

THE BERNSTEIN REPORT

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Dear Reader,

We have discussed the strange circumstances concerning the federal tax treatment for decedents whose death occurred in 2010 in many prior letters. The legislation that initially repealed the federal estate tax for 2010 and established a modified carryover basis for assets inherited from a 2010 decedent indicated that the basis of assets would have to be reported on a tax form within nine months of the decedent's death. This requirement was extended and the due date for the form was scheduled to be April 18th of this month along with the deadline for filing the decedent's final income tax return.

The estate tax legislation in late 2010 provided a choice for the estates of 2010 decedents to choose between the revised federal estate tax and no federal estate tax coupled with the modified carryover basis. The IRS just announced that the tax form (Form 8939) for reporting the income-tax basis of assets to heirs is not due April 18, but the decedent's final income tax return will be due as scheduled. The due date for Form 8939 will be announced in an upcoming guidance and the form itself will be published soon after the guidance is issued. (IR-2-11-33). This continuing saga has certainly placed executors and their counsel in a difficult situation because they have had to prepare to comply with a unique and almost unprecedented tax law and had the due date moved twice. This also potentially delays the settlement of the estate and the distribution of assets to the heirs.

The Senate recently passed legislation (S. 23) that would prohibit an individual or entity from obtaining a patent for devising a tax strategy. This bill had bipartisan sponsorship and passed the Senate by a vote of 95 to 5. It would apply prospectively only and would not affect any patents prior to the date of enactment. This bill would not prevent the application for a patent for developing computer software for tax preparation. It is expected that the House of Representatives will consider this legislation in the near future and it is not expected to generate significant opposition.

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, diaries; and financial statements regarding stocks, bonds, and real estate.

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 2009 tax return on August 15, 2010, under a 4-month automatic extension, the IRS would have until August 15, 2013, to audit that return. If you kept the 2009 return until January 1, 2014, 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 2010 return you may have just filed (or intend to file under extension) until January 1, 2015. 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, 2010 returns should be kept until January 1, 2018, 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 2010 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. 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.

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.

3. Special Rules for 2010 Decedents. The legislation reinstating the estate tax in late 2010 creates a unique situation where the executors of the estates of the more wealthy decedents will probably choose to avoid the estate tax and adopt the modified carryover basis tax regime provided by IRC Sec. 1022. This will require the executor to report the basis of the assets to the heirs as the basis is adjusted under these rules. The report of the basis of any individual asset should be retained by the heir inheriting the asset until the period of limitations has run for the income-tax return reporting the sale or disposition of the asset by the heir. In other words, the information concerning the basis of such inherited assets should be retained according to the rules discussed above with respect to an income tax return reporting the gain or loss on such assets. Although the 2010 legislation returns estates to the basis step-up rules that were applicable prior to the temporary repeal of the estate tax, Congress has discussed the possibility of requiring reporting of the basis of assets to heirs to provide consistency between the estate and income tax systems. It is likely that such legislation will be enacted in the future and this will provide an additional record-keeping burden for family members inheriting assets.

RECENT CASES AND RULINGS

Tax Court Clarifies a Post-Termination Circumstance for a Qualified Personal Residence Trust (QPRT)

The decedent created a QPRT during her lifetime to make a gift of a personal residence of substantial value to freeze the value of the property for estate and gift tax purposes and remove the value of the residence from her gross estate. The decedent created a three-year QPRT and filed a gift tax return and paid the appropriate gift taxes on the value of the remainder interest in the residence following her retained three-year term. When the QPRT was planned with her advisors, it was explained to her that she would need to pay fair rental for the property if she continued to live in it following the termination of the QPRT.

The decedent survived the three-year term and continued to live in the residence. The remainder beneficiaries of the QPRT (two property trusts created by the decedent) took steps to talk to advisors concerning how to form a lease with the decedent and determine adequate rent for the property. The requirement to pay rent was again communicated to the decedent. The advisors indicated that it would be acceptable to enter into the lease agreement and satisfy the required rent prior to the end of the tax year. Unfortunately, the decedent passed away within six months of the termination of the QPRT, prior to entering into any lease agreement and payment of rent.

The IRS took the position that the residence should be included in the decedent's gross estate and assessed an estate tax deficiency of over \$3 million. The IRS also denied the estate's deduction for the rent (determined to be over \$46,000) as a claim against the estate. The IRS reasoned that the decedent should include the residence in the gross estate at the date of death value of the residence since the decedent had an implied agreement to remain in the residence under the difficult provisions of IRC Sec. 2036(a). The court looked at precedent and determined that the decedent had not, in fact, entered into an implied agreement to remain in the residence without paying adequate rent. The record of correspondence of all parties indicated that the decedent would have entered into a lease agreement and paid rent to remain in the property. The decedent's untimely death prevented the completion of the lease and payment of the required rent. As a result, the provisions of IRC Sec. 2036(a) would not apply and the residence avoids taxation in the decedent's gross estate for estate tax purposes. (*Estate of Riese v. Commissioner*, T.C. Memo. 2011-60).

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.

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