Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

August 2012

How Long Should You Keep Records?

Individual taxpayers and business owners must deal with an enormous amount of record keeping. Data arrives regularly, electronically and on paper. Keeping track can be a challenge.

Just as challenging, you must decide which records to keep and how long. If you just keep everything, you will have increased storage responsibilities and a more difficult time locating the information you need. Moreover, the longer you retain records, the greater the chance that someone might access them and use them improperly.

So how long should you keep records? The short answer is it depends. Some records can be destroyed after a short time, but others must be kept indefinitely, depending on the nature of the transactions they describe.

Timetable for tax records

Generally, you must keep tax records that support the income, deductible expenses, and credits you report on a tax return. In addition, you should keep copies of the returns you file. The basic rule is you should keep these records until the limitation period runs out for the return the record is related to. The limitation period is the period in which you can amend a return to claim a credit or refund, or the IRS can assess additional tax.

Generally, the limitation period for a return is three years after you file the return. If you file your return before its due date, it is treated as filed on the due date for these purposes. Thus, as of this writing, you can shred and erase most tax records for 2008 and earlier years (however, if you filed on extension for 2008, the limitation period may not be up yet, depending on when you filed). Your tax records for 2009 and 2010 should be retained because the limitation

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Costly Care

A 65-year-old couple retiring in 2012 will need an estimated $240,000 to cover medical expenses throughout retirement.

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period for those returns has not run out.

Exceptions exist:

- If you mistakenly did not report income that you should have, and the shortfall is more than 25% of the gross income shown on your return, you should keep records for six years, rather than three years.
- If you filed an amended return to claim a credit or a refund, you should keep records for (a) three years from the date you filed your original return or (b) two years from the date you paid the tax, whichever is later.
- After you have filed a claim for a loss from worthless securities or a bad debt deduction, keep the relevant records for seven years.
- If you have employees, you also should keep all employment tax records for at least four years after the date the tax became due or has been paid, whichever is later.

Caution: If you did not file a tax return—or, even worse, filed a fraudulent return—the limitation period never runs out. Keep tax records for those years indefinitely.

Beyond the limit

Even if you haven't amended a tax return, you may have to hold onto some records for an extended time period. That's true of records connected to assets such as securities or real estate. Until you dispose of such assets in a taxable transaction, you should keep records that support your claimed gain or loss as well as any depreciation, amortization, or depletion deductions you've taken. If you have received property in a tax-free exchange, you should keep the records that relate to the property you relinquished and to the property you acquired until the limitation period expires for the year in which the new property is sold in a taxable disposal.

In addition, you should keep records of nondeductible contributions to retirement accounts indefinitely. Those contributions will allow you to avoid some tax on future withdrawals and on Roth IRA conversions. You also should retain home-improvement records as long as you own a house because those outlays could reduce the tax you'll owe when you sell.

Filing for the future

The IRS permits businesses, sole proprietors, and individual taxpayers to store tax documents electronically. Besides documents that originate electronically, the IRS rules also permit taxpayers to convert paper documents to electronic images and maintain only the electronic files. This allows for the paper documents to be destroyed.

For businesses, the IRS electronic record retention rules require electronic files to provide enough information to justify entries made on tax returns, so the tax liability can be determined. Those records must be detailed enough to explain transactions and identify any underlying source documents. Companies must make electronic records available to the IRS upon request and provide the IRS with any help needed to access the information contained in those records.

If your company uses an electronic storage system for its records, you should be sure that the system can index, store, preserve, retrieve, and reproduce the electronic data. Make sure the system provides reasonable controls for the integrity, accuracy, and reliability of your data. For your own security, you'll want a system that's designed to prevent and detect any unauthorized revision or deletion of your data.

Beyond taxes, other vital business documents must be retained for extended time periods. The requirements usually are set by state law. However, legal documents such as contracts, leases, and binding agreements probably should be retained in hard copy document form. ■

Wellness Programs for a Healthier Bottom Line

About 70% of U.S. employers offer some type of wellness initiative, according to a recent survey conducted by the International Foundation of Employee Benefit Plans (IFEBP). Among the survey respondents, about 20% have analyzed the return on investment (ROI) from these programs. In most cases, ROI has been positive.

Employers introduce wellness initiatives in order to encourage employees to seek preventive care and to adopt healthier lifestyles. The programs might urge workers to get flu shots, for example, and to undergo various types of health screenings and risk assessments. Other common offerings include smoking cessation and weight management programs.

