THE BERNSTEIN REPORT

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Published By: Richard S. Bernstein and Associates, Inc.

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MARCH 2010

Dear Reader,

There have been a number of tax provisions considered by Congress in the past month. The bill to increase the debt ceiling included PAYGO (pay as you go) provisions that will require revenue offsets if tax cuts are included in the bill. Specifically excepted from the PAYGO requirements are the reinstatement of the federal estate and generation-skipping taxes, but only to the extent that the exemption amount does not exceed $3.5 million and the top rate is returned to 45 percent. There is also an exception for the alternative minimum tax (AMT) relief to prevent more middle-income taxpayers from becoming subject to the AMT.

There was some noise about the federal estate tax reform legislation being added to the jobs bill or the emergency unemployment compensation extension, but this does not appear that likely at this time. The most common prediction is that estate tax reform will be delayed until after the election. However, since most everyone predicted that this had to be addressed prior to the end of 2009, it is apparent that anything is possible. We might even see the sunset of the repeal at the end of this year with a return to 2001-level estate, gift, and generation-skipping transfer taxes. There is certainly going to be some impact from the decision of Charles Rangel to step down from the Chair of the House Ways and Means Committee. His successor will have a great deal of influence as to the provisions included in any tax legislation.

The Senate has begun consideration of the extenders legislation passed by the House at the end of last year. The Senate version (American Workers, State, and Business Relief Act of 2010) contains different provisions and revenue offsets. If this bill is passed by the Senate, it would require the Joint Tax Committee to resolve the differences. Unless you've stopped listening to the news, you realize that getting something through the Senate is no certainty, but many of the extenders provisions are important and have bi-partisan support.

We normally provide you with a tax-recordkeeping report during tax season. The federal estate and generation-skipping transfer tax repeal for 2010 contained a much less discussed, but similarly controversial, provision to eliminate the income-tax basis step-up provisions for estates of decedents dying in 2010. The inside report discusses some typical recordkeeping suggestions and provides some guidelines for what should be added to your planning to react to the new carryover basis rules.

Cordially,

Richard S. Bernstein

A Second Opinion Costs You NOTHING,
But Could Save You MILLIONS!

WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION, SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?

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. The current law concerning estates has provided a rather unique and troubling situation with a temporary one-year repeal of the federal estate and generation-skipping taxes and a one-year repeal of the so-called basis step-up rules that otherwise establish the income-tax basis for assets passing to heirs. For 2010, the assets would pass to heirs under what is technically referred to as the modified carryover basis rules. This change in the law has been a subject of a couple of articles in traditional media outlets, but has received far less attention than the repeal of the estate and generation-skipping tax. We feel that this law may be changed retroactively, but barring that development, it would be imperative to understand the impact of this rule on recordkeeping and compliance. 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 2008 tax return on August 15, 2009, under a 4-month automatic extension, the IRS would have until August 15, 2012, to audit that return. If you kept the 2008 return until January 1, 2013, 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 2009 return you may have just filed (or intend to file soon) until January 1, 2014. 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, 2009 returns should be kept until January 1, 2017, 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 repeal (for 2010) of the basis step-up rules for estates. As discussed below, recordkeeping for certain transactions may continue indefinitely; particularly with respect to sales of assets.

IMPACT OF MODIFIED CARRYOVER BASIS RULES

For decedents dying during 2010, the basis step-up rules in effect for many years were replaced by a modified carryover basis system. This change may be repealed retroactively, in effect

just for 2010, or adopted for the indefinite future depending on legislation expected before the end of this year. Most practitioners dread the recordkeeping and compliance associated with this change. In addition, commentators have indicated that this change in the law actually imposes a tax burden on heirs at a significantly lower level of wealth than those affected by the 2009 federal estate and generation-skipping tax.

Although the law under IRC Sec. 1022 is lengthy and complex, we'll attempt a brief synopsis that will make the discussion of recordkeeping more understandable. The starting point is that heirs will inherit assets with the adjusted cost basis held by a decedent at the time of his or her death in 2010. A basis adjustment (increase) is permitted for up to $1.3 million for assets passing to heirs. Limitations to the basis adjustment include (1) the increase for any asset is limited to its fair market value at the time of death and (2) assets that are items ordinarily subject to income (not capital gains) tax such as qualified retirement accounts or IRAs cannot receive this adjustment to basis. There an additional $3 million in basis can be added to assets passing to a surviving spouse. The rules for the spousal transfers are similar, but not identical, to the long-standing rules for a federal estate tax marital deduction. The basis of assets inherited by heirs will determine their exposure to capital-gains tax when the assets are sold. Thus, heirs could be subject to capital gains taxes on assets if the decedent leaves over $1.3 million (if there is no surviving spouse or the other heirs receive more than $1.3 million from the estate).

Although the recordkeeping caused by this change is extraordinary, the immediate compliance issues for 2010 include:

- The basis adjustments discussed above are made at the discretion of the executor of the estate. It is quite possible that wills drafted prior to 2010 don't address this in the directions or powers provided to the executor. It's also likely that state probate law doesn't contemplate this role. Wills and living trusts should be revised to incorporate this direction according to the estate owner's wishes. There probably should be a clause protecting the executor for using the discretion to allocate basis. This law has the potential for making some heirs unhappy.
- The IRS is going to have to develop a form for estates of decedents dying in 2010 to report the basis of assets to the IRS and to the heirs of the estate. This form will probably be issued in August.
- Congress (if this provision is not repealed retroactively) is probably going to provide technical corrections to the law and impose burdens on financial institutions with respect to the reporting of basis to the executor and/or heirs of an affected estate. Irrespective of this possible repeal, a proposal has already been made to require basis reporting to heirs to ensure the consistency with respect to the income and estate tax systems.

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. This issue has been exacerbated by the modified carryover basis rules discussed above. 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 a modified carryover basis for property inherited in 2010. This creates a situation

for the heirs where the basis of property must be determined by the executor at the time of the owner's death, and records of this carryover basis (as adjusted by the executor) must be reported to and retained by the heirs to determine gain at the time the property is subsequently sold.

The modified carryover basis adjustment rules for an estate create an unforeseen record-keeping problem since the individual with the best knowledge with respect to the records for the basis of the property items would be deceased at the time the information is needed. This is not the time to help an elderly family member purge the filing cabinets. Better yet, it might be very beneficial to have a serious conversation with family members about the identification and location of any records that would provide evidence of basis.

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.

This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

This tax letter, prepared by a nationally recognized tax authority, is published monthly by

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