($\$75,000 \times 0.9\%$). His completed Form 8959 follows.

³⁸ Treas. Reg. §31.3102-4.

³⁹ *Questions and Answers for the Additional Medicare Tax*. Mar. 6, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax] Accessed on Mar. 26, 2015.

⁴⁰ Ibid.

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For Example 6

Form 8959 Department of the Treasury Internal Revenue Service	Additional Medicare Tax ► If any line does not apply to you, leave it blank. See separate instructions. ► Attach to Form 1040, 1040NR, 1040-PR, or 1040-SS. ► Information about Form 8959 and its instructions is at www.irs.gov/form8959 .	OMB No. 1545-0074 <div style="text-align: center; font-size: 24pt; font-weight: bold;">2014</div> Attachment Sequence No. 71
Name(s) shown on return George Diamos		Your social security number 333-44-5555
Part I Additional Medicare Tax on Medicare Wages		
1 Medicare wages and tips from Form W-2, box 5. If you have more than one Form W-2, enter the total of the amounts from box 5	1	130,000
2 Unreported tips from Form 4137, line 6	2	
3 Wages from Form 8919, line 6	3	
4 Add lines 1 through 3	4	130,000
5 Enter the following amount for your filing status: Married filing jointly \$250,000 Married filing separately \$125,000 Single, Head of household, or Qualifying widow(er) \$200,000		
	5	200,000
6 Subtract line 5 from line 4. If zero or less, enter -0-	6	0
7 Additional Medicare Tax on Medicare wages. Multiply line 6 by 0.9% (.009). Enter here and go to Part II	7	0
Part II Additional Medicare Tax on Self-Employment Income		
8 Self-employment income from Schedule SE (Form 1040), Section A, line 4, or Section B, line 6. If you had a loss, enter -0- (Form 1040-PR and Form 1040-SS filers, see instructions.)	8	145,000
9 Enter the following amount for your filing status: Married filing jointly \$250,000 Married filing separately \$125,000 Single, Head of household, or Qualifying widow(er) \$200,000		
	9	200,000
10 Enter the amount from line 4	10	130,000
11 Subtract line 10 from line 9. If zero or less, enter -0-	11	70,000
12 Subtract line 11 from line 8. If zero or less, enter -0-	12	75,000
13 Additional Medicare Tax on self-employment income. Multiply line 12 by 0.9% (.009). Enter here and go to Part III	13	675
Part III Additional Medicare Tax on Railroad Retirement Tax Act (RRTA) Compensation		
14 Railroad retirement (RRTA) compensation and tips from Form(s) W-2, box 14 (see instructions)	14	
15 Enter the following amount for your filing status: Married filing jointly \$250,000 Married filing separately \$125,000 Single, Head of household, or Qualifying widow(er) \$200,000		
	15	
16 Subtract line 15 from line 14. If zero or less, enter -0-	16	
17 Additional Medicare Tax on railroad retirement (RRTA) compensation. Multiply line 16 by 0.9% (.009). Enter here and go to Part IV	17	
Part IV Total Additional Medicare Tax		
18 Add lines 7, 13, and 17. Also include this amount on Form 1040, line 62, (Form 1040NR, 1040-PR, and 1040-SS filers, see instructions) and go to Part V	18	675
Part V Withholding Reconciliation		
19 Medicare tax withheld from Form W-2, box 6. If you have more than one Form W-2, enter the total of the amounts from box 6	19	1,885
20 Enter the amount from line 1	20	130,000
21 Multiply line 20 by 1.45% (.0145). This is your regular Medicare tax withholding on Medicare wages	21	1,885
22 Subtract line 21 from line 19. If zero or less, enter -0-. This is your Additional Medicare Tax withholding on Medicare wages	22	0
23 Additional Medicare Tax withholding on railroad retirement (RRTA) compensation from Form W-2, box 14 (see instructions)	23	0
24 Total Additional Medicare Tax withholding. Add lines 22 and 23. Also include this amount with federal income tax withholding on Form 1040, line 64 (Form 1040NR, 1040-PR, and 1040-SS filers, see instructions)	24	0

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 59475X

Form **8959** (2014)

2015 Workbook

Example 7. Pat and Sam are married and file a joint return each year. In 2015, Pat receives \$240,000 in wages. Sam is retired and only has investment income. Pat's employer withholds \$360 for the additional Medicare tax $((\$240,000 \text{ wages} - \$200,000 \text{ withholding threshold}) \times 0.9\%)$. Because the threshold for MFJ taxpayers is \$250,000 and investment income is not subject to the tax, the couple's additional Medicare tax liability for 2015 is \$0.

Pat and Sam are required to file Form 8959 because Pat's Medicare wages exceed \$200,000. Part V of their 2015 Form 8959 follows.

4

1040-PR, and filers, see instructions, and go to Part v 18

Part V Withholding Reconciliation			
19	Medicare tax withheld from Form W-2, box 6. If you have more than one Form W-2, enter the total of the amounts from box 6	19	3,840
20	Enter the amount from line 1	20	240,000
21	Multiply line 20 by 1.45% (.0145). This is your regular Medicare tax withholding on Medicare wages	21	3,480
22	Subtract line 21 from line 19. If zero or less, enter -0-. This is your Additional Medicare Tax withholding on Medicare wages	22	360
23	Additional Medicare Tax withholding on railroad retirement (RRTA) compensation from Form W-2, box 14 (see instructions)	23	
24	Total Additional Medicare Tax withholding. Add lines 22 and 23. Also include this amount with federal income tax withholding on Form 1040, line 64, Form 1040NR, 1040-PR, and 1040-SS filers, see instructions)	24	360

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Note. The \$360 on line 24 of Form 8959 is included in the total federal income tax withheld shown on line 64 of Pat and Sam's 2015 Form 1040.

Taxpayers with Wages and SE Income

To calculate the tax liability of a taxpayer who has both wages and SE income, the income from the two sources is first combined. Then the threshold amount is subtracted from that sum. Any positive amount remaining after subtracting the applicable threshold amount from the combined sum is subject to the additional Medicare tax.

Example 8. Muriel and Harry are married and file a joint return each year. In 2015, Muriel earns \$140,000 as a self-employed consultant, and Harry earns wages of \$130,000 as a corporate manager.

Because Harry's wages are below the \$200,000 withholding threshold for the additional Medicare tax, his employer does not withhold any additional tax from his income. However, when Muriel and Harry file their 2015 joint return, they must pay \$180 of additional Medicare tax $(\$140,000 \text{ SE income} + \$130,000 \text{ wages} - \$250,000 \text{ threshold}) \times 0.9\%$.

Compensation Subject to RRTA

Income subject to the RRTA that exceeds the taxpayer's applicable threshold is also subject to the 0.9% additional Medicare tax.⁴¹ However, the taxpayer's threshold amount applies separately to Medicare wages and to RRTA wages. Accordingly, the taxpayer **does not** combine these income sources to determine their additional Medicare tax liability. Similarly, the taxpayer's threshold applies separately to SE income and to RRTA wages.

Example 9. Use the same facts as **Example 8**, except instead of having \$140,000 in SE income, Muriel has \$140,000 of RRTA compensation. Muriel and Harry are not liable for the additional Medicare tax because each source of income is compared separately to the \$250,000 threshold for MFJ taxpayers. Neither Muriel's \$140,000 RRTA compensation nor Harry's \$130,000 of Medicare wages exceeds the threshold.

If both spouses receive compensation subject to RRTA taxes, their compensation is combined to determine whether the threshold has been reached.

NET INVESTMENT INCOME TAX

Beginning January 1, 2013, taxpayers with incomes above certain thresholds are subject to the net investment income tax (NIIT).⁴² The NIIT imposes an additional 3.8% tax on most passive sources of income.

The 3.8% NIIT applies to the **lesser** of:

- The taxpayer's net investment income (NII) for the year, or
- The amount of modified adjusted gross income (MAGI) in excess of the taxpayer's threshold amount.

MAGI is defined as adjusted gross income (AGI) increased by the amount of the foreign-earned income exclusion (FEIE) less the amount of the deductions or exclusions omitted from AGI because they are related to FEIE.

The taxpayer's threshold amount depends on their filing status, as shown in the following table.

Filing Status	Threshold Amount (MAGI)
MFJ and QW	\$250,000
MFS	125,000
Single and HoH	200,000

Example 10. In 2014, Harry and Jill (who file MFJ) had NII of \$120,000 and MAGI of \$280,000. They paid the NIIT on only \$30,000 (\$280,000 MAGI – \$250,000 threshold) because that is less than their NII of \$120,000. Harry and Jill paid NIIT of \$1,140 for 2014 ($3.8\% \times \$30,000$).

⁴¹ IRC §§3201 and 3101.

⁴² IRC §1411.

The NIIT applies to the following types of income.

