Advanced Planning Strategies

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Dear Reader,

The process of tax or Social Security reform has moved slowly, as we predicted. There has been a great deal of campaigning and debating over the details, particularly about any changes to the Social Security system. Its immense popularity is illustrated by the President's inability to make much headway after making private accounts a priority, even with the Republican control of Congress. The AARP has taken the position that the system should not be privatized except to supplement the current guaranteed defined benefits. Solutions besides private accounts include (1) raising the retirement age, (2) increasing payroll taxes, (3) means testing for benefit qualification, (4) changing the cost-of-living adjustment formula, or (5) some combination of these options. Increasing the retirement age seems to have garnered some support, including that of Alan Greenspan, who also supports private accounts.

The President's Tax Reform Panel is looking at every option, such as a combination of income tax and consumption tax. A national sales tax bill has already been proposed. The President has emphasized that tax benefits for home ownership and charitable contributions must be retained by any new system.

Some news from the IRS includes proposed regulations for Roth Sec. 401(k) plans. Beginning in 2005, certain employees can choose to designate some or all of their 401(k) contributions as taxable income. The benefit of this would be tax-free build-up and distribution from these contributions. The employer must amend the plan to permit this option; the proposed regulations provide guidance for such amendments. In addition, the IRS released Notice 2005-31 that provides the procedure for deducting state and local sales taxes (in lieu of deducting state income taxes) on federal income tax returns, beginning with the 2004 returns due this month. The Notice indicates that the amount deductible will be based on a formula that includes the state(s) of residence, total income, and number of dependents or the actual sales taxes paid. Because this guidance has come at such a late date and the taxpayer has to make choices in determining whether (and how) to take this deduction, it may be necessary for many affected taxpayers to put their income tax return on extension until August by filing Form 4868 and paying an estimated amount of income tax for 2004.

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 2003 tax return on August 15, 2004, under a 4-month automatic extension, the IRS would have until August 15, 2007, to audit that return. If you kept the 2003 return until January 1, 2008, 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 2004 return until January 1, 2009. 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. A new record-keeping issue arose from last fall’s tax legislation. Some taxpayers may choose to take an itemized deduction for state sales taxes in lieu of state income taxes. The taxpayer can use the proxy table deduction but is permitted to deduct actual sales taxes paid. This might require maintaining records related to state sales taxes paid and is particularly important for large-ticket items.

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 these 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 FAVORABLY ON DISCLAIMER OF JOINT ACCOUNT BY SURVIVING SPOUSE

A husband and wife maintained a joint brokerage account with the account passing at death to the survivor. Each contributed to the account and could unilaterally withdraw his or her contributions from the account. The account contained unit investment trusts, corporate bonds, municipal bonds, CDs, and cash. The wife, following the broker's advice, retitled the account to her sole ownership following the husband's death. The wife directed sales and purchases from the account over the next 8 months and withdrew some cash.

The wife retained a law firm 6 months after the husband's death to assist in settling the estate. On advice from the law firm, she disclaimed her beneficial survivorship interest in her husband's share of the account within the 9-month time limit for disclaimers. Preceding the disclaimer, the account was divided into three accounts. The wife's account contained the proceeds from any sales and the securities purchased after the husband's death. The remaining two accounts, one in the estate's name and one held as a tenancy in common between the wife and the estate, held no securities that were purchased after the husband's death and contained no funds from which the wife made withdrawals. The disclaimed portion passed to the husband's revocable trust and helped fund the credit shelter trust created at his death. The IRS permitted the disclaimer (Ltr. 200503024) based primarily on two factors. First, the husband's share of the account did not become a completed transfer to her until his death because he could unilaterally withdraw his contribution. Thus, the disclaimer within 9 months of death is timely. Second, because the accounts were separated, the wife could benefit from specific assets but be treated as not having accepted the benefits from other separate distinct assets prior to the disclaimer (Treas. Reg. Sec. 25.2518-3(d)).

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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