



# Advanced Planning Strategies

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April 2006

Dear Reader,

The Budget process has moved along with some speed, but significant debate and further revision are likely. The conference committee will probably be working on the final bill by the time this letter arrives. Of course, there are specific agendas that are critical components of the debate. The extension of the lower tax rates for dividends and capital gains is a primary objective of the President, and most in Congress are concerned about extending relief from the alternative minimum tax (AMT). There is a somewhat growing anti-tax-cut sentiment in Congress, specifically spawned by the concerns over the deficit and backlash over cuts in spending programs, such as the recent amendments to Medicaid.

It is difficult to make informed objective opinions, even for practitioners who research these issues daily. The revenue projections are based on specific timeframes and are often confusing and highly criticized. Government agencies also issue conflicting reports. Recently, one agency concluded that the reductions in dividend and capital gain tax rates have had an extremely positive effect on the economy, the investment sector, and job creation. However, it has been questioned whether the tax revenue lost was greater than the increase in revenue generated by a more favorable economy.

The Senate is attempting to include an increase for tax enforcement of up to \$500 million. Senators have expressed concern over the estimate of the "tax gap," which represents the amounts owed to the IRS but uncollected. In its most recent estimate, the IRS concluded that about \$290 billion went uncollected in a single year (2001) after enforcement efforts. To put this into perspective, this is nearly equal to the current federal budget deficit.

It is unlikely that the tax reconciliation bill will include extensive or controversial items in an election year. Certainly, it is unlikely that many in Congress will back proposals that can be attacked for significantly worsening the budget deficit. As always, we will provide you with a planning summary of any important developments that ensue.

*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 2004 tax return on August 15, 2005, under a 4-month automatic extension, the IRS would have until August 15, 2008, to audit that return. If you kept the 2004 return until January 1, 2009, the general limitations period for a tax audit would have expired. Some taxpayers obtain additional 60-day extensions for filing 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 2005 return until January 1, 2010. 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, 2005 returns should be kept until January 1, 2013, 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 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.

**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.

**3. State and Local Sales and Use Taxes.** Although the budget reconciliation bill has not passed at the time this letter was written, it is possible that the itemized deduction for state and local sales and use taxes will be extended into 2006 and beyond. This deduction can be used in lieu of the deduction for state and local income taxes. Although many will generally choose to use the IRS tables for a proxy figure for this deduction, it is important to keep records of sales taxes, particularly those paid on large items such as motor vehicles, boats, aircrafts, and homes (including building materials). These records may provide substantiation for a valuable deduction in the event this deduction is extended by Congress.

## 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

### RESIDENCE CONTRIBUTED TO FAMILY PARTNERSHIP INCLUDED IN DECEDENT'S GROSS ESTATE

The decedent contributed her personal residence to a family partnership to reduce estate taxes and probate expenses. She entered into a lease agreement with the partnership and continued to live in the residence until her death. The partnership held no other asset and was formed for the stated purpose of real estate management, but the court concluded that it did not have a profit motive. Interests in the partnership were contributed to family members, and the decedent transferred the residence for no consideration. The decedent ultimately gave all her interest in the partnership to family members as a gift.

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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