In order to boost participation in wellness programs, companies typically provide incentives. Employers might offer employees a lower contribution

to the company health plan, if employees take certain preventive measures or take part in a fitness program. Further lures could include tangible rewards such as gift cards, cash bonuses, and merchandise ranging from iPods to flat screen TVs.

Virtue's rewards

With such incentives, plus the hiring of an outside firm to administer the program, wellness initiatives can be expensive. Nevertheless, those outlays not only can result in a healthier, more productive workforce, they also can more than pay for themselves. "For every dollar spent on wellness initiatives, most organizations see between $1 to $3 decreases in their overall health care costs," the IFEBP concludes.

Why is the ROI so impressive? Employees who participate in wellness programs generally wind up in better health: they lead more wholesome lifestyles, and they may detect medical conditions before they become serious. Eventually, company-wide expenses for expensive medications and procedures will decline, or grow at a slower pace, resulting in lower health care costs. Other financial benefits include reduced sick leave absenteeism as well as lower claims for workers' compensation and disability management.

Business owners who introduce such initiatives should be patient. You can expect it to take three years or more for the cost savings to become apparent. Even sooner, though, you might see a boost in morale as employees hear the message that you want them to get well and stay well. ■

Tax Savings Versus College Aid

For parents, income shifting is a proven tax-saving tactic. If your children have investment assets and report the income from those assets, they'll owe little or no tax. However, transferring investment assets to your children probably will reduce your family's eligibility for college financial aid. By understanding the tradeoffs involved, you can make informed decisions.

Custodial concerns

Parents who wish to shift investment income to their children can establish custodian accounts under the Uniform Transfers to Minors Act or the Uniform Gifts to Minors Act. Interest, dividends, and capital gains may then be reported by their children, who will owe less tax.

Example 1: Kyle Watson has a son, Grant, age 8. Over the years, Kyle has transferred $35,000 worth of bond fund shares to Grant. In 2012, the bond fund pays $1,400 in interest income to Grant; this fund also distributes $400 to Grant as his share of its long term capital gains for the year. If Kyle had retained those fund shares, he would have owed ordinary income tax on the interest income at rates up to 35%, plus 15% tax on the long-term capital gains distribution. Young Grant, though, owes no tax on the capital gains and not more than 10% on the interest income.

Thus, some family tax savings exists. Grant can reinvest nearly all of his investment income, after tax, and continue to build a college fund.

Although the tax savings are helpful, shifting income in this manner has some drawbacks. For one, money transferred to a custodial account belongs to the minor. In our example, Kyle no longer will have unlimited access to the money. When Grant comes of age (generally, between ages 18 and 21, depending on state law), he will have access to the money still in his custodial accounts and may not follow Kyle's advice on how to spend it.

Another drawback: the so-called "kiddie tax" applies to the investment income of most youngsters before they reach college age, as well as many college students. This tax now limits income shifting to $1,900 of investment income per year. Thus, the maximum tax savings are modest.

Trusted Advice

Kiddie Tax Coverage

- Children under age 18 are subject to the kiddie tax.
- Eighteen-year-olds are considered kiddies if their earned income is no more than half of their support for the year.
- Full-time students under age 24 also are considered kiddies if their earned income is no more than half of their support.
- For kiddies, low taxed investment income is limited to $1,900 in 2012. Excess amounts are taxed at their parents' rates.
- Regardless of age, married children filing joint returns are not subject to the kiddie tax.

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Barriers to aid

In addition, students are expected to pay heavily from their own funds when they attend college. The more they can pay, by the financial aid formula, the less aid they'll be granted.

Example 2: Kim Harmon has been accepted at a university where the total costs are $35,000 a year. If the Harmons' expected family contribution is $22,000, Kim will be eligible for $13,000 of aid. However, if the family can be expected to pay $31,000, Kim can get only $4,000 of aid.

According to the financial aid formula, students are expected to contribute 20% of their assets to pay for college, but parents are only expected to pay 5.64% of assets. The more assets held by Kim, the greater the family's expected contribution and the less financial aid Kim can receive.

The bottom line is that transferring assets to a student can save income tax but also will reduce the family's potential for college financial aid.