- Taxable interest
- Ordinary dividends
- Nonqualified annuity distributions

Note. Annuity distributions subject to the NIIT should be identified with the **special distribution code “D” in box 7 of Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*** Code D indicates distributions from nonqualified annuities (often referred to as self-invested annuities) and certain life insurance contracts. **In most cases, the taxable distribution shown in box 2a of the Form 1099-R is reported on line 3 of Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts.***

- Rents reported on Schedule E (except for real estate professionals and self-rental)
- Royalties
- **Passive** income from a trade or business activity
- Income from the trade or business of trading in financial instruments
- Income from the trade or business of trading in commodities
- Net capital and ordinary gains from the sale of assets (unless associated with a trade or business of a materially participating taxpayer)

The following types of income are specifically **excluded** from the definition of NII.⁴³

- Tax-exempt interest
- Gain from the sale of a principal residence (if excluded from gross income under IRC §121)
- Wages
- Unemployment compensation
- Alaska Permanent Fund dividends
- Alimony
- Social security benefits
- Gains from the disposition of certain property used in a trade or business
- Distributions from certain qualified plans
- Income subject to SE tax
- Working interest in oil or gas property⁴⁴
- Income derived from a nonpassive trade or business⁴⁵

In calculating NII, the taxpayer deducts from their passive sources of income any expenses incurred in earning that income. Form 8960 is used to report NII and to calculate the NIIT.

⁴³ TD 9644, 2013-51 IRB 676.

⁴⁴ IRS Pub. 925, *Passive Activity and At-Risk Rules*.

⁴⁵ IRC §1411(c)(1)(A)(i).

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Example 11. Use the same information as **Example 10**. In 2014, Harry and Jill have \$125,000 in passive sources of income, and they have \$5,000 in expenses allocable to this income. These amounts are reflected on Harry and Jill's 2014 Form 8960, which follows.

Form 8960 Department of the Treasury Internal Revenue Service (99)	Net Investment Income Tax— Individuals, Estates, and Trusts ▶ Attach to your tax return. ▶ Information about Form 8960 and its separate instructions is at www.irs.gov/form8960 .	OMB No. 1545-2227 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2014</div> Attachment Sequence No. 72
Name(s) shown on your tax return Harry and Jill Kaspersky		Your social security number or EIN 987-77-7777
Part I Investment Income <input type="checkbox"/> Section 6013(g) election (see instructions) <input type="checkbox"/> Section 6013(h) election (see instructions) <input type="checkbox"/> Regulations section 1.1411-10(g) election (see instructions)		
1 Taxable interest (see instructions)	1	45,000
2 Ordinary dividends (see instructions)	2	50,000
3 Annuities (see instructions)	3	
4a Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	30,000
b Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	
c Combine lines 4a and 4b	4c	30,000
5a Net gain or loss from disposition of property (see instructions)	5a	
b Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b	
c Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c	
d Combine lines 5a through 5c	5d	
6 Adjustments to investment income for certain CFCs and PFICs (see instructions)	6	
7 Other modifications to investment income (see instructions)	7	
8 Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7	8	125,000
Part II Investment Expenses Allocable to Investment Income and Modifications		
9a Investment interest expenses (see instructions)	9a	750
b State, local, and foreign income tax (see instructions)	9b	4,250
c Miscellaneous investment expenses (see instructions)	9c	
d Add lines 9a, 9b, and 9c	9d	5,000
10 Additional modifications (see instructions)	10	
11 Total deductions and modifications. Add lines 9d and 10	11	5,000
Part III Tax Computation		
12 Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-	12	120,000
Individuals:		
13 Modified adjusted gross income (see instructions)	13	280,000
14 Threshold based on filing status (see instructions)	14	250,000
15 Subtract line 14 from line 13. If zero or less, enter -0-	15	30,000
16 Enter the smaller of line 12 or line 15	16	30,000
17 Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). Enter here and include on your tax return (see instructions)	17	1,140
Estates and Trusts:		
18a Net investment income (line 12 above)	18a	
b Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b	
c Undistributed net investment income. Subtract line 18b from 18a (see instructions). If zero or less, enter -0-	18c	
19a Adjusted gross income (see instructions)	19a	
b Highest tax bracket for estates and trusts for the year (see instructions)	19b	
c Subtract line 19b from line 19a. If zero or less, enter -0-	19c	
20 Enter the smaller of line 18c or line 19c	20	
21 Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (.038). Enter here and include on your tax return (see instructions)	21	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 59474M

Form **8960** (2014)

CAPITAL GAINS TAX

ATRA permanently set the tax rate for long-term capital gains (assets held for more than one year) at 15% for many middle-income taxpayers. In addition, it eliminated a long-term capital gains tax for taxpayers in the two lowest income brackets. However, ATRA raised the long-term capital gains rate from 15% to 20% for taxpayers with ordinary income taxed at the highest marginal rate.

The following table shows the 2015 capital gains tax rates for individuals in the various ordinary tax brackets.

Tax Rate on Ordinary Income	Tax Rate on Long-Term Capital Gains	2015 Rates Up to...			
		Single	MFJ	MFS	HoH
10%	0%	\$ 9,225	\$ 18,450	\$ 9,225	\$ 13,150
15%	0%	37,450	74,900	37,450	50,200
25%	15%	90,750	151,200	75,600	129,600
28%	15%	189,300	230,450	115,225	209,850
33%	15%	411,500	411,500	205,750	411,500
39.6%	20%	413,200	464,850	232,425	439,000

Note. There are several exceptions to these capital gains rates. Net capital gain from selling collectibles (such as artwork or a coin collection) is taxed at a maximum rate of 28%. Unrecaptured IRC §1250 gain is taxed at a maximum rate of 25%. The taxable part of a gain from selling IRC §1202 qualified small business stock is taxed at a maximum rate of 28%. For a thorough discussion of capital gains, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses.

Reporting Capital Gains

The IRS **recently simplified the process for reporting certain capital gains**. In 2011, the IRS introduced Form 8949, *Sales and Other Dispositions of Capital Assets*. This form was created in conjunction with the revised Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, on which brokers report cost basis information.

Form 8949 required the taxpayer to report the details of each of their transactions involving the sale or exchange of capital assets (or involuntary conversions). It was designed so that the taxpayer and the IRS could reconcile the amounts reported to the taxpayer on Forms 1099-B. Schedule D, *Capital Gains and Losses*, was to function merely as a summary document for the detailed transactions listed on Form 8949. The only exception to the burdensome Form 8949 reporting requirement was that the taxpayer could attach to the form a separate statement containing transaction details, rather than file multiple Forms 8949.

It soon became apparent that this new requirement was a burden to many taxpayers. Accordingly, the IRS revised the requirements in 2014 and again allowed direct reporting on Schedule D for certain qualifying transactions. For these transactions, the taxpayer is not required to file Form 8949.

In many cases, a taxpayer **may now aggregate transaction totals and report them directly on Schedule D**, line 1a (for short-term transactions) or line 8a (for long-term transactions). Doing so is possible for sales and other dispositions of capital assets (other than collectibles) if both of the following conditions are satisfied.

- The taxpayer received a Form 1099-B (or substitute statement) stating that basis was reported to the IRS. The form must not show a nondeductible wash sale loss in box 5.
- The taxpayer does not need to make any adjustments to the basis, type of gain or loss (short-term or long-term), or amount of gain or loss reported on Form 1099-B.

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If these two requirements are met, the taxpayer need not file Form 8949 or an additional statement. The taxpayer must file Form 8949 for transactions that do not meet these requirements, however.

Note. For a detailed explanation of Form 8949 and Schedule D, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses.

Example 12. Marcus received the following Form 1099-B for 2014. His records indicate that all the information reported on this form is correct. He has no other capital gains or losses for the year.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. Century Corporation 456 100th Street New York, NY 10001			Applicable check box on Form 8949 <div style="text-align: center; font-size: 24pt;">D</div>		OMB No. 1545-0715 <div style="font-size: 24pt; font-weight: bold;">2014</div> Form 1099-B	Proceeds From Broker and Barter Exchange Transactions
1a Description of property (Example 100 sh. XYZ Co.) 100 sh. CC Co.						
PAYER'S federal identification number <div style="text-align: center; font-weight: bold;">36-0123456</div>		RECIPIENT'S identification number <div style="text-align: center; font-weight: bold;">999-77-6666</div>	1b Date acquired 12/31/2010	1c Date sold or disposed 04/01/2014	<div style="text-align: center; font-weight: bold;">Copy B For Recipient</div> <p>This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.</p>	
			1d Proceeds <div style="text-align: right;">\$ 68,000</div>	1e Cost or other basis <div style="text-align: right;">\$ 32,450</div>		
			1f Code, if any	1g Adjustments <div style="text-align: right;">\$</div>		
RECIPIENT'S name Marcus Oelwein			2 Type of gain or loss: Short-term <input type="checkbox"/> Long-term <input checked="" type="checkbox"/>	3 If checked, basis reported to IRS <input checked="" type="checkbox"/>		
Street address (including apt. no.) 123 Status Street			4 Federal income tax withheld <div style="text-align: right;">\$</div>	5 If checked, noncovered security <input type="checkbox"/>		
City or town, state or province, country, and ZIP or foreign postal code Chicago, IL 60606			6 Reported to IRS: Gross proceeds <input checked="" type="checkbox"/> Net proceeds <input type="checkbox"/>	7 If checked, loss is not allowed based on amount in 1d <input type="checkbox"/>		
Account number (see instructions)			8 Profit or (loss) realized in 2014 on closed contracts <div style="text-align: right;">\$</div>	9 Unrealized profit or (loss) on open contracts—12/31/2013 <div style="text-align: right;">\$</div>		
CUSIP number			10 Unrealized profit or (loss) on open contracts—12/31/2014 <div style="text-align: right;">\$</div>	11 Aggregate profit or (loss) on contracts <div style="text-align: right;">\$</div>		
14 State name	15 State identification no.	16 State tax withheld <div style="text-align: right;">\$</div>	12	13 Bartering <div style="text-align: right;">\$</div>		

Form **1099-B** www.irs.gov/form1099b Department of the Treasury - Internal Revenue Service

Marcus is not required to file Form 8949. Instead, the information from Form 1099-B is reflected on the following Schedule D.

