

Tax Planning Tips for 2000 and Beyond

It's important to keep in mind simple tax strategies when preparing for tax season. Many of these strategies, however, can be implemented at any time during the year.

1. Contribute to an IRA – and do it early in the year.

If a taxpayer contributes \$2,000 annually to an IRA at the beginning of the year, the account will be worth \$540,585 (assuming a 12% return) at the end of 30 years. However, if the taxpayer makes the same contribution at the end of the year, the IRA would be worth only \$482,665 in 30 years.

2. Pay IRA fees from separate funds.

Having custodial fees deducted from an IRA each year significantly reduces the account's long-term value. A \$50 fee deducted from a taxpayer's IRA at the beginning of each year for 30 years will reduce the account's value by 13,515 (assuming a 12% return). Most banks and brokerage firms permit customers to pay the custodial fee separately rather than have it deducted from the account. Fees paid from separate funds are also deductible as a miscellaneous itemized deduction.

3. Establish a Roth IRA.

Although contributions to a Roth IRA are not tax deductible, withdrawals have this advantage. They are not included in a taxpayer's income if received when the account has been open for at least five years and the taxpayer is at least 59 ½ years old.

4. Convert an existing IRA to a Roth IRA.

An existing IRA can be converted to a Roth IRA if the taxpayer's adjusted gross income does not exceed \$100,000. In the year of conversion, the taxpayer must include the entire IRA balance in income if contributions were deducted when they were made. If the contributions were not deducted, only the accumulated earnings are included in income.

5. Help a child establish an IRA.

Since children (and some young adults) themselves often cannot afford to establish an IRA themselves, a gift of money from a parent or grandparent to be used for an IRA contribution will allow a child to build a substantial nest egg. If a taxpayer contributes \$2,000 to an IRA beginning at age 19 (assuming he or she has sufficient earned income) and continues contributing for seven more years, that \$16,000 investment will be worth \$2,043,715 when the taxpayer reaches age 65 (assuming a 12% rate of return). However, if the taxpayer does not begin contributing \$2,000 to an IRA until age 27 – and continues for 38 more years – the \$78,000 investment will be worth only \$1,368,020 at age 65. Getting a head start on saving for retirement, therefore, significantly increases retirement assets – with a considerably smaller investment.

6. Give appreciated stock to charity.

The taxpayers charitable contributions deduction will be the stock's fair market value. The increase in value is not included in income – thus avoiding capital tax gains.

7. Consider asking for additional benefits instead of a raise.

Employee expenses paid by an employer are a working-condition fringe benefit and are deductible by the taxpayer's employer. They are not, however, included in the taxpayer's income. If the employee pays for the expenses, they are treated as a miscellaneous itemized deduction, subject to a 2% floor, and probably will not provide a tax benefit.

8. Don't overwithhold.

This year, the average tax refund was \$1,342. Why give the government an interest-free loan? Adjust withholding to properly reflect anticipated deductions and exemptions.

9. Remember to adjust the basis of mutual fund shares for reported income.

The cost of mutual funds increases by the amount of annual income distributed that the taxpayer reinvests in the fund. Failure to make the necessary adjustments means the income will be reported twice: once when it is received and again when shares are sold. Keeping records up to date is essential since shares may be sold many years later.

10. Take full advantage of education tax incentives.

The education loan interest deduction, Hope Scholarship credit, Lifetime Learning Credit, education IRA and qualified state tuition programs can significantly reduce the cost of higher education.

Shifting the Burden of Proof

Keeping good tax records has always been important, but the IRS Restructuring and Reform Act of 1998 made it even more so. One of the act's boldest initiatives was shifting the burden of proof from the taxpayer to the IRS in civil tax matters.

The burden shift applies to both individuals and businesses. It does not, however, cover all situations. It applies only in court proceedings on civil tax matters. It does apply to a partnership, corporation or trust with a net worth over \$7 million. The burden shift is not automatic; instead it occurs only if the taxpayer fulfills the following **three** requirements:

1. Introduces credible evidence relevant to determining taxpayer income or estate or gift tax liability.
2. Cooperates with reasonable requests from the IRS in its investigation.
3. Complies with the substantiation and record-keeping requirements in the code and regulations.

