



Advanced Planning Strategies

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Dear Reader,

The President signed the much-debated economic stimulus bill on March 9. The Job Creation and Worker Assistance Act of 2002 represents a scaled-down version of the tax legislation that was first introduced in the fall of last year. The law creates provisions that are effective September 11, 2001. It may be necessary for taxpayers to file amended returns for these provisions if their 2001 returns were already filed.

Some key components of the bill include:

- There is a special 30 percent bonus depreciation allowance for certain property placed in service between September 11, 2001, and September 10, 2004. This depreciation allowance permits the immediate deduction of 30 percent of the adjusted cost basis in the property with normal depreciation allowance then computed on the reduced basis of the property. The provision applies to (1) property with a recovery period of 20 years or less, (2) computer software eligible for a depreciation deduction, (3) water utility property, and (4) leasehold improvement property.
- The first-year depreciation allowance for automobiles and light trucks placed in a business use is increased to \$7,160 for vehicles placed in service on or after September 11, 2001.
- Net operating losses can be carried back 5 years for losses incurred in 2001 and 2002.
- Teachers will be permitted to deduct expenses incurred in 2002 and 2003 up to \$250 for books, supplies, computer equipment, and other supplementary materials used in the classroom. Eligible individuals include teachers, counselors, principals, and aides for kindergarten through 12th grade who work at least 900 hours during the school year. This deduction is not limited by the itemized deduction threshold.
- The Archer medical savings account deadline was extended to 2003.
- Form 1099 can now be furnished electronically if the recipient consents.

Some tax legislation that has been discussed was not included in the Act, notably the provisions to enhance charitable donations that we described in prior letters. We'll keep you abreast of these tax developments as they unfold.

Knowledge is not power. Only knowledge in use is power.

WHAT YOU SHOULD KNOW ABOUT TAX RECORD KEEPING

Most people wonder what they should do with their tax records. These items include old returns; substantiating information such as receipts, canceled checks, and diaries; and financial statements regarding stocks, bonds, and real estate. Here are some guidelines for determining what to keep and for how long.

INCOME TAX RETURNS AND SUPPORTING INFORMATION

1. **Old Tax Returns.** The general rule for income tax audits is that the IRS has 3 years from either the due date of a return or the date the return is actually filed (whichever is later) to initiate an audit. For example, if you filed your 2000 tax return on August 15, 2001, under a 4-month automatic extension, the IRS would have until August 15, 2004, to audit that return. If you kept the 2000 return until January 1, 2005, the general limitations period for a tax audit would have expired. Some taxpayers obtain additional 60-day extensions for the filing of their returns, delaying the due date to as late as October 15 of the year following the year to which the return relates. To be on the safe side, you should keep your return until the first day of the year that is 5 years later than the year to which the return relates. For example, a 2001 return should be kept until January 1, 2006. This rule of thumb ensures that the 3-year statute of limitations for the return will have expired by the time you throw the return away.

2. **Income Tax Returns Involving a Substantial Understatement of Income.** If there is any possibility that you have neglected to declare more than 25 percent of your income on a return, you are playing a different, and much more dangerous, game. The IRS has a 6-year statute of limitations (rather than 3) to audit such returns. It must prove, of course, that more than 25 percent of the taxpayer's income was omitted from the return. Still, if this is a possibility, you should keep your return until the first year that is 8 years later than the year to which the return relates. For example, 2001 returns should be kept until January 1, 2009, if substantial understatement is a potential problem.

3. **Income Tax Returns Involving Fraud.** If you intentionally file a fraudulent return, there is no statute of limitations for an audit. Therefore, the IRS can come after you at any time. Of course, if a taxpayer is intentionally defrauding the IRS, record keeping is probably not an issue in the first place.

4. **Information Supporting Past Returns.** It is advisable to keep all supporting information for a return for as long as you keep the return. Once a return is audited, generally any part of it may be subject to examination. Therefore, use the same guidelines just described to keep your supporting information.

SPECIFIC RECORDS THAT REQUIRE LONGER SAFEKEEPING

Some tax-related records must be kept for longer periods of time in order to preserve the tax benefits associated with them. These include the following:

1. **Statements Relating to the Purchase of a Business, Marketable Securities, and Other Investments.** All statements and tax information relating to stocks, bonds, mutual funds, limited partnerships, rental property, collectibles, and other investments should be kept until after the investments are sold, redeemed, or given away. Such statements provide evidence of the taxpayer's income tax basis and/or any depreciation claimed with respect to the investments, which determines the taxpayer's gain or depreciation recapture upon sale or other disposition.

It appears at first glance that such records should then be kept after the disposition for the additional period of time applicable to tax returns required for the disposition (e.g., to report capital gains) as described above under the previous heading. Note, however, that the current rules provide for an income tax basis adjustment for property (commonly known as a step-up), with certain exceptions, at the time the taxpayer dies holding such property. However, the legislation that repealed the federal estate tax also eliminated the basis step-up. The legislation provides for a modified carryover basis for the

decedent's heirs. This change occurs for only one year (2010) as a result of the "sunset" provision in the legislation. It is necessary under this new tax regime for record keeping concerning cost-basis issues to continue into subsequent generations of heirs until the property is sold—a potentially indefinite period.