2015 Workbook

For Example 12

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR.
► Information about Schedule D and its separate instructions is at www.irs.gov/scheduled.
► Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2014
Attachment
Sequence No. 12

Name(s) shown on return

Marcus Oelwein

Your social security number

999-66-7777

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 .				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .	68,000	32,450		35,550
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then go to Part III on the back				15 35,550

For Paperwork Reduction Act Notice, see your tax return instructions.

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Schedule D (Form 1040) 2014

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QUALIFIED DIVIDEND INCOME

Qualified dividend income is subject to the same tax rates as long-term capital gains. Consequently, ATRA also increased the maximum tax rate for qualified dividend income to 20%. Qualified dividend income is reported in box 1b of Form 1099-DIV, *Dividends and Distributions*.

Qualified dividend income meets all of the following requirements.⁴⁶

- The dividend must have been paid by a U.S. corporation or a qualified foreign corporation.
- The taxpayer must have held the stock for more than 60 days during the 121-day period that began 60 days before the ex-dividend date. (The required holding period is different for preferred stock. See IRS Pub. 17, *Your Federal Income Tax*, for more information.)
- The dividends are not among the following types specifically excluded from the definition of qualified dividends.
 - ♦ Capital gain distributions
 - ♦ Dividends paid on deposits with certain financial institutions
 - ♦ Dividends from a tax-exempt corporation or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year
 - ♦ Dividends paid by a corporation on employer securities held on the date of record by an employee stock ownership plan maintained by that corporation
 - ♦ Dividends on any share of stock when the taxpayer is obligated to make related payments for positions in substantially similar or related property
 - ♦ Payments in lieu of dividends but only if the taxpayer has reason to know the payments are not qualified dividends
 - ♦ Payments shown on Form 1099-DIV, box 1b, from a foreign corporation to the extent the taxpayer has reason to know the payments are not qualified dividends

PERSONAL EXEMPTION PHASEOUT

In 2015, taxpayers are granted a personal exemption of \$4,000 for themselves and for each of their dependents. However, this exemption is reduced by 2% for each \$2,500 (or part of \$2,500) that AGI exceeds a certain threshold and is eliminated entirely at higher income levels, as shown in the following table.⁴⁷

Filing Status	2015 Phaseout Begins	Exemption Entirely Eliminated
Single	\$258,250	\$380,750
MFJ and QW	309,900	432,400
MFS	154,950	216,200
HoH	284,050	406,550

⁴⁶ IRS Pub. 17, *Your Federal Income Tax*.

⁴⁷ Rev. Proc. 2014-61, 2014-47 IRB 860.

Example 13. Josh and Linda have three children. For the 2015 tax year, they have an AGI of \$380,000 and file MFJ. Except for the personal exemption phaseout, they would be entitled to \$20,000 in personal exemptions (\$4,000 × 5 family members). However, their AGI exceeds the beginning of the phaseout threshold by \$70,100 (\$380,000 – \$309,900).

The excess over the phaseout threshold is divided by \$2,500, which rounds up to 29 (\$70,100 ÷ \$2,500 = 28.04). Therefore, Josh and Linda must reduce their exemptions by 58% (29 × 2 %). This means that their personal exemptions are reduced by \$11,600 (\$20,000 × 58%). Josh and Linda can claim total personal exemptions of \$8,400 (\$20,000 – \$11,600).

The personal exemption phaseout range is indexed annually for inflation.

ITEMIZED DEDUCTION LIMITATION

As with the personal exemption, certain itemized deductions are limited once a taxpayer reaches a certain income threshold. This limitation, sometimes called the **Pease limitation**,⁴⁸ was **permanently reinstated** for tax years after 2012.

The Pease limitation is triggered when AGI exceeds the following threshold amounts for 2015.⁴⁹

Filing Status	AGI at which Limitation Begins
Single	\$258,250
MFJ and QW	309,900
MFS	154,950
HoH	284,050

The Pease limitation reduces itemized deductions by the lesser of:

1. 3% of the amount of AGI exceeding the threshold, or
2. 80% of the itemized deductions that would otherwise be allowable.⁵⁰

All other limitations on itemized deductions are applied before the Pease limitation.⁵¹ Therefore, the following itemized deductions are not subject to this limitation.

- Medical and dental expenses
- Gambling losses
- Casualty and theft losses
- Investment interest

The practical impact of the Pease limitation is that high-income taxpayers are often subject to a marginal tax rate that is effectively 3% higher than the statutory marginal tax rate. For example, a taxpayer in the 35% tax bracket may have an effective marginal tax rate of 36.05% (35 × 103%).⁵²

⁴⁸ Representative Donald Pease of Ohio drafted the original provision. It was in effect from 1991 through 2009 and then eliminated in 2010 through 2012. ATRA permanently reinstated the Pease limitation for tax years after 2012.

⁴⁹ Rev. Proc. 2014-61, 2014-47 IRB 860.

⁵⁰ IRC §68(a).

⁵¹ IRC §68(d).

⁵² *Deficit Reduction: The Economic and Tax Revenue Effects of the Personal Exemption Phaseout (PEP) and the Limitation on Itemized Deductions (Pease)*. Hungerford, Thomas L. Feb. 1, 2013. Congressional Research Service. [<http://fas.org/sgp/crs/misc/R41796.pdf>] Accessed on Mar. 27, 2015.

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Taxpayers always have the option of selecting the standard deduction, instead of itemizing deductions. The standard deduction is not subject to the Pease limitation.

Example 14. Rayna, who is single, had an AGI of \$350,000 for 2015. Her itemized deductions **before** applying the Pease limitation are as follows.

State and local taxes	\$12,000
Mortgage interest	13,500
Charitable contributions	20,000
Medical and dental expenses (in excess of 10% threshold)	5,000
Total itemized deductions before Pease limitation	<u>\$50,500</u>

The Pease limitation is the **lesser** of the following.

- $3\% \times (\$350,000 \text{ AGI} - \$258,250 \text{ threshold for single taxpayer}) = \$2,753$
- $80\% \times (\$50,500 \text{ total itemized deductions} - \$5,000 \text{ medical expenses}) = \$36,400$

Therefore, Rayna is subject to the \$2,753 reduction. **She can claim total itemized deductions of \$47,747 (\$50,500 – \$2,753).**

IMPACT ON HIGH-INCOME TAXPAYERS

The following examples illustrate the effects of several recent tax provisions on high-income taxpayers.

Example 15. Ray and Laura are married and have three young children. In 2012, they have good jobs and earn high wages. They also have some investment income. Following is a summary of their 2012 income, exemptions, deductions, and taxes.

	Income Taxed at Ordinary Rates	Income Taxed at Capital Gain Rates	Total Income
Income			
Wages	\$520,000		\$520,000
Long-term capital gains		\$ 60,000	60,000
Qualified dividends		55,000	55,000
Interest income	15,000	0	15,000
Total income	<u>\$535,000</u>	<u>\$115,000</u>	<u>\$650,000 (AGI)</u>
Exemptions and Deductions			
Personal exemptions (\$3,800 × 5 family members)	(19,000)		(19,000)
Itemized deductions	<u>(60,000)</u>		<u>(60,000)</u>
Taxable income	<u>\$456,000</u>	<u>\$115,000</u>	<u>\$571,000 (Taxable income)</u>
Tax Summary			
Ordinary income tax per tax computation worksheet	\$128,740		\$128,740
Capital gain tax (at 15%)		17,250	17,250
Total tax	<u>\$128,740</u>	<u>\$ 17,250</u>	<u>\$145,990 (Total tax)</u>

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Example 16. Use the same information as **Example 15**, except the tax year is 2014. Following is a summary of Ray and Laura's 2014 income, exemptions, deductions, and taxes.