To substantiate a deduction by adequate records, a taxpayer – either an employee or a self-employed individual – must maintain:

1. An account book, diary, statement of expense or similar log in which the taxpayer lists each element of an expenditure at or near the time it was made.
2. Documentary evidence (for example receipts or paid bills) for away-from-home lodging and other expenditures of \$75 or more.

An accurate record must include a written statement of business purpose unless it is evident from the surrounding facts and circumstances. The documentary evidence should establish the expenditure amount, date, place and character.

Specific record keeping and substantiation requirements apply to listed property, charitable contributions and employee expenses. Specific rules also apply to taxpayers using electronic storage and ADP systems to maintain books and records.

Even without the new burden of proof rules, a taxpayer failing to maintain adequate records faces serious consequences. The IRS may disallow a deduction, impose penalties for negligence or fraud or require the taxpayer to use an IRS-prescribed method to determine income.

The IRS permits a taxpayer who can prove records were destroyed by fire, flood or earthquake – or even in a non-natural casualty such as theft or loss – to reconstruct those records under most circumstances. If the taxpayer fails to keep adequate books and records, the IRS has several methods as its disposal to reconstruct the taxpayer's income.

Not all Trusts are Trustworthy

There's something about the word *trust* that makes people feel secure. In the financial world, however, the use of that word can be deceiving. Each year the IRS investigates fraudulent trust schemes that promise participants they will reduce or eliminate income taxes. In recent years, convictions for such schemes have increased. The convictions illustrate that many trust schemes do not provide promised federal income tax relief. In addition, buyers could be subject to civil and criminal penalties.

The courts have held many trust arrangements to be shams, with no economic substance. The resulting income and expenses are attributed to the actual earner of the income. Contrary to the claims of promoters, trusts are not a legal way to pay personal expenses with pre-tax dollars, reduce personal tax liability or avoid income or employment taxes.

Fraudulent trusts. Fraudulent trusts often hide the true ownership of assets and income or disguise the substance of transactions. Currently, two fraudulent arrangements are being promoted: a domestic package and a foreign package. The former refers to a series of trusts created in the United States. The latter are formed offshore and outside U.S. jurisdiction. The goal is to fraudulently reduce taxable income to nominal amounts. Although these schemes give the appearance of separating responsibility and control from the benefits of ownership, they are in fact controlled and directed by the taxpayer.

Here are some common fraudulent trust schemes CPAs should watch out for:

- ♦ ***Business Trust.*** This involves the transfer of an ongoing business to a trust. Also called an unincorporated business organization, a pure trust or a constitutional trust, it makes it appear that the taxpayer has given up control of his or her business. In reality, however, through trustees or other entities controlled by the taxpayer, he or she still runs day-to-day activities and controls the business's income stream. Such arrangements provide no tax relief.
- ♦ ***Equipment or Service Trust.*** This trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust. This type of arrangement has the same pitfalls as the business trust, and it will result in no tax reduction.
- ♦ ***Family Residence Trust.*** Taxpayers transfer family residences, including furnishings, to a trust, which sometimes rents the residence back to the taxpayer. The trust deducts depreciation and the expenses of maintaining and operating the residence, including gardening, pool service and utilities.
- ♦ ***Charitable Trust.*** Taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, education or recreation expenses on behalf of the taxpayer or family members. The trust then claims the payments as charitable deductions on its tax returns. These alleged charitable organizations often are not qualified and have no IRS exemption letter; hence contributions are not deductible. Charitable deductions are not allowed when the donor receives personal benefit from the alleged gift.

- ◆ *Foreign Trust.* These trusts often are domiciled in a foreign country that imposes little or no tax on trusts and also provides financial secrecy. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds ultimately are distributed or made available to the original owner, purportedly tax-free. In fact, the income from these arrangements is fully taxable.

