



# Advanced Planning Strategies

Albert E. Gibbons, CLU, ChFC, AEP  
President, AEG Financial Services

April 2003

Dear Reader,

Republican congressional leaders introduced bills to enact President Bush's budget plan. The bills include approximately \$700 billion for tax relief to stimulate the economy. However, the looming deficit forecast has Democrats and some moderate Republican legislators concerned about the size of the package. With the uncertainties about the costs of war with Iraq and added homeland security measures, the size of the deficit could increase to troublesome levels in the short run with new tax cuts. However, history has taught us that tax revenues can change dramatically in a relatively short period of time with economic booms or downturns. We expect the debate about the stimulus package to continue for awhile and some compromise to pass, perhaps early in the summer.

The Senate Finance Committee approved a measure to provide more stimulus for charitable giving. Congress should consider the Charity Aid, Recovery and Empowerment (CARE) Act of 2003 (S. 476) in the near future. The legislation includes the following benefits:

- allow non-itemizers to deduct qualified donations made in 2003 and 2004
- permit tax-free donations to be made from a donor's IRA to a qualified charity. The donations would be allowable after age 70 ½ for direct donations and after age 59 ½ for donations to a charitable remainder trust, pooled income fund or charitable gift annuity.
- increase the deduction for donations of "apparently wholesome food" by farmers or restaurants
- make similar increases for contributions of books from inventory to charity
- increase the deductible limit from 30 to 50 percent of the donor's contribution base for contributions of long-term capital gain property for conservation purposes
- alter the treatment of a charitable remainder trust that has unrelated business taxable income (UBTI). Under the new provision a penalty tax of 100 percent of the actual UBTI would be imposed rather than removing the tax-exempt status for the years a charitable remainder trust has UBTI.

As always, we'll continue to keep you abreast of the developments and provide a prompt planning summary of any significant tax legislation that is enacted.

*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 2001 tax return on August 15, 2002, under a 4-month automatic extension, the IRS would have until August 15, 2005, to audit that return. If you kept the 2001 return until January 1, 2006, 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, you should keep a 2002 return until January 1, 2007. 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, 2002 returns should be kept until January 1, 2010, 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.

## IRS GUIDANCE

The IRS has a helpful publication *Recordkeeping for Individuals* (Publication 552) that details the type of records that are sufficient for various substantiation compliance issues. The publication also lists the statute of limitations, but is not as specific as our discussion above with respect to disposal of records. A copy of the publication can be received free of charge from the IRS or downloaded from [www.irs.gov](http://www.irs.gov).

## RECENT CASES AND RULINGS

### TAX COURT IMPOSES LIABILITY FOR EMPLOYMENT TAXES FOR PAYMENTS MADE TO SHAREHOLDER/OFFICER OF CORPORATION

Employers are liable for federal employment taxes (FICA and FUTA) for wages paid to employees. In the case of a regular (C) corporation, there is a strong tax incentive to pay excessive salaries and bonuses to shareholder/employees. Payments made to shareholder/employees as dividends rather than wages are nondeductible to the corporation while “reasonable” compensation for services is deductible as an ordinary and necessary business expense. For an S corporation, all income is generally taxed to shareholders, and the corporate deduction is not relevant. In this instance, disguising salary payments as corporate dividends could result in a smaller employment tax burden. For this reason, the underpayment of salaries and, hence, employment taxes by S corporations has been a target audit item for several years.

This issue was investigated by the court in *Nu-Look Design v. Commissioner* (T.C. Memo 2003-52). The shareholder/president of the S corporation earned ordinary income, which was passed through to the shareholder on a Schedule K-1 of Form 1120S. Essentially, all income was treated as a dividend and no employment taxes were paid. However, neither the corporate records nor any other evidence indicated that dividends had been distributed. The court determined that the president “performed more than minor services” for the corporation and was classified as an employee who received remuneration for services. As such, the income was subject to FICA and FUTA and the corporation was held liable for the tax. As a point of information for anyone who might think that smaller cases will slip under the radar screen at the IRS, the income in this instance never reached \$15,000 in any of the disputed tax years.

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***



**Albert E. Gibbons, CLU, ChFC, AEP**  
**AEG FINANCIAL SERVICES**  
1288 Valley Forge Road, #53  
Phoenixville, PA 19460  
Tel. (610) 917-8940  
Fax. (610) 917-8962  
Email. [algibbons@algibbons.com](mailto:algibbons@algibbons.com)  
Web: [www.algibbons.com](http://www.algibbons.com)