	Income Taxed at Ordinary Rates	Income Taxed at Capital Gain Rates	Total Income
Income			
Wages	\$520,000		\$520,000
Long-term capital gains		\$ 60,000	60,000
Qualified dividends		55,000	55,000
Interest income	15,000	0	15,000
Total income	\$535,000	\$115,000	\$650,000 (AGI)
Exemptions and Deductions			
Personal exemptions (entirely phased out for AGIs over \$305,050)	(0)		(0)
Itemized deductions ^a	(49,651)		(49,651)
Taxable income	\$485,349	\$115,000	\$600,349 (Taxable income)
Tax Summary			
Ordinary income tax per tax computation worksheet	\$138,951		\$138,951
Capital gain tax (at 20%)		\$ 23,000	23,000
Additional Medicare tax ^b	2,430		2,430
NIIT ^c	4,940		4,940
Total tax	\$146,321	\$ 23,000	\$169,321 (Total tax)

^a \$60,000 total deductions — \$10,349 Pease reduction

^b (\$520,000 wages — \$250,000 threshold) × 0.9%

^c (\$60,000 capital gain + \$55,000 dividends + \$15,000 interest) × 3.8%

Observations for **Example 15** and **Example 16**.

1. Although Ray and Laura's income was the same in 2012 and 2014, their taxes increased by \$23,331 (\$169,321 — \$145,990). This is an increase of 16%.
2. These examples do not take into account the effects of the AMT or state tax liability.

PROACTIVE PLANNING

The various provisions mentioned in this section that affect high-income taxpayers present numerous planning opportunities. The remainder of this section briefly discusses the following tax-planning strategies, which tax practitioners may want to consider for their high-income clients.

- Grouping activities
- Using installment sales for appreciated assets
- Purchasing municipal bonds
- Contributing the highest amounts possible to retirement plans
- Contributing to a health savings account

Grouping Active and Passive Business Activities

As mentioned previously, the ACA implemented the NIIT, which is a 3.8% tax on passive sources of income for individuals with incomes exceeding certain thresholds. The NIIT applies to passive sources of income derived from trades or businesses. However, federal regulations allow the taxpayer to group active and passive business and rental activities into a single activity if they comprise an appropriate economic unit.⁵³ The grouped activities are then treated as a single activity for purposes of determining whether the material participation requirements of IRC §469 are met. Without grouping, the taxpayer would have to establish material participation separately for each activity.

Note. Grouping also treated the grouped activities as a single activity for net income computation purposes. For a discussion of how the grouping rules may be used to benefit a taxpayer with passive losses and nonpassive income, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities.

To determine whether activities form an appropriate economic unit, a taxpayer must consider all relevant facts and circumstances. Any reasonable method may be used to make this determination. In general, however, the following factors should be considered.⁵⁴

- The similarities and differences in the types of trades and businesses
- The extent of common control
- The extent of common ownership
- The geographic location
- The interdependencies between or among activities, which may include the extent to which the activities:
 - ♦ Buy or sell goods between or among themselves
 - ♦ Involve products or services generally provided together
 - ♦ Have the same customers
 - ♦ Have the same employees
 - ♦ Use a single set of books or records to account for the activities

Caution. Once a taxpayer makes a grouping election, they generally may not regroup those activities in a later tax year.⁵⁵ However, regrouping is required when the original grouping is clearly inappropriate or if there is a material change in the taxpayer's circumstances that makes the current grouping inappropriate.⁵⁶

NIIT regulations also allow a taxpayer who becomes subject to the NIIT to elect to regroup (and disregard the prior grouping election), on a one-time only basis.⁵⁷ Called the “fresh-start” election, this special grouping election must be made in the first tax year, beginning on or after January 1, 2014, in which the taxpayer owes NIIT.

To initiate a new grouping, the taxpayer must file a written statement with the original income tax return the first year in which two or more activities are grouped into a single activity. The statement must provide the names, addresses, and employer identification numbers (EIN) for the activities included in the group. The statement must also contain a declaration that the grouped activities form an appropriate economic unit for the measurement of gain or loss under the passive activity rules.⁵⁸ A sample grouping election statement follows.

⁵³ Treas. Reg. §1.469-4(c).

⁵⁴ Ibid.

⁵⁵ Treas. Reg. §1.469-4(e)(1).

⁵⁶ Treas. Reg. §1.469-4(e)(2).

⁵⁷ Treas. Reg. §1.469-11(b)(3)(iv).

⁵⁸ See IRS Pub. 925, *Passive Activity and At-Risk Rules*.

Name: Marcie A. Quielle
Taxpayer ID: 555-55-5555
Year Ended: 2015

Election to Group Activities Pursuant to Treas. Reg. 1.469-4(c)

The taxpayer hereby elects to group activities together so that the grouped activities are treated as a single activity for the year ended 2015 and all years thereafter. The taxpayer represents that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for the purposes of IRC §469.

The following activities are to be grouped together and treated as one activity:

Marcie A. Quielle	Quielle, LLC
345 Quail Drive	345 Quail Drive
Anytown, IA 78765	Anytown, IA 78765
SSN: 555-55-5555	EIN: 36-5555555

Note. After the first election is made, it is good practice for the taxpayer to make a confirmatory election each subsequent tax year. The first line of the preceding statement can be altered to read, “The taxpayer hereby confirms their existing election to group the following activities...”

Example 17. Junior has an interest in a partnership that operates a retail store. He recently acquired an interest in an S corporation that owns similar stores. Junior materially participates in the partnership activities but does not meet the material participation requirements for his interest in the S corporation. Junior’s income from each venture exceeds \$150,000.

As long as all the other requirements are met, Junior can group the two activities. The grouped activities are then treated as a single activity for purposes of determining whether the material participation requirements are met. As a result, Junior does not have to pay the 3.8% NIIT that would otherwise apply to his S corporation earnings. This reduces his tax by \$5,700 (\$150,000 S corporation income × 3.8%).

Note. For more information about grouping passive activities, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities.

Installment Sales for Appreciated Assets

IRC §453 defines an **installment sale** as a disposition of property in which the taxpayer receives at least one payment after the tax year of the sale. An installment sale allows the taxpayer to spread the total gain over multiple tax years. Spreading the gain over multiple years may result in lower taxable income in those years.

The rules for installment sales do not apply to the following types of transactions.

- Sales of inventory
- Dealer sales
- Sales of stocks or securities

Caution. An installment sale of §1245 depreciated property requires immediate recognition of depreciation recapture in the year of sale.

Purchasing Municipal Bonds

Tax-exempt interest on any state or local bond is excluded from an individual taxpayer's gross income under IRC §103(a). Accordingly, investing in municipal bonds can be wise for high-income individuals. This exclusion does not apply to:

- Any private activity bond that is not a qualified bond (within the meaning of IRC §141),
- Any arbitrage bond (within the meaning of IRC §148), and
- Any bond not in registered form (unless the bond meets the applicable requirements of IRC §149).

Note. Although interest on municipal bonds is excluded from gross income, there are many other important factors applicable to the investment and/or the investor that should be considered before recommending an investment.

Funding Retirement Plans to Fullest Extent Possible

Taxpayers can contribute **pretax** earnings to tax-deferred retirement accounts, such as 403(b) and 401(k) plans. **For 2015, the maximum amounts that can be contributed to these accounts are as follows.**

	Regular	Catch-Up (Age 50 and Over)
Maximum deductible employee annual retirement contribution to qualified retirement accounts	\$18,000	\$6,000
Maximum IRA contribution	5,500	1,000

Making such contributions reduces income, thereby reducing tax liability. In addition, the contributions grow tax-free until distributions are taken. When distributions are taken after retirement, the withdrawals are taxed at the taxpayer's ordinary income rate. That rate may be lower than the rate paid before the taxpayer retired.

The law discourages early withdrawals of these funds. Taxpayers who are younger than age 59½ pay a 10% penalty on early withdrawals, unless they qualify for an exception to the penalty.⁵⁹

Note. For a thorough explanation of the early withdrawal penalty and its exceptions, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 1: Select Rules for Retirement Plans.

Contributing to a Health Savings Account

Contributing to a health savings account (HSA) is another option that may be attractive for high-income taxpayers. An individual and their employer can contribute **pretax** dollars to an HSA, and the contributed amount can grow tax free. HSA funds are not subject to federal income tax as long as they are used to pay qualified out-of-pocket medical expenses.

Note. Contributions to HSAs made from January 1 through April 15 can be taken as a prior year deduction.

⁵⁹ IRC §72(t).

