



# Advanced Planning Strategies

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April 2007

Dear Reader,

The new Congress is moving slowly with respect to tax legislation. There has been significant difference between the House and Senate versions of the small business tax relief provisions to be incorporated into any minimum wage increase. Although there appears to be support for the minimum wage increase, the House approved a much smaller package of small business tax cuts and seems reluctant to provide more tax relief without revenue offsets.

The House Ways and Means Committee held a hearing last month on the alternative minimum tax (AMT). The AMT appears to be the target of criticism for anyone who discusses the complexity and fairness of the federal income tax. However, a complete repeal would be extremely expensive and would require substantial tax increases in other areas to offset the cost. Congress will probably settle for extending the current AMT relief (in the form of larger exemptions) for an additional year or two. Even a one-year extension has an estimated price tag of \$57 billion.

The impetus for the repeal of the AMT is largely fueled by the fear that the AMT has begun to encroach on the income tax returns of middle-income taxpayers. House Ways and Means Committee Chairman Charles Rangel estimated that approximately 23 million taxpayers currently have an AMT burden. However, the Tax Policy Center reported that over one-half of the AMT would be paid by taxpayers with annual incomes over \$200,000 and 89 percent from taxpayers with income over \$100,000 (the highest-earning 16 percent of households) if no AMT relief is enacted. In addition, the tax cuts from the 2001 and 2003 tax acts lowered the burden of the regular income tax and, as a result, actually increased the exposure to AMT. In fact, if the tax cuts of 2001 and 2003 are extended without AMT relief, the number of taxpayers subject to AMT will double in 2010. Obviously, the AMT fix is going to take a good deal of compromise and will necessitate a thorough examination of tax policy and how the various tax rules interact.

Here are some tax numbers from IRS statistics that you might find interesting. Individual income tax returns filed last year for 2005 income totaled 134.5 million, an increase of 1.6 percent over the previous year. The adjusted gross income reported on these returns was \$7.4 trillion, an increase of 8.9 percent over the previous year.

*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 2005 tax return on August 15, 2006, under a 4-month automatic extension, the IRS would have until August 15, 2009, to audit that return. If you kept the 2005 return until January 1, 2010, 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 2006 return until January 1, 2011. 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, 2006 returns should be kept until January 1, 2014, 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. This creates a situation for the heirs where the value of the property must be determined

by the executor at the time of the owner's death, and records of this stepped-up basis must be retained by the heirs to determine gain at the time the property is subsequently sold. This creates an unforeseen record-keeping problem if an estate tax return is not required for the estate and the property is not easily valued. Suppose a valuable heirloom is inherited and sold 10 years later. How will the seller know the date-of-death value of the property if no estate tax return is required and no appraisal was performed at the time the property was inherited?

The legislation that repeals the federal estate tax also eliminates the basis step-up (both changes for 2010 only). The legislation provides for a modified carryover basis for the decedent's heirs. It is necessary under this new tax regime for record keeping concerning the decedent's cost basis 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. A tax form not yet developed will be used to report the basis of inherited property. Under the carryover basis scenario, these records should be kept until the period of limitations has run on the return, reporting the subsequent sale of the inherited property. If the heir chooses to keep the property, the record-keeping requirement goes on indefinitely.

**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, a "qualified appraisal" must be obtained.

**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.** This deduction, extended recently for 2006 returns, 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).

## **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.

## RECENT CASES AND RULINGS

### IRS RULES FAVORABLY ON LIFE INSURANCE TRANSFERS TO GRANTOR TRUSTS

The IRS recently addressed two situations that would provide flexibility to an irrevocable trust holding life insurance. In the first situation, the grantor has an existing life insurance trust and creates a new trust, funding it with a cash gift equal to the value of the life insurance policy held by the existing trust. The new trust purchases the policy from the existing trust for its fair market value. Both the existing trust and the new trust are grantor (A/K/A defective) trusts for income tax purposes with respect to the grantor. This means that some power is included in the trust under Code Secs. 671-678 that causes the grantor of the trusts to be treated as the income tax owner of both trusts. The second situation is the same except that only the new trust is a grantor trust for income tax purposes.

The IRS ruled (Rev. Rul. 2007-13, 2007-11 I.R.B. 684) that the transfer of the policy does not result in adverse income tax consequences in either situation. The transfer-for-value rule applied to life insurance transfers could make the death benefits subject to income tax if a policy is transferred for valuable consideration. However, these transfers meet an exception to the rule because the grantor is treated as the owner of the transferee-trusts' assets for income tax purposes and the insured is an exception from the transfer-for-value rule. Note, however, that these trusts are treated as owned by the grantor for income, but not gift or estate, tax purposes. Thus, the gifts to the trust are completed gifts and the policy is not included in the gross estate of the grantor-insured. The income tax ownership of the trust should not present a problem to the grantor because a life insurance policy will not generally provide taxable income.

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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