If a taxpayer participates in a trust that improperly evades tax, he or she is still liable for taxes, interest and civil penalties. Violations of the Internal Revenue Code with the intent to evade income taxes may result in a civil fraud penalty or criminal prosecution. Civil fraud can include a penalty of up to 75% of the underpayment of tax attributable to the fraud, in addition to the taxes owed. Criminal conviction may result in fines up to \$250,000 and up to five years in prison.

During the 1990's, the IRS witnessed a substantial increase in both civil examinations and criminal investigations of fraudulent trusts. The tax court consistently found against such schemes, deeming them shams or merely grantor trusts that will not deliver the promised tax benefits.

The IRS cautions taxpayers to beware of sales pitches that sound too good to be true. If they are in doubt about investing in a trust, clients should be advised to seek guidance from a tax professional or from the IRS. Taxpayers who have erred by participating in a problem trust should file an amended return immediately. To report suspected tax fraud, call 800-829-0433. For more information about the IRS policy on fraudulent trusts, read IRS Public Announcement Notice 97-24, *IRS Warns of Abusive Trusts*, available at www.treas.gov/irs/ci/tax_fraud/notice.htm. Publication 2193, *Too Good to Be True Trusts*, at www.treas.gov/irs/ci/tax_fraud/alert.htm warns taxpayers to avoid trusts that advertise bogus tax benefits.

The Final Frontier

Who – if anyone – gets to tax transactions that take place in cyberspace? The question becomes more pressing as Amazon.com, ebay.com, etrade.com and similar Web sites become a more popular way to buy everything.

The Internet Tax Freedom Act (ITFA) enacted in 1998, puts a three-year moratorium on the imposition of new taxes on Internet access and electronic commerce. It also creates a 19-member commission to recommend how – and if – remote commerce including web sales should be taxed.

One proposal under consideration would declare the Internet a permanent tax-free zone. State governments, which depend heavily on sales tax revenue, see such a proposal as a threat to their sovereignty. Others are concerned such a change would give Internet sellers an advantage over conventional merchants.

Another solution is to extend current sales tax concepts to Internet transactions. Taxes would be levied based on the destination of a sale – usually the state where the buyer is located. To make this easier, the National Association has reached an agreement that would result in each state changing a single tax rate on all transactions.

A third possible outcome is to formulate a new method of taxation that recognizes the unique nature of remote commerce. One such proposal is a seller-based tax system that grants the seller's state the sole right to tax a transaction. While this is consistent with European methods, it differs dramatically from the way transactions are currently taxed.

It is unlikely the ITFA Commission will reach a decision within the required 19-month timetable. It does seem likely, however, that the days of untaxed Internet commerce are numbered.

Gimme Shelter

At a time when few things are certain a death and taxes, techniques that freeze the value of appreciating assets for estate tax purposes can be an important way for CPAs to help clients save money. One such technique is the qualified personal residence trust (QPRT). Because the regulations governing these trusts have changed since they first were created, CPAs now find they are less flexible. However, a new strategy has emerged that means QPRTs remain an attractive tax planning tool for certain homeowners.

Although qualified personal residence trusts are less flexible than when they first were created, they still can provide attractive tax benefits to certain homeowners. To set up a QPRT, a taxpayer transfers a remainder interest in his or her personal residence to someone else in trust while retaining possession of the residence for a term of years.

Under 1997 treasury department regulations, a taxpayer no longer can buy back the residence from the trust during its term. This was a common practice under prior law because it left trust beneficiaries with cash rather than a residence with a low-income tax basis.

Individuals or couples cannot use their annual gift tax exclusions to shelter QPRT transfers from tax. Rather, they must reduce their unified credit. While this reduces the amount they can leave tax-free at death, the hope is the tax savings on the property's subsequent appreciation will make the transaction worthwhile.

The property of a taxpayer can put in a QPRT includes his or her primary residence or a vacation home if personal use exceeds 14 days per year or 10% of the days it is rented out. The trustee can sell the residence during the trust term and has two years to reinvest the proceeds in a replacement residence.

Although the grantors cannot purchase the residence during the trust term, the remainder beneficiaries can buy it just before the trust ends in exchanged for a promissory note. When the trust terminates, the note is distributed to the children and disappears as a liability. The children's income tax basis in the residence now equals its purchase price and the parents can avoid capital gains on up to \$500,000 under IRC section 121.