To qualify for an HSA, an individual must meet the following requirements.⁶⁰

- Be covered under an HSA-qualified high-deductible health plan⁶¹
- Have no disqualifying health coverage
- Not be a Medicare enrollee
- Not have received Veterans Administration (VA) medical benefits within the prior three months⁶²
- Not be eligible to be claimed as a dependent on another person's tax return

In 2015, the contribution limits to an HSA are \$3,350 for an individual and \$6,650 for a family. For an individual age 55 and older, both limits increase by \$1,000 — that is, to \$4,350 for an individual and to \$7,650 for a family.⁶³

Note. For more information about HSAs, see IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

REPORTING OF SAND EXTRACTION INCOME

FRACKING INDUSTRY AND DEMAND FOR SAND

Energy companies' demand for sand to use in the hydraulic fracturing, or "fracking," process has greatly increased. In 2014, the extraction of sand became a \$10 billion industry.⁶⁴ That year, energy companies used approximately 95 billion pounds of sand, a 30% increase from the quantity used in 2013.⁶⁵

Even with the recent collapse of crude oil prices, most domestic oil producers expect the demand for fracking sand to remain relatively stable during 2015. However, that optimistic outlook is clouded by a lack of crude oil storage capacity. During the 7-week period ending on March 4, 2015, the United States produced and imported an average of 1 million more barrels of oil than it consumed each day.⁶⁶

The most desirable fracking sand is called **Northern White**. **The largest deposits of Northern White are located in Wisconsin, Illinois, Minnesota, and Iowa also have large quantities.**⁶⁷ To date, this type of sand has been found only in North America.

Sand is expensive, but its cost represents a small part of the total cost of producing crude oil using the fracking process. Oil producers, in general, have discovered that using more sand results in more oil production.⁶⁸

⁶⁰ IRC §223.

⁶¹ IRC §223(c)(2)(A).

⁶² IRS Notice 2004-50 and IRS Notice 2008-59.

⁶³ Rev. Proc. 2014-30, 2014-20 IRB, 1009.

⁶⁴ *Fracking Makes Sand a \$10 Billion Industry*. Weissmann, Dan. Jan. 13, 2015. Marketplace.org. [www.marketplace.org/topics/world/fracking-makes-sand-10-billion-industry] Accessed on Mar. 30, 2015.

⁶⁵ *Small Firm Strikes It Rich with Fracking Sand*. Zuckerman, Gregory. Sep. 15, 2014. Wall Street Journal. [www.wsj.com/articles/small-firm-strikes-it-rich-with-fracking-sand-1410801465] Accessed on Mar. 30, 2015.

⁶⁶ *Oil Overflow: U.S. Running Out of Crude Storage*. Fahey, Jonathan. Mar. 4, 2015. Pantagraph.com. [www.pantagraph.com/business/oil-overflow-u-s-running-out-of-crude-storage/article_a04b8376-3a92-5ff5-b4aa-8c8589e3bf0c.html]. Accessed on Mar. 30, 2015.

⁶⁷ *Fracking Makes Sand a \$10 Billion Industry*. Weissmann, Dan. Jan. 13, 2015. Marketplace.org. [www.marketplace.org/topics/world/fracking-makes-sand-10-billion-industry] Accessed on Mar. 30, 2015.

⁶⁸ Ibid.

HUGE PROFITABILITY OF SAND MINING COMPANIES

In early 2015, the sand used for fracking sold for approximately \$53 per ton in the Midwest. The median cost of production is \$25 per ton.⁶⁹ Clearly, sand mining companies are making a good profit. With the recent decrease in crude oil prices, the price per ton of fracking sand has predictably declined. However, the future sales of many sand mining companies were locked in under forward-pricing contracts entered into before the plunge in crude oil prices.⁷⁰

ACQUISITION TACTICS OF SAND MINING COMPANIES

The limestone mining industry often operates on royalty contracts, in which the owner of the limestone deposits retains an economic interest. However, royalty contracts are seldom used by sand mining companies (producers).⁷¹ Instead, **sand producers prefer and usually demand an outright purchase of the land containing a sand deposit.** Many sand producers are currently mining sand on land they purchased in the 20–30 years prior to 2015.⁷² Consequently, they may feel they have an advantage when negotiating contracts for sand extraction with landowners.

Sand producers are willing to pay a premium for land with sand deposits. For example, in the Utica, Illinois area, sand producers typically paid \$20,000–\$28,000 per acre for such land in 2014.⁷³ However, that year probably marked the height of sand acquisition activities by producers. This means that the price per acre paid by producers in 2015 and beyond will likely decline.

TAX-PLANNING OPTIONS FOR LANDOWNERS OF SAND DEPOSITS

When selling land containing sand deposits, most landowners want to get as much immediate cash as possible. An outright sale of such land to a sand producer is usually taxed at a long-term capital gain rate. In addition, a large long-term capital gain on the sale may result in AMT liability.

When selling such land outright, the landowner should consider an installment sale. An installment sale may provide the following tax advantages.

1. A greater likelihood that the long-term capital gain in the installment sale period will be taxed at a capital gain rate of less than the maximum 20%
2. A greater likelihood that the long-term capital gain in the installment sale period will avoid AMT liability

Another and perhaps better option available to the landowner is to convince the sand producer to enter into a royalty agreement (contract). Under a typical royalty contract, the royalty rate is stipulated and becomes effective when sand is actually removed by the producer. In many royalty contracts, an advance payment is made when the buyer and seller sign the contract. This payment is then applied as a reduction in the actual royalty payments due to the landowner when the sand is removed by the producer.

⁶⁹ *Oil Price War Catches State's Frac Sand Mines in the Crossfire*. Taschler, Joe. Jan. 17, 2015. Milwaukee, Wisconsin Journal Sentinel. [www.jsonline.com/business/oil-price-war-catches-states-frac-sand-mines-in-the-crossfire-b99426314z1-288923781.html] Accessed on Apr. 9, 2015.

⁷⁰ *Good Times Run Out for Sand Producers*. Molinski, Dan. Jan. 1, 2015. Wall Street Journal. [www.wsj.com/articles/good-times-run-out-for-sand-producers-1420153520] Accessed on Mar. 30, 2015.

⁷¹ Based on numerous phone interviews conducted by the author with attorneys representing sand mining companies operating in LaSalle County, Illinois, in January 2015.

⁷² Ibid.

⁷³ Ibid.

Example 18. Jerry, a crop-share landlord, owns a 120-acre tract of farmland in LaSalle County, Illinois. A geologist's report indicates that a deposit of Northern White sand is located 45 feet beneath the surface and is approximately 100 feet deep. Jerry contacts Rhonda, an attorney who is experienced in securing mineral royalty contracts for landowners.

After several meetings with the sand producers, Rhonda advises Jerry to accept a **royalty contract** with Quality Silica, Inc. (Quality Silica), that includes the following terms and conditions.

1. The **royalty rate is \$5 per ton**, to be paid when the sand is actually removed.
2. The area covered by the royalty contract is 120 acres.
3. The contract is dated November 1, 2014, and will be effective for 20 years.
4. On November 1, 2024, Jerry and Quality Silica can mutually agree on a different royalty rate for the second 10-year period covered under the contract. If they cannot agree on a new royalty rate, the \$5 per ton original royalty rate will apply for the second 10-year period.
5. **Quality Silica will pay Jerry an advance minimum royalty of \$3,000 per acre, for a total of \$360,000, on December 1, 2014.** The \$360,000 will be applied as a reduction in the royalty payments due Jerry when sand is actually removed in future years. If no sand is removed during the 20-year royalty period, Jerry will not be obligated to return the \$360,000.

In 2014, Jerry paid the following expenses related to the royalty contract.

Expense	Amount Paid
Rhonda's legal fee	\$15,000
Geologist report	8,000
	<u>\$23,000</u>

Jerry is entitled to a percentage depletion deduction in 2014. The percentage depletion rate for sand is 5% of royalty income.⁷⁴ Therefore, **Jerry's allowable 2014 depletion allowance is \$18,000** (\$360,000 royalty × 5%).

Jerry's royalty income and associated expenses are reported on his 2014 Schedule E, *Supplemental Income and Loss*, which follows.

⁷⁴ IRS Pub. 535, *Business Expenses*, p. 37 (2015).

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For Example 18

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service (99)
Name(s) shown on return

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

► Attach to Form 1040, 1040NR, or Form 1041.

► Information about Schedule E and its separate instructions is at www.irs.gov/schedulee.

OMB No. 1545-0074

2014

Attachment
Sequence No. **13**

Jerry

Your social security number

987-65-4321

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C or C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No

B If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

1a Physical address of each property (street, city, state, ZIP code)

A **120 acres located in LaSalle County, Illinois**

B

C

1b	Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV	
A	5		A	365	0	<input type="checkbox"/>
B			B			<input type="checkbox"/>
C			C			<input type="checkbox"/>

Type of Property:

- 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe)

Income:		Properties:	A	B	C
3	Rents received	3			
4	Royalties received	4	360,000		
Expenses:					
5	Advertising	5			
6	Auto and travel (see instructions)	6			
7	Cleaning and maintenance	7			
8	Commissions.	8			
9	Insurance	9			
10	Legal and other professional fees	10	23,000		
11	Management fees	11			
12	Mortgage interest paid to banks, etc. (see instructions)	12			
13	Other interest.	13			
14	Repairs.	14			
15	Supplies	15			
16	Taxes	16			
17	Utilities.	17			
18	Depreciation expense or depletion	18	18,000		
19	Other (list) ►	19			
20	Total expenses. Add lines 5 through 19	20	41,000		
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	319,000		
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()	()
23a	Total of all amounts reported on line 3 for all rental properties	23a			
b	Total of all amounts reported on line 4 for all royalty properties	23b	360,000		
c	Total of all amounts reported on line 12 for all properties	23c			
d	Total of all amounts reported on line 18 for all properties	23d	18,000		
e	Total of all amounts reported on line 20 for all properties	23e	41,000		
24	Income. Add positive amounts shown on line 21. Do not include any losses	24	319,000		
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()		
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26	319,000		

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2014

Observations for Example 18.

