



# Advanced Planning Strategies

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

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Dear Reader,

There has been a significant amount of debate about tax policy. However, there is usually very little substantive action in an election year. A lot of discussion has transpired with respect to the federal estate tax. A repeal is scheduled for 2010, with a return of the tax to what existed under the previous rules at the beginning of 2001. Under current law, the exemption from estate tax is \$1.5 million per decedent; increases to \$2 million in 2006 and \$3.5 million in 2009 are scheduled. Key Republicans in the Congress have suggested accelerating the repeal to 2009 and adding more years to it on a piecemeal basis. Democratic leaders have offered a compromise with a higher exemption (\$3.5 million is usually the figure that has been tossed around) and a lower maximum rate. Recently, the growing deficit has increased the sympathy of some Republicans in Congress for the possibility of a compromise, perhaps ultimately lowering the estate tax rate to that on capital gains.

Some pension-related legislation has a decent chance of passing this year. The House of Representatives passed the "Pension Equity Funding Act" (H.R. 3108) and the "Tax Relief Extension Act" last fall, which both contained similar pension provisions. The Senate recently passed the "Pension Stability Act," which contained some amended provisions of the House bill. The Joint Committee on Taxation is currently considering a compromise bill. The legislation would change the interest rate used in computing the required contributions and allowable deductions for contributions to defined-benefit plans. The rate currently used is the 30-year Treasury obligation rate. This would be replaced by interest rates (based on indexes) of conservative long-term corporate bonds. The method for reducing funding deficits (i.e., if the plan's funding is less than 90 percent) would be changed to provide funding relief for certain employers.

Now that it is filing season, many individuals are struggling with assembling and storing tax records. Unfortunately, it is not easy for most people to digitize all receipts and records. The inside report provides useful guidelines for the prudent retention of tax records. Many types of records will have to be saved for a much longer time than you might imagine.

***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 2002 tax return on August 15, 2003, under a 4-month automatic extension, the IRS would have until August 15, 2006, to audit that return. If you kept the 2002 return until January 1, 2007, 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 2003 return until January 1, 2008. 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, 2003 returns should be kept until January 1, 2011, 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 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. Note, however, that the current version of the carryover basis provision would exempt some amount (\$1.3 million for property left to nonspouse beneficiaries and an additional \$3 million for property left to a surviving spouse) and would allow a basis step-up for the exempt amount of assets. Thus, the record keeping burden will be lessened for the next generation for estates under the exempt amount.

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

### IRS RULES THAT RECEIPT OF LIFE INSURANCE PROCEEDS IS DEEMED AT DATE OF DEATH FOR S CORPORATION ACCOUNTING PURPOSES

The minority shareholders of an S corporation formed a limited liability company (LLC) and acquired a life insurance policy on the life of a key person majority owner. The LLC transferred ownership of the policy to the S corporation to fund a stock redemption agreement. Under the agreement, the S corporation will redeem the shares held by the key person immediately upon the key person's death for a promissory note issued by the corporation. The remaining shareholders will elect at that time under Sec. 1377(a)(2) of the Internal Revenue Code to terminate the S corporation's taxable year. The death claim will then be submitted to the insurer, and the corporation will use the proceeds to pay the funds owed to the key person's estate. The purpose of the termination of the tax year before the receipt of the insurance proceeds is to have the proceeds allocated for income-tax-basis purposes solely to the stock the surviving shareholders hold.

The IRS, in a private ruling (Ltr. 200409010), held that the proceeds of life insurance are received for tax purposes at the date of the insured's death. The IRS reasoned that the procedure to validate the death claim and receive proceeds is a ministerial act and that the insurance company would have no reason to deny the claim based on the facts of this case. Thus, the proceeds must be allocated proportionately to the deceased shareholder's stock interest and will provide the deceased stockholder's estate with an upward basis adjustment for income tax purposes. This basis adjustment will probably not be useful because the estate will already have received a basis adjustment to the date-of-death value of the stock.

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)