What if a taxpayer does not have earned income but wants to take advantage of the benefits of an IRA? Or, what if she has the good fortune of receiving an unusually large bonus and wants to shelter some of the income from tax? Taxpayers can shelter their income through a charity gift arrangement called a deferred gift annuity. A deferred gift annuity involves a simple contract between a donor and a charity.

In exchange for an irrevocable gift of cash or securities, a charity agrees to pay the taxpayer or one to two other annuitants a fixed sum each year for life, beginning at least one year after the gift date. A portion of each payment is tax-free, which will increase each payment's after-tax value depending upon the taxpayer's bracket.

A minimum gift is usually \$5,000, payable in cash, mutual fund shares, or appreciated securities. In return, the taxpayer will receive an immediate income tax deduction for a substantial portion of the value of the gift.

Some people make one gift, other make gifts each year until retirement. Unlike other retirement savings vehicles, there are no limits on the amount that may be gifted.

The Safe-Harbor Solution

Effective as of 1999, the Small Business Job Protection Act of 1996 introduced safe-harbor formulas for 401(k) plans that eliminate the need for companies to perform annual nondiscrimination testing. These changes should allow small employers to contribute higher amounts on behalf of highly compensated employees (HCEs).

Nondiscrimination tests effectively eliminate the ability of many small businesses and professional firms to adopt 401(k) plans because non-HCEs often elect not to participate. The result is that HCEs can defer little or no income under the plan.

The safe-harbor formulas provide a way for employers to avoid nondiscrimination testing by adopting a plan with a relatively generous employer match – one that includes a contribution of at least 4% of pay on behalf of all eligible employees (depending on employee contributions).

Safe-harbor matching contributions must be 100% vested at all times. Such contributions generally may not be distributed to employees until the earlier of when they terminated employment or reach age 59 ½.

Watch out for IRA Rules

If you've been faithfully putting money into your Individual Retirement Account and other retirement plans, congratulate yourself. However, if you're currently contemplating retirement, you'll learn that saving diligently is only half of the equation.

One of the first decisions you need to make is whether to tinker with your present IRA. In addition to the traditional IRA, you may be eligible to establish a Roth IRA or convert your traditional IRA to a Roth. If you select a Roth IRA, you and your heirs generally won't pay income taxes on the distributions which accumulate tax-free as long as certain guidelines are followed.

However, unlike the traditional IRA, annual contributions to a Roth aren't deductible. You'll also probably owe taxes when you make the conversion. Not everyone will qualify for the conversion – a taxpayer's adjusted gross income must not exceed \$100,000.

Here are some other tips:

- ♦ Choose the correct distribution method. By age 70 ½, many people must begin withdrawing annually from their traditional IRAs or face tax penalties. Retirees can take their minimum payments using one of two methods that will calculate life expectancy. Once they choose, however, they can't switch to the other formula even if the tax consequences are disastrous. For a Roth IRA, there are no mandatory distributions during your lifetime.
- ♦ Check beneficiaries. Make sure the beneficiaries listed on your IRAs are correct. If the paperwork isn't correct, however, your desires won't be honored later even if you've named the correct beneficiaries in a will because beneficiary designations override what's in the will.
- ♦ Pay attention to the tricky rollover regulations. If you're planning to roll over your retirement distribution from your employer, you'll want to avoid a mandatory 20% federal tax withholding. To avoid paying the tax, you should instruct your employer to send your retirement nest egg directly to a rollover IRA account of your choosing.

Insrutable Index Funds

With the stock market's rise, index funds have grown to gigantic proportions. But they aren't right for all investors. By understanding the investment-management process of index funds CPAs will be better able to advise their clients or employers.

An index fund is a mutual fund that buys the same securities as those in an index. For example, S&P 500 index funds track the total return of 500 of the largest public company stocks in the United States. The stocks that make up that index are determined by the six-member S&P 500 index community.

There are a number of reasons why investors are attracted to index fund investing. The S&P 500 has consistently outperformed most equity portfolio managers in recent years. Stock turnover is low, so expenses are also low, giving index funds a head start in performance. Low securities turnover also results in better timing of realized gains.