1. Entering into a royalty contract (as opposed to an outright sale of the 120 acres to a sand producer) offers Jerry several advantages. One is that he can continue the crop-share lease of the land to a tenant farmer until Quality Silica begins sand extraction. That activity may start several years after 2014, depending on numerous factors.
2. Based on the geologist's report, the sand deposits on Jerry's 120 acres are potentially quite valuable. Depending on numerous future considerations, Quality Silica's sand mining operations on Jerry's land could be extensive and very profitable. **Via the royalty contract, Jerry is retaining an economic interest in the sand deposits. This allows him to benefit from Quality Silica's future sand production activities.**
3. One disadvantage of entering into a royalty agreement (as opposed to selling the property) is that any net royalty activity profit is reported as **ordinary income** on Schedule E.
4. If and when Quality Silica begins to mine sand on Jerry's 120 acres, he will be entitled to a 5% depletion allowance on actual royalties that exceed \$360,000. See IRS Pub. 535, *Business Expenses*, for information about the computation of depletion.

IDENTITY THEFT

PREVENTION AND DETECTION

The IRS uses various fraud-prevention measures and filters to stop the vast majority of invalid refunds. From 2011 through 2014, the IRS detected 19 million suspicious returns, prevented more than \$63 billion in fraudulent refunds, and significantly reduced the time required to resolve an identity theft case.

In addition, the IRS substantially increased the number of filters they use to detect identity theft. Filters were first used to detect fraudulent returns in 2012. The use of filters has steadily grown over the past several years. From 2012 to 2013, the number of filters used increased from 11 to 80.⁷⁵ In 2014 and 2015, the number of filters grew to 114 and 196, respectively. During 2014, the IRS rejected 338,807 e-filed returns and 15,915 paper-filed returns in an effort to prevent issuing fraudulent refunds.⁷⁶

Note. For further details regarding identity theft and other tax scams encountered by the IRS during the 2015 filing season, the congressional testimony of Timothy P. Camus, Treasury Inspector General for Tax Administration (TIGTA) Deputy Inspector General for Investigations can be found at uofi.tax/15b4x1 [www.treasury.gov/tigta/congress/congress_03122015.pdf].

By late 2012, the IRS had more than 3,000 employees working on identity theft cases, which is more than twice the number of employees dedicated to this purpose in 2011. In addition, more than 35,000 employees who work with taxpayers were trained to recognize signs of identity theft and provide assistance to victims.⁷⁷

⁷⁵ *Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Refunds*. Sep. 30, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/auditreports/2013reports/201340122fr.pdf] Accessed on Aug. 17, 2015.

⁷⁶ *Hearing Before the Committee on Finance, United States Senate*. Mar. 12, 2015. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/congress/congress_03122015.pdf] Accessed on Aug. 17, 2015.

⁷⁷ *IRS Combats Identity Theft and Refund Fraud on Many Fronts*. Oct. 28, 2014. IRS. [www.irs.gov/uac/Newsroom/IRS-Combats-Identity-Theft-and-Refund-Fraud-on-Many-Fronts] Accessed on Aug. 20, 2015.

IDENTITY-THEFT PREVENTION TIPS

There are many ways for a taxpayer to be vulnerable to identity theft. For example, a taxpayer's stolen identification may be used to prepare and file a fraudulent tax return that shows a refund. The thief's account information may then be used to obtain the refund. This may serve to delay the bona fide refund to which the victim is entitled.

In recent years, the IRS has taken several steps to increase its ability to detect fraud **before** refunds are issued. Those improvements include the following.⁷⁸

- Deploying more than 100 filters
- Limiting direct deposit
- Locking deceased taxpayers' accounts
- Improving cooperation with local law enforcement
- Working with state departments of corrections to curtail refund fraud by prisoners
- Partnering with financial institutions and software developers
- Working with the prepaid access card industry

There are several steps a taxpayer can take to prevent identity theft. These include the following.

- Social security cards and other documents with a social security number (SSN) or individual taxpayer identification number (ITIN) should not be carried in the taxpayer's wallet or purse. These should be stored in a safe place at home.
- An SSN or ITIN should not be provided to a business or other party unless absolutely necessary.
- Confidential financial and other personal information should be protected and access to this information should be limited by using physical locks, computer passwords, or other security measures.
- Credit reports should be reviewed annually.
- Personal computers should be protected using firewalls, anti-spam and anti-virus software, updated security patches, and passwords for online accounts should be regularly changed.
- Personal information should only be provided by phone, fax, or Internet if it is given to a known party.

Note. If a taxpayer believes they are at risk of becoming an identity theft victim because of lost or stolen personal information, they may contact the IRS Identity Protection Specialized Unit at 800-908-4490. Further preventative steps may be found at [uofi.tax/15b4x2](https://www.irs.gov/identityprotection) [www.onguardonline.gov].

SIGNS OF TAX IDENTITY THEFT

There are signs that may alert a taxpayer that they are a victim of identity theft. These include the following.

- The taxpayer discovers that more than one tax return for them was filed with the IRS.
- The taxpayer discovers there is a balance due, refund offset, or collection action taken against them for a year for which they did not file a tax return.
- IRS records indicate the taxpayer received more wages than actually received.
- The taxpayer's state or federal benefits were reduced or canceled because the agency received information about an income change.

⁷⁸ Ibid.

RESOLVING TAX IDENTITY THEFT

Tax returns must continue to be timely filed even during the period when the IRS is resolving an identity theft case for the taxpayer. Any return that was the subject of identity theft must be filed in **paper form**. Preparers should attach the following items to these paper-filed returns.⁷⁹

- A copy of the e-file rejection notice (typically provided by the preparer's software)
- Form 8948, *Preparer Explanation for Not Filing Electronically*, indicating why the return is not being e-filed (The e-file rejection code should be noted, along with an explanation that the taxpayer is a possible identity-theft victim.)
- Form 14039, *Identity Theft Affidavit*

Note. A separate Form 14039 should be filed for each spouse filing jointly if both spouses are affected.

- A copy of any IRS correspondence received by the taxpayer regarding possible identity theft issues

Note. Copies of such correspondence should be attached to the return.

- Any erroneous refund checks the taxpayer received

Note. It may be prudent to write "void" on the front and back of the check being returned to the IRS.

The paper return should be mailed to the address for paper-filed returns for the taxpayer's geographic area.

Note. Addresses for mailing paper returns may be found at **uofi.tax/15b4x3** [www.irs.gov/uac/Where-to-File-Paper-Tax>Returns-With-or-Without-a-Payment].

If a payment is due, it should be included with the return unless the taxpayer is unable to pay and requests an installment payment plan. If an installment payment plan is requested, Form 9465, *Installment Agreement Request*, should also be attached to the return.

Form 14039 follows. This form may be found at **uofi.tax/15b4x4** [www.irs.gov/pub/irs-pdf/fl4039.pdf].

⁷⁹ *Taxpayer Guide to Identity Theft*. Jul. 27, 2015. [www.irs.gov/uac/Taxpayer-Guide-to-Identity-Theft] Accessed on Aug. 19, 2015; Instructions to Form 8948.

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Complete and submit this form if you are an actual or potential victim of identity theft and would like the IRS to mark your account to identify questionable activity.

Check only one of the following two boxes if they apply to your specific situation. (Optional for all filers)

- ☐ I am submitting this form in response to a mailed notice or letter from the IRS.
- ☐ I am completing this form on behalf of another person, such as a deceased spouse or other deceased relative. You should provide information for the actual or potential victim in Sections A, B, & D.

Note to all filers: Failure to provide required information on **BOTH** sides of this form **AND** clear and legible documentation will delay processing.

THIS FORM MUST BE SIGNED ON THE REVERSE SIDE (SECTION F).

Section A – Reason For Filing This Form (Required for all filers)

Check only **ONE** of the following two boxes. You **MUST** provide the requested description or explanation in the lined area below.

- 1 ☐ I am a victim of identity theft **AND** it is affecting my federal tax records.

You should check this box if, for example, your attempt to file electronically was rejected because someone had already filed using your Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN), or if you received a notice or correspondence from the IRS indicating someone was otherwise using your number.

Provide a short explanation of the problem and how you were made aware of it.

- 2 ☐ I have experienced an event involving my personal information that may at some future time affect my federal tax records.

