



# Advanced Planning Strategies

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The IRS sent out questionnaires to permit filers to determine eligibility for a rebate check under the Economic Stimulus Act of 2008. A payment calculator is also available on [www.irs.gov](http://www.irs.gov). Payments are scheduled to be mailed beginning May 16 and ending July 11 based on the last two digits in the recipient's social security number, with the higher numbers receiving checks last. However, the use of direct deposit would significantly speed up the receipt of the funds since all direct deposits would be completed by May 16.

The Senate passed a budget resolution by a vote of 99-1 which contains many tax related proposals. One significant issue is the federal estate tax. The resolution approved freezing the federal estate tax at the exemption amount and rate scheduled for 2009. That is, the exemption would shelter \$3.5 million per decedent with the excess taxable at 45 percent. The same exemption amount and rate would apply to the federal generation-skipping transfer tax. Amendments offered to increase the exemption to \$5 million and lower the rate to 35 percent failed to pass.

The budget resolution is not a tax bill and is not considered the final word on this subject, but some serious discussion of the federal estate tax must begin fairly soon to address a significant problem with the current status of the law. That is, the exemption amount increases from \$2 million to \$3.5 million on January 1, 2009 and the federal estate tax is repealed for one year only in 2010. The federal estate tax would return in 2011 and thereafter with a \$1 million exemption and marginal rates as high as 60 percent. The impact of the law as currently enacted in the immediate future is that an individual who is terminally ill later this year will save \$675,000 in federal estate taxes by surviving until January 1, 2009. The timing of death will have an even bigger impact in 2010 and 2011.

Obviously, it is not in the best interest of the public to create such discrepancies in tax burdens based on the date of death. It has made estate planning extremely uncertain and challenging to Americans and their advisers to have an unpredictable future for the federal estate tax. We certainly anticipate some resolution to this issue prior to 2010, and maybe before the end of this year. We'll let you know as the discussions become serious and contain more specific proposals.

**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 2006 tax return on August 15, 2007, under a 4-month automatic extension, the IRS would have until August 15, 2010, to audit that return. If you kept the 2006 return until January 1, 2011, 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 2007 return until January 1, 2012. 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, 2007 returns should be kept until January 1, 2015, 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 repeal of the federal estate tax (discussed on the cover letter) contains a provision that 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. The appraisal is required whether the contribution is made by an individual or a business entity.

**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.

## 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

### Relief Granted for Transfer of S Corporation Stock to an IRA

A corporation made the election to be taxed as an S corporation. Shares of the corporation's stock were inadvertently issued to a shareholder's IRA account instead of the shareholder directly. The mistake was recognized after some tax years had closed and the corporation took remedial action and redeemed the shares from the IRA and issued them to the shareholder. An IRA is not an eligible shareholder for S corporation stock and the issuance of stock to an ineligible shareholder causes termination of the S status for the corporation and its shareholders.

The IRS ruled (Ltr. 200807002) that the termination of the S election was inadvertent within the meaning of IRC Sec. 1362(f) and permitted the S status to continue. However, the IRS conditioned its ruling on the IRA being treated as the shareholder for periods in which the corporation reported a net loss and the shareholder being treated as the owner for periods in which the corporation reported net gain. All other shareholders must treat each item of the corporation's income, loss, deduction, or credit under normal pass through rules applicable to S corporation shareholders. The ruling essentially retroactively renews the S election, except for the requirement that the IRA receives any net loss. A pass through loss will not provide any tax benefit to an IRA, whereas, the loss, if passed through to the shareholder would be deductible on the shareholder's individual income tax return to the extent the shareholder had sufficient basis in his or her stock.

This ruling indicates the importance of monitoring activities with an S corporation and its shareholders. Although tax law changes have made many strides with respect to flexibility for ownership of S corporations, there are still numerous restrictions on ownership that could inadvertently terminate S status and result in adverse income tax consequences.

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future*



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