There is, however, a downside to investing in index funds. Because stock selection is not based on fundamentals, the fund usuall7 plays homage to past performance, not future potential. In addition, the fund is not diversified in terms of market capitalization, the investment approach is inherently passive; and there is no risk control in a down market.

Active portfolio management may be a viable alternative for some investors. Active managers serve their clients best by employing a sell discipline that locks in gains and redeploys assets to more attractive investment opportunities. CPAs should be careful when recommending index funds. The best way to fulfill an investment goal is through thoughtful and deliberate investment choices.

Tax-Exempts and Fiduciaries

For CPAs who work for or advise tax-exempt entities such as charities, retirement Plans or other nonprofit organizations, it's important to be aware that the client has fiduciary responsibility to manage the organization's assets with care and prudence. Additional factors to keep in mind:

- ◆ If the entity does not have a well-defined investment policy, then the organization's investment approach may be adrift. The entity should establish a policy that addresses the organization's goal for its investment portfolio and the boundaries within which portfolio management will occur – asset allocations, appropriate levels of risk, performance goals, portfolio management costs and methods for objective ongoing evaluation.
- ◆ The organization's investment policy may not accommodate the passive nature of index fund investments. For example, an index fund may be too heavily weighted in one sector, such as technology, or it might invest in companies that the organization would not buy shares of directly because of social concerns.
- ◆ Mutual funds may conduct activities that an exempt organization would not engage in during the course of ordinary business care and prudence, such as margin debt obligations, investments in futures contracts and repurchase agreements. CPAs should consider whether employing these devices complies with their client's investment policy.

Active Investment Strategies

To actively approach the market, CPAs should follow these strategies:

- 1.** Develop a specific investment goal for your client or employer and establish an investment policy that governs the management of the portfolio.
- 2.** Review the prospectus of any potential or existing investment to help determine whether the fund's investment policy matches your understanding and expectations. If the prospectus does not provide sufficient information, dig deeper. Request the "Supplemental Part B Prospectus: (statement of additional information) from the last fund.
- 3.** Incorporate the basics: research, value, buying low and selling high, rather than being swept up in market hype about index funds.
- 4.** Engage in an active rather than passive approach to investing. Select managers with a defined management discipline that liquidates overvalued stocks in favor of re-balancing in undervalued issues. Avoid the market creep of momentum investing presented by index funds.
- 5.** Blend the advantages of growth and value styles. These styles tend to balance one another during up- and down- market cycles.

The Question to Outperform

The debate over the efficiency of financial markets leaves investors – and those who advise them – to answer the question: Can active portfolio managers exploit market inefficiencies enough to overcome the costs of their efforts? For those who answer no, the best option is to own passively managed funds.

Mutual funds incur five types of expenses: operating expenses and distribution fees, the cost of cash, trading expenses, market-impact costs and taxes. CPAs should be aware that each of these categories creates a cost hurdle of 1% or more than active managers must surmount to outperform the less-expensive passive management strategy.

Operating expenses receive the most investor attention because they are the most visible. The average operating expense for an actively managed fund is 1.53%. For an index or passive-asset-class fund, the expenses range is between 0.2% and 0.5%.

Taxes on fund distributions are the biggest expense most investors face. One study showed that taxes cut investor returns by 57.5%. To help combat this, CPAs can recommend a wide range of passively managed asset-class or index funds that are also tax managed.

The best way to achieve the greatest percentage of available returns is to minimize all fund expenses. Index and passive-asset-class funds are a winning strategy because investors pay much lower fees.

Cristofani Trust Examined

The Cristofani trust is a powerful tool for maximizing gift tax annual exclusions; as two U.S. Tax Court cases demonstrate, the Cristofani trust concepts offer substantial estate planning benefits with less uncertainty than other planning concepts.

Burden of Proof in Tax Controversies Explored

Practitioners and taxpayers will benefit from an overview of the fundamental rules regarding burden of proof and the standard of proof in tax adjudications; this article describes both pre- and post- IRS Restructuring and Reform Act.