You should check this box if you are the victim of non-federal tax related identity theft, such as the misuse of your personal identity information to obtain credit. You should also check this box if no identity theft violation has occurred, but you have experienced an event that could result in identity theft, such as a lost/stolen purse or wallet, home robbery, etc.

Briefly describe the identity theft violation(s) and/or the event(s) of concern. Include the date(s) of the incident(s).

Section B – Taxpayer Information (Required for all filers)

Taxpayer's last name	First name	Middle initial	The last 4 digits of the taxpayer's SSN or the taxpayer's complete Individual Taxpayer Identification Number (ITIN)
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Taxpayer's **current** mailing address (apt., suite no. and street, or P.O. Box)

City	State	ZIP code
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Tax year(s) affected (Required if you checked box 1 in Section A above)	Last tax return filed (year) (If you are not required to file a return, enter <i>NRF</i> and do not complete the next two lines)
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Address on last tax return filed (If same as current address, write "same as above")

City (on last tax return filed)	State	ZIP code
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Section C – Telephone Contact Information (Required for all filers)

Telephone number (include area code) <input type="checkbox"/> Home <input type="checkbox"/> Work <input type="checkbox"/> Cell	Best time(s) to call
--	----------------------

I prefer to be contacted in (select the appropriate language) ☐ English ☐ Spanish ☐ Other _____

Section D – Required Documentation (Required for all filers)

Submit this completed form and a **clear and legible** photocopy of at least one of the following documents to verify your identity. If you are submitting this form on behalf of another person, the documentation should be for that person. If necessary, enlarge the photocopies so all information and pictures are clearly visible.

Check the box next to the document(s) you are submitting:

- ☐ Passport ☐ Driver's license ☐ Social Security Card ☐ Other valid U.S. Federal or State government issued identification**

** Do not submit photocopies of federally issued identification where prohibited by 18 U.S.C. 701 (e.g., official badges designating federal employment).

2015 Workbook

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Section E – Representative Information (Required only if completing this form on someone else's behalf)

If you are completing this form on behalf of another person, you **must** complete this section and attach **clear and legible** photocopies of the documentation indicated.

Check only **ONE** of the following four boxes next to the reason why you are submitting this form

- ☐ The taxpayer is deceased and I am the surviving spouse. *(No attachments are required)*
- ☐ The taxpayer is deceased and I am the court-appointed or certified personal representative.
Attach a copy of the court certificate showing your appointment.
- ☐ The taxpayer is deceased and a court-appointed or certified personal representative has not been appointed.
Attach a copy of the death certificate or the formal notification from the appropriate government office informing the next of kin of the decedent's death. Indicate your relationship to the decedent: _____
- ☐ The taxpayer is unable to complete this form and I have been appointed conservator or have Power of Attorney (POA) authorization.
Attach a copy of the documentation showing your appointment as conservator or your POA authorization.
If you are the POA and have been issued a CAF number by the IRS, enter it here: _____

Representative's name _____

Current mailing address _____

City _____

State _____

ZIP code _____

Section F – Penalty Of Perjury Statement and Signature (Required for all filers)

Under penalty of perjury, I declare that, to the best of my knowledge and belief, the information entered on this form is true, correct, complete, and made in good faith.

Signature of taxpayer or representative of taxpayer _____

Date signed _____

Instructions for Submitting this Form

Submit this form and **clear and legible** copies of required documentation using **ONE** of the following submission options.

Mailing **AND** faxing this form **WILL** result in a processing delay.

By Mail	By FAX
<p>If you checked Box 1 in Section A and are unable to file your return electronically because the primary and/or secondary SSN was misused, attach this form and documentation to your paper return and submit to the IRS location where you normally file. If you have already filed your paper return, submit this form and documentation to the IRS location where you normally file. Refer to the "Where Do You File" section of your return instructions or visit IRS.gov and input the search term "Where to File".</p> <p>If you checked Box 1 in Section A and are submitting this form in response to a notice or letter received from the IRS, return this form and documentation with a copy of the notice or letter to the address contained in the notice or letter.</p> <p>If you checked Box 2 in Section A (you do not currently have a tax-related issue), mail this form and documentation to:</p> <p style="text-align: center;">Internal Revenue Service PO Box 9039 Andover MA 01810-0939</p>	<p>If you checked Box 1 in Section A and are submitting this form in response to a notice or letter received from the IRS that shows a reply FAX number, FAX this completed form and documentation with a copy of the notice or letter to that number. Include a cover sheet marked "Confidential." If no FAX number is shown, follow the mailing instructions on the notice or letter.</p> <p>If you checked Box 2 in Section A (you do not currently have a tax-related issue), FAX this form and documentation to: (855) 807-5720.</p> <p>NOTE: The IRS does not <i>initiate</i> contact with taxpayers by email, fax, or any social media tools to request personal or financial information. Report unsolicited email claiming to be from the IRS and bogus IRS websites to phishing@irs.gov.</p> <p>NOTE: For more information about questionable communications purportedly from the IRS, visit IRS.gov and input the search term "Fake IRS Communications".</p>

Other helpful identity theft information may be found on www.irs.gov/uac/Identity-Protection. Additionally, locations and hours of operation for Taxpayer Assistance Centers can be found at www.irs.gov (search "Local Contacts").

Note: The Federal Trade Commission (FTC) is the central federal government agency responsible for identity theft awareness. The IRS does not share taxpayer information with the FTC. Refer to the FTC's website at www.identitytheft.gov for additional information, protection strategies, and resources.

Privacy Act and Paperwork Reduction Notice

Our legal authority to request the information is 26 U.S.C. 6001.

The primary purpose of the form is to provide a method of reporting identity theft issues to the IRS so that the IRS may document situations where individuals are or may be victims of identity theft. Additional purposes include the use in the determination of proper tax liability and to relieve taxpayer burden. The information may be disclosed only as provided by 26 U.S.C. 6103. Providing the information on this form is voluntary. However, if you do not provide the information it may be more difficult to assist you in resolving your identity theft issue. If you are a potential victim of identity theft and do not provide the required substantiation information, we may not be able to place a marker on your account to assist with future protection. If you are a victim of identity theft and do not provide the required information, it may be difficult for IRS to determine your correct tax liability. If you intentionally provide false information, you may be subject to criminal penalties. You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send this form to this address. Instead, see the form for filing instructions. Notwithstanding any other provision of the law, no person is required to respond to, nor shall any person be subject to a penalty for failure to comply with, a collection of information subject to the requirements of the Paperwork Reduction Act, unless that collection of information displays a currently valid OMB Control Number.

Form **14039** (Rev. 2-2014) Catalog Number 52525A

www.irs.gov

Department of the Treasury - Internal Revenue Service

THE IDENTITY PROTECTION PIN (IP PIN)

An IP PIN is a 6-digit number assigned annually to eligible taxpayers to help prevent the misuse of their SSN on a fraudulent income tax return. Taxpayers who are assigned an IP PIN **must** use it to confirm their identity on their current federal tax return and any delinquent returns filed during the calendar year.

Note. If a return is e-filed with a missing or incorrect IP PIN, it will be rejected by the IRS. Filing a paper return with a missing or incorrect IP PIN will delay its processing because the IRS requires time to verify that the return is not fraudulent.

For taxpayers who are eligible for an IP PIN, a new IP PIN is issued each year for use on the subsequent year's tax return. The IP PIN is used as a supplement to the taxpayer's SSN to identify the taxpayer as the valid owner of the SSN and related tax account.

Observation. TIGTA found that the IRS issued 1.2 million IP PINs to taxpayers to use in filing tax returns in 2014, up from 770,000 in 2013. In addition, it appears that use of an IP PIN did not result in an overall delay in processing returns. For further information, see **uofi.tax/15b4x5** [www.treasury.gov/tigta/press/press_tigta-2014-36.htm].

OBTAINING AN IP PIN

To obtain an IP PIN, the taxpayer's identity must be confirmed online. Immediate access to an email account is necessary to receive and use a special confirmation code. The taxpayer receives their IP PIN after the IRS confirms the taxpayer's identity.

Note. If the IRS invited the taxpayer to participate in the 2014 IP PIN pilot program but the taxpayer decided not to participate, the taxpayer may continue filing tax returns without an IP PIN. For more information on the IP PIN pilot program in effect for 2015, which covers Florida, Georgia, and the District of Columbia, see **uofi.tax15b4x6** [www.irs.gov/Individuals/Identity-Protection-PIN-Pilot-Program].

In 2015, the taxpayer **must** obtain an IP PIN to file a current or prior year return if the taxpayer:⁸⁰

- Received a CPO1 notice (sent to taxpayers who are victims of identity theft) with a new IP PIN and misplaced it,
- Had an IP PIN in a prior tax year and did not receive a new one for the current year, or
- Had an e-filed return rejected because the IP PIN was wrong or missing

Note. A previously issued IP PIN may be retrieved at **uofi.tax/15b4x7** [www.irs.gov/Individuals/Electronic-Filing-PIN-Request]. Furthermore, a temporary replacement IP PIN may be obtained by contacting the Identity Protection Specialized Unit at 800-908-4490 or by visiting the nearest Taxpayer Assistance Center. For additional general information about IP PINs, see **uofi.tax/15b4x8** [www.irs.gov/Individuals/Frequently-Asked-Questions-about-the-Identity-Protection-Personal-Identification-Number-%28IP-PIN%29].