Weighing the choices

Shifting investment income to youngsters will deliver the proverbial "bird in the hand." You know that you'll save tax every year. Saving hundreds of dollars a year, over a period of many years, can add thousands of dollars to your family's savings. It's true that custodial accounts will go to your children when they become adults, but many youngsters can be trusted to use the money wisely.

Conversely, there is nothing guaranteed about college financial aid. Your student might become a star athlete or receive an appointment to a military academy, thus, making financial aid unnecessary. Alternatively, your income and net worth might be so great by the time your children are in college that no financial aid will be offered. Families in these circumstances might have benefitted by shifting income to save tax each year.

From another perspective, college costs have been rising sharply and may continue to do so. Higher costs mean that more families will qualify for aid, especially if they will have more than one child in college at the same time. Such families stand to benefit from saving in the parent's name to increase potential financial aid. What's more, parents who save through 529 college plans won't owe income tax on the earnings in those plans, so there may not be a great need to shift investment income.

If you have children who probably will be attending college in the future, our office can help you weigh the available alternatives. ■

Did You Know?

Among young workers (age 25–34), men contribute more to employer retirement plans than women: 7.6% of salary, on average, versus 6.1%. For preretirees (age 50–64), the gender gap is reversed, with women contributing 10.1% of pay versus 9.4% for men.

Source: ING Retirement Research Institute

Investing on the New Frontier

The conventional wisdom holds that this century has been disappointing for stock market investors. Through the first quarter of 2012, the benchmark S&P 500 Index showed a return just over 4% per year, for the prior 10 years. That was less than half the long-term average; for the 40 years from 1972–2011, the broad U.S. stock market has returned nearly 10% a year to investors.

Still, this century has rewarded some investors who put their money into stocks from emerging markets. According to Morningstar, its diversified emerging markets category of mutual funds gained nearly 13% a year for those 10 years. These funds invested largely in Chinese and Brazilian stocks. Indeed, Morningstar's Latin American stock category of funds led all others with annualized returns over 17% for those 10 years, mainly because of their focus on Brazil.

Growth spurt

Why did Chinese and Brazilian companies, among others, reward investors, while American, Japanese, and European stocks generally lagged? In a word, growth. Some developing nations enjoyed rapid economic growth as they adopted market-oriented economies, and companies based in those countries posted significant profits.

Emerging markets investments may continue to outperform others... or they may not. History is filled with examples of investments that soared for a period of time and then came back to earth. Moreover, growth from current levels may be harder to attain than that from the starting point of 10 years earlier.

Meanwhile, some investors are seeking the next round of emerging markets—countries that now are in a position similar to that of China or Brazil at the turn of the century. Such countries are known as frontier markets, to differentiate them from more familiar emerging markets. Advocates of frontier market investments assert that investors will profit from these markets in the next decade, just as shareholders benefitted from emerging markets in the last 10 years.

Defining the terms

The globe has become divided into three types of markets. The industrialized nations of the world attract most capital from investors. Emerging markets, as previously noted, have taken steps on the path to economic development. Frontier markets (which are not in either of the other two categories) have farther to go before they offer a broad range of companies in which to invest and an efficient stock market for trading shares.

Investors can choose among many countries that are neither developed nor emerging. Nevertheless, not all of these nations are considered frontier markets. Generally, sophisticated investors seeking promising frontier markets look for an assortment of publicly traded companies, liquid trading opportunities, reporting requirements for public companies, established property rights, and a rule of law that extends to sizable companies. With such features in place—which are by no means present in all parts of the world—shareholders of public companies may have realistic hopes of pocketing profits.

The countries that meet the criteria for being a frontier market tend to be largely rural, with a low technology base yet some signs of market capitalism. Often, they offer human capital in the form of young and willing workers.

Appealing aspects

If countries can be classed as frontier markets, they may provide opportunities for investors. Because they are starting from a smaller base, frontier markets may grow faster than developed nations and emerging markets in the future.

Such growth could help create an expanding middle class, leading to more demand for high quality goods and services. That demand, in turn, may generate profits and higher stock prices. In addition, some frontier markets have ample natural resources, which they can profitably export to other countries. A recent report from Citigroup listed Bangladesh, Iraq, Mongolia, Nigeria, Sri Lanka, and Vietnam among frontier markets projected to report superior economic growth over the next several decades.

Moreover, major financial institutions typically do not devote extensive resources to following the companies in frontier markets. That may create opportunities to find well priced frontier market stocks with excellent growth potential.

