



# Advanced Planning Strategies

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The President's 2010 budget proposal has attracted considerable commentary in the news media and the tax provisions are going to generate significant debate and criticism. The first legislative steps began last month and many of the items were incorporated. It would surprise us if the process was completed quickly. Some changes would be adopted this year and others would occur simply through expiration of provisions scheduled to "sunset" over the next couple of years. There is a strong possibility that adjustments could be made to tax provisions as they expire.

Senator Baucus introduced the "Taxpayer Certainty and Relief Act of 2009" that permanently extends much of the middle-class tax relief enacted in 2001 and 2003. Many of these provisions were extended and/or enhanced several times already. The House Ways and Means Committee began work on similar legislation. The two bills, if enacted in the respective chambers, would be sent to the Joint Tax Committee to iron out differences, perhaps with some new wrinkles.

Here's some of the details that are available to us thus far:

- Alternative Minimum tax (AMT). Permanently extend the AMT exemption (at 2009 level) and index it for inflation.
- Tax Brackets. Make the 10, 25 and 28 percent tax rates permanent.
- Capital Gains Rate. Make the reduced long-term capital gains rate permanent for taxpayers in brackets up to and including 28 percent.
- Marriage Penalty. Make the enhanced standard deduction for joint filers permanent.
- Adoption Benefits. Make the \$10,000 credit permanent.
- Estate, Gift, and Generation-Skipping Transfer (GST) Taxes. Make the 2009 exemption amount (\$3.5 for estate and GST) permanent and index the amount for inflation. The provision would also make the exemption portable to be transferred (if unused) to a surviving spouse to make the exemption potentially \$7 million (ignoring indexing) at the second death. The provision would also raise the special use valuation reduction (currently \$1 million) to \$3.5 million (with indexing) for real estate used in a family business or farm. There already have been efforts to make further amendments to this proposal.

We'll be following the progress of this legislation closely for you and will provide a planning summary if it is enacted.

*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 2007 tax return on August 15, 2008, under a 4-month automatic extension, the IRS would have until August 15, 2011, to audit that return. If you kept the 2007 return until January 1, 2012, 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 the 2008 return you may have just filed until January 1, 2013. 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, 2008 returns should be kept until January 1, 2016, 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 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 was just added by the recent stimulus legislation. Some taxpayers will be able to take a deduction for sales taxes paid on certain motor vehicles purchased after February 16th and before the end of this year. The sales receipt should be retained until the end of the audit period for the 2009 return (as discussed above).

### 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. Recent legislation requires brokers to report basis in stocks, bonds, mutual funds, options and other securities for securities purchased after 2010. This information sent to the IRS will make recordkeeping more important since the

IRS will be better equipped to catch under-reported gains through a matching program.

It appears at first glance that such records should then be kept after the disposition of affected assets 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. Unfortunately, the recent decline in value of many financial assets and real would result in a basis step-down for assets that have declined in value as a result of this tax provision.

The basis adjustment rules for an estate create 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? This problem will be magnified by the higher threshold (\$3.5 million in 2009) for the filing of estate tax returns. It is easy for the heirs in a modest estate to decide to forgo appraisals, but could cause significant tax difficulties later when the inherited assets are sold.

**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

### S Corporation Found to Have One Class of Stock Following Family Dispute

The Fifth Circuit upheld the Tax Court's finding that a family-held S corporation did not have a prohibited class of stock (*Minton v. Commissioner*, 103 AFTR 2d 2009). The taxpayer was a 50-percent owner of an S corporation. The two 50-percent shares were purchased by the taxpayer and her sibling in 1986. As part of the purchase, the buyers received monthly annuity payments from the corporation. A dispute arose between the taxpayer and the co-owner and no buy-out agreement could be reached. After the taxpayer successfully defended the validity of her ownership interest in the corporation, the taxpayer's counsel determined that the original sale created a preferred distribution pattern for the original sellers and created a second class of stock at the time of the sale in 1986. S corporation rules prohibit a second class of stock and this event would effectively terminate the S election retroactively to the time of the sale in 1986.

Taxpayer relied on this conclusion and did not report her share of the undistributed income of the corporation for the then current year, and filed amended returns for prior years. If the corporation did not have a valid S election, the undistributed income would be taxable to the corporation and not the shareholders. The Circuit court agreed with the Tax Court that the taxpayer failed to carry the burden of proof that the corporation had a prohibited second class of stock. It was determined that the records and evidence were not clear as to the nature and terms of the sales transaction in 1986. This is another example of why record keeping (corporate minutes and purchase and sale documents in this instance) is critical.

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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