Caution. Using a replacement IP PIN delays the processing of a tax return and any corresponding refund because the IRS must manually verify the taxpayer's identity.

⁸⁰ *Get an Identity Protection PIN (IP PIN)*. Jun. 11, 2015. [www.irs.gov/Individuals/Get-An-Identity-Protection-PIN] Accessed on Aug. 19, 2015.

TAX GUIDANCE ABOUT IDENTITY THEFT PROTECTION SERVICES

The IRS announced that the value of identity protection services provided by an organization to a victim of identity theft should not be included in the victim's gross income for tax purposes.⁸¹ This rule applies to any taxpayer who believes the safety of their personal information may have been breached. Identity protection and data protection services include credit monitoring and reporting services, identity theft insurance policies, and services to restore victims' identities.

Note. For additional details regarding this income exclusion, see IRS Announcement 2015-22. In this announcement, the IRS mentioned that identity theft constituted the largest single consumer complaint to the Federal Trade Commission for the last 15 years.

CYBER SECURITY FOR TAX PREPARERS

On May 26, 2015, the IRS announced that criminals acquired data from sources outside the IRS to obtain information on approximately 100,000 taxpayers.⁸² On August 17, 2015, the IRS announced that an additional 220,000 taxpayers' accounts may have been accessed.⁸³ The criminals used the "Get Transcript" online application available through the IRS website. The outside information allowed the criminals to obtain the necessary authentication in order to access tax account information. The IRS discovered this breach because it noticed an unusually high level of activity with the online "Get Transcript" application. This unusually high level of activity was a signal that indicated unauthorized use of the system was taking place. Immediately after this discovery, the online transcript application was temporarily shut down.

Note. For further details on the IRS data security breach and subsequent steps taken by the IRS, see **uofi.tax/15b4x10** [www.irs.gov/uac/Newsroom/IRS-Statement-on-the-Get-Transcript-Application]. In addition, for a continually updated list of information about breaches of government, businesses, and other organizations, see **uofi.tax/15b4x11** [www.idtheftcenter.org/images/breach/ITRCBreachReport2015.pdf].

Because tax preparers work with confidential taxpayer information, it is prudent to take steps to make that information as secure as possible. Some steps that the tax preparer may consider to protect individual taxpayer information are discussed in this section. Moreover, individuals will find some of the following information useful for the protection of their own tax information.

PASSWORDS

Criminals use special software, word lists, and even known information about clients or employees to automate password submissions in an attempt to obtain correct passwords. Frequently, the word lists used consist of names, common movie characters, movie titles, dates, and other items typically used within a password. Software that is used to find correct passwords can be very efficient at doing this.

⁸¹ IRS Ann. 2015-22 (Aug. 14, 2015).

⁸² *IRS Statement on the "Get Transcript" Application*. May 26, 2015. [www.irs.gov/uac/Newsroom/IRS-Statement-on-the-Get-Transcript-Application] Accessed on Aug. 20, 2015.

⁸³ *Additional IRS Statement on the "Get Transcript" Incident*. Aug. 17, 2015. Internal Revenue Service. [www.irs.gov/uac/Newsroom/Additional-IRS-Statement-on-the-Get-Transcript-Incident] Accessed on Aug. 27, 2015.

As a defensive measure, the tax practitioner can implement a password policy that requires each password to have a more complex combination of characters. This makes it more difficult for hacker software to successfully determine a password to gain unauthorized access to client data. For example, a password policy might require each office password to meet the following guidelines.

- The password must be a minimum of eight characters in length.
- Any three of the following elements must be used.
 - ♦ Upper case letters
 - ♦ Lower case letters
 - ♦ Numbers
 - ♦ Special characters (such as “!” or “&”)

A further effective step in preventing hacker software from eventually discovering a password is to require each employee to change their password periodically (such as every 90 days).

Because tax preparers typically use various forms of software and online systems, they may have several different passwords. Use of a password manager not only serves as a useful password organization tool, but it also stores passwords in an encrypted fashion. This serves as a defense against hacker software that detects keystrokes or uses other sophisticated techniques that can find the user’s password in various systems.⁸⁴ Generally, with a password management system, the user can create stronger passwords that are much more difficult to breach. The user can save those passwords within a defensive, encrypted system that has added safeguards that the user accesses with a single master password. This eliminates the vulnerabilities of using the same or similar passwords across a number of systems in an unencrypted fashion.

Note. For additional details on password management systems, see **uofi.tax/15b4x12** [www.cnet.com/how-to/how-and-why-to-set-up-and-use-a-password-manager/].

PREVENTING MALICIOUS SOFTWARE

Criminals may install malicious software on a tax preparer’s computer in order to obtain sensitive client information or disrupt the tax preparer’s computer systems. Such malicious software is referred to as “malware.” Generally, malware is installed on a computer when the user visits websites, downloads software from untrustworthy sources, or installs trustworthy software into which malware has “bundled” itself. In addition, malware may use other already-installed malware to get into the tax preparer’s computer.⁸⁵

Examples of malware⁸⁶ includes ransomware (which disables the tax preparer’s entire computer), worms (which continually replicate themselves within a computer and destroy data and files), and browser hijackers (which redirect normal Internet search activity to other content). Browser hijackers let malware developers monitor the tax preparer’s web activity, making this form of malware particularly dangerous if the tax preparer uses online banking or makes online credit card purchases. Viruses are a form of malware.

Note. For additional information on the various types of malware and the vulnerabilities that may exist within the tax preparer’s office, see **uofi.tax/15b4x13** [www.malwaretruth.com/the-list-of-malware-types/].

⁸⁴ *How and why to set up and use a password manager.* Elliott, Matt. Dec. 8, 2014. CNet. [www.cnet.com/how-to/how-and-why-to-set-up-and-use-a-password-manager/] Accessed on Aug. 21, 2015.

⁸⁵ *How Does Spyware, Malware, or Crapware Get on My Computer?* How-To-Geek. [www.howtogeek.com/howto/2998/how-does-spyware-malware-or-crapware-get-on-my-computer/] Accessed on Aug. 21, 2015.

⁸⁶ *The Truth About Malware.* For17seconds. [www.malwaretruth.com/the-list-of-malware-types/] Accessed on Aug. 21, 2015.

Defensive steps a tax preparer may take to reduce their vulnerability to malware include the following.⁸⁷

- Using software to detect and remove various forms of malware
- Using up-to-date anti-virus software
- Using a firewall to protect the computer system from unauthorized intrusions
- Using an updated browser
- Ensuring that email systems have their spam filters enabled

In addition, preventing the use of personal electronic devices enhances security. If a personal device or laptop that does not have the same security features as office systems is synchronized or plugged into an office system (using a USB port, for example), this compromises the security of the systems in the tax preparer's office.⁸⁸

ADDITIONAL SECURITY MEASURES

Following are some additional steps that the tax preparer may consider in order to increase the security of sensitive data.⁸⁹

- **Hard drive encryption.** Full encryption of each hard drive in the tax preparer's office provides an extra layer of protection against unauthorized access that password protection does not provide.
- **Back up all data using a remote location.** Backing up data in a secure, remote location ensures that there is a complete copy of sensitive client data that can still be used if the original data is damaged or compromised.
- **Use portable backup devices that are secure.** Use of secure portable storage devices ensures that if the device is stolen or lost, no one else can access the information and use it for identity theft or other illegal purposes.

Note. Additional security measures for tax preparers are outlined by the AICPA. In addition to cyber security, these measures also consider office operations, physical security, travel protocol, and financial controls. The AICPA publication that discussed these security measures can be found at uofi.tax/15b4x14 [www.aicpa.org/publications/personalfinancialplanning/downloadabledocuments/checklist_operational%20security.pdf].

⁸⁷. *How to Avoid Malware*. Phelps, Justin. Nov. 16, 2010. PC World. [www.pcworld.com/article/210891/malware.html] Accessed on Aug. 21, 2015.

⁸⁸. *OIG Identifies Data Security Vulnerabilities Within HHS Agencies*. May 11, 2015. iHealthBeat. [www.ihealthbeat.org/articles/2015/5/11/hhs-oig-identifies-data-security-vulnerabilities-within-hhs-agencies] Accessed on Aug. 21, 2015.

⁸⁹. *Five essential security measures to protect your business—no matter its size*. Mah, Paul. Jun. 20, 2013. PC World. [www.pcworld.com/article/2042358/five-essential-security-measures-to-protect-your-business-no-matter-its-size.html] Accessed on Aug. 21, 2015.

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