Already, some funds offer investors access to frontier markets. These include exchange-traded funds and mutual funds designed to track a frontier markets index.

If you are interested in the concept of frontier markets, be aware that such investments are likely to be volatile. Any portfolio allocation should be modest. ■

Selling a Life Insurance Policy Can Be Taxing

Life insurance is a valuable financial planning tool for many people. However, there might come a time when you no longer need or wish to keep paying for your policy. Depending on the specific details of your policy, you may have several options: you might be able to surrender your policy for its cash value; withdraw money; borrow against the policy; or exchange it for another life insurance policy, an annuity, or a long-term care policy.

In recent years, yet another choice has emerged. You may be able to sell a life insurance policy you no longer wish to retain. With life settlements, as these sales are known, an investor group might buy a policy, pay the necessary premiums to keep the policy in force, and collect cash at the death of the insured individual. Sometimes, a policy sale will bring in more money than the other options.

Selling a life insurance policy at a profit will generate a tax obligation. That obligation became larger with an IRS announcement in 2009.

Example 1: Mark Arnold bought a life insurance policy years ago, when his children were young. Over the years, he paid a total of $250,000 in premiums. Now that Mark's children are grown and Mark's wife Anne has ample assets, Mark decides he no longer needs that policy. He sells it and receives $600,000.

Until a few years ago, Mark would have reported a $350,000 gain from the sale: $600,000 received less his $250,000 in premiums. However, in 2009, the IRS released Revenue Ruling 2009-13, which introduced the concept of adjusted basis to these transactions. As the IRS put it, "To measure a taxpayer's gain upon the sale of a life insurance contract, it is necessary to reduce basis by that portion of the premium paid for the contract that was expended for the provision of insurance before the sale." In other words, subtract the cost of life insurance protection from the

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basis to determine the taxable gain. The cost of life insurance is generally comparable to the premiums the policyholder would have paid for term life insurance; the number is available from the insurance company.

In this case, Mark's cost of insurance was $40,000. Now his basis is reduced from $250,000 to $210,000, and the gain on a sale for $600,000 is increased from $350,000 to $390,000. This added gain makes the transaction more taxing and makes life settlements less appealing, compared with the alternative courses of action.

Fortunately for policy sellers, the basis adjustment is favorably taxed as a long-term capital gain. Say that Mark had $380,000 of cash value in this policy. The $130,000 gap between the premiums he paid ($250,000) and his policy's cash value ($380,000) is taxed as ordinary income, at rates up to 35% in 2012. The other $260,000 of Mark's profit ($390,000 total gain minus the $130,000 taxed as ordinary income) is only taxed at 15% this year as a long-term gain.

Beyond taxes

If you are thinking of selling a life insurance policy, taxes are one of several issues to consider. For instance, will you be comfortable knowing that investors will profit by your death? Are you sure your loved ones no longer need the coverage?

Even if you decide that you'd be willing to sell, buyers might not have sufficient interest to make a substantial bid. Investors who buy life insurance will want to know your life expectancy, as revealed by your medical reports.

Buyers usually prefer cash value (permanent) life insurance, which can be kept in force until the insured individual dies. Term life policies probably need to be convertible to permanent life in order for buyers to offer an attractive amount. ■

Trusted Advice

Life Insurance Tax Benefits

- Death benefits paid by a life insurance policy usually are not subject to income tax. However, those benefits may be subject to estate tax.
- Permanent (as opposed to term) life policies typically have an investment component called the "cash value." Inside the policy, any cash value earnings are tax free.
- Policyholders generally can withdraw money up to the amount of premiums paid tax-free. They can also borrow against permanent life insurance cash values tax-free as long as the policy remains in force. However, excess borrowing or withdrawals might cause the policy to lapse and may generate tax obligations.

TAX CALENDAR

AUGUST 2012

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2012. This due date applies only if you deposited the tax for the quarter in full and on time.

August 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

SEPTEMBER 2012

September 17

Individuals. If you are not paying your 2012 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2012 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. File a 2011 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic 6-month extension.

Deposit the third installment of estimated income tax for 2012. Use the worksheet Form 1120-W to help estimate tax for the year.

Partnerships. File a 2011 calendar year income tax return (Form 1065). This due date applies only if you timely requested an automatic 5-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1.

S corporations. File a 2011 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic 6-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

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