2. Records Pertaining to Your Personal Residence. Records of the cost of your home and any improvements to it should be retained until the home is sold, and then for the additional period of time applicable to tax returns. These records provide evidence of the tax cost of your home. The basis of your home is still an important issue if the gain on the home approaches the \$250,000 (\$500,000) limit on the exclusion of gain from the sale of a personal residence.

3. Nondeductible Contributions to Retirement Plans. If you have made nondeductible contributions to an IRA or any other retirement plan, you should keep evidence of such contributions until your money is withdrawn from these plans. Again, the reason is that nondeductible contributions provide you with income tax basis in the plan funds.

MISCELLANEOUS RECORD KEEPING TIPS

1. Charitable Contributions. You need a letter from the recipient charity to acknowledge individual contributions of \$250 or more. If you give a charity property other than cash, you must file Form 8283, Noncash Charitable Contributions, with your income tax return if the property is worth over \$500. If the noncash contribution is valued at \$5,000 or more, you must attach a written appraisal prepared by an independent appraiser to your return. These records should be kept for the same length of time as the tax returns they support.

2. Business Travel and Entertainment Expenses. If you are claiming deductions for business expenses, any such deductions relating to travel or entertainment must be supported by a diary prepared by the taxpayer. The diary must be maintained "at or near" the time of each expenditure. This diary should include the time and place of the travel or entertainment, the amount spent, the business purpose of the expense, and the name and business relationship of the person or persons entertained in the case of entertainment expenses. These receipts should be kept for the period of time generally applicable to tax returns.

ESTATE AND GIFT TAX RETURNS AND RECORD KEEPING REQUIREMENTS

1. Gift Tax Returns. The same general rules applicable to income tax returns apply to annual gift tax returns. That is, a 3-year statute of limitations applies to the initiation of an audit. The IRS has issued regulations describing substantiation requirements to ensure the protection of the statute of limitations for gift tax purposes. At this time, we have no cases or rulings on these new requirements. It is possible that the IRS could challenge the substantiation or appraisal information on gift tax returns many years after the expiration of the statute of limitations. The challenge will be based on the adequacy of the substantiation provided with the initial return and will most likely occur when the donor's estate is audited. Our recommendation at this time is that all records, such as valuation reports, bank records, and any other items substantiating a gift tax return, should be kept until the donor's estate tax return is settled.

2. Estate Tax Returns. The statute of limitations is, again, 3 years from the date the return is filed. However, in many cases, the estate tax return is extended by 6 months beyond the normal due date of 9 months following the date of the decedent's death. Thus, the examination period may continue for 51 months following the decedent's death. In addition, the estate will file income tax returns as long as the estate is open. These income tax returns will also have a 3-year statute of limitations. A good rule of thumb is to keep the estate records for 5 years after the decedent's death or until a final closing agreement

is reached with the IRS, if later. If the federal estate tax repeal actually comes to fruition, a new estate return will be required to report the modified carryover basis of property items left to heirs. It will be necessary to maintain this return and associated records until the limitations period has run on the income tax return reporting the sale of the last estate item to be sold by the heirs—record keeping could last for generations under this compliance requirement.

RECENT CASES AND RULINGS

TAX COURT APPROVES DISCOUNTED CASH FLOW METHOD OF VALUATION IN STOCK HELD BY ESTATE

In an interesting estate valuation case concerning the value of closely held S corporation stock, the Tax Court provided a good discussion of the use of appraisal testimony (*Heck v. Commissioner*, T.C. Memo 2002-34). The court in this instance rejected a portion of the appraisal methodology of both the executor's and the IRS's appraiser. The court stated, "Nonetheless, we are not bound by the opinion of any expert witness, and we may accept or reject expert testimony in the exercise of our sound judgment. Although we may accept the opinion of an expert in its entirety, we may be selective in determining what portions of an expert's opinion, if any, to accept. Finally, because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence" (citations removed). This case represents an increasing trend for the courts to carefully scrutinize the valuation reports and not merely accept the opinion that is viewed more reasonable.

The IRS's appraiser relied heavily on a market comparison to comparable companies. In this case, the stock being valued was Korbel champagne and the IRS used Mondavi and Canandaigua as appropriate comparables for performing a financial ratio analysis. The court held that the market comparison methodology was inappropriate because the comparables used were too few and dissimilar to the stock held by the estate. The court approved the discounted cash flow method used by the executor's appraiser.

With respect to applicable valuation discounts, however, the court favored much of the IRS's analysis. It approved a 35 percent overall discount that was very specific to the type of discount. The court concluded that the marketability discount included a discount for liquidity, risks associated with operating as an S corporation, and the right of first refusal over the transfer of stock. The S corporation risk involved the possibility that the S status could be revoked and the income tax liability of each shareholder regardless of actual distributions. The estate's position resulted in an appraised value of \$16,380,000 while the IRS appraised the stock's value at \$30,177,000. The court's blended approach resulted in a final value of \$20,269,736.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

***Positioning our clients
for the future***



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