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HOW LONG SHOULD CLIENTS RETAIN TAX RECORDS?

At this time of year, when you are gathering records for return preparation, many clients ask how long they should keep their records. Use the following as a guide.

PERSONAL INCOME TAX RECORDS

These records may have to be produced if the Internal Revenue Service (or a state or local taxing authority) were to audit your return or seek to assess or collect a tax. In addition, lenders, co-op boards or other private parties may require you to produce copies of your tax returns as a condition to lending money, approving a purchase or otherwise doing business with you.

Keep returns indefinitely and the supporting records usually for six years. In general, except in cases of fraud or substantial understatements of income, the IRS can only assess tax for a year within three years after the return for that year was filed (or, if later, three years after the return was due). For example, if you filed your 1996 individual income tax return by its original due date of April 15, 1997, IRS would have until April 15, 2000, to assess a tax deficiency against you. If you filed your return late, IRS generally would have three years from the date you filed the return to assess a deficiency.

The problem with the three-year rule is that the assessment period is extended to six years if more than 25% of gross income is omitted from a return. In addition, the assessment period does not begin to run until a return is filed. Therefore, if the IRS claims you never filed a return for a particular year, it can assess tax for that year at any time (even beyond three or six years), unless you can prove you did file. Proving you filed would, of course, be impossible after you have discarded your returns.

While it's impossible to be completely sure the IRS will not at some point seek to assess tax, retaining tax returns indefinitely and important records for six years after the return is filed should, as a practical matter, be adequate.

RECORDS RELATING TO PROPERTY

Keep in mind the tax consequences of a transaction that occurs in one year may depend on things that happened in earlier years—and that the period for which you should retain records must be measured from the year in which the tax consequences actually occur. This may be significant, for example, where you sell property you bought years earlier.

For example, suppose you bought your home in 1980 for $100,000 and made an additional $20,000 of capital improvements in 1988. To determine the tax consequences of the sale, it's necessary to know your basis (i.e., original cost plus capital improvements). If you sell your home in 1998, and your return for that year is

audited, you may have to produce records relating to the purchase in 1980 and the capital improvement in 1988 to be able to prove your basis. Therefore, those records should be kept for at least six years after your 1998 return has been filed instead of just six years after the transactions they relate to occurred. (Even though as much as $250,000 of homesale gain can now escape tax (up to $500,000 for joint return filers), you should still retain all records relating to home purchases and improvements. There's no telling how much the home will be worth when it's sold, and there's no guarantee the homesale exclusion will still be available when the future sale takes place.)

When new property takes the basis of old property, records relating to the old property should be kept until six years after the sale of the new property is reported. For example, suppose you purchased a car for business use in 1995 and you traded it in on a new car for business use in 1998. If you sell the new car in 1999, your basis in the new car will determine whether you have a tax gain or a tax loss on the sale, and your basis in the new car is determined, at least in part, by your basis in the car you traded in1995. Accordingly, records relating to your old car should be kept until 2006 (i.e., for six years after your 1999 return is filed).

Similar considerations apply to other property which is likely to be purchased and sold–for example, stock in a business corporation or in a mutual fund, bonds (or other debt securities), etc. In particular, remember if you reinvest dividends to purchase additional shares of stock, each reinvestment is a separate purchase of stock, and the records of each reinvestment should be kept for at least six years after the return is filed for the year in which the stock is sold.

Because the calculation of the casualty and theft loss deduction is determined in part by your basis in the damaged or stolen property, you'll need to have records to support that basis, until six years after you file the return claiming the loss deduction.

SEPARATION OR DIVORCE

If separation or divorce becomes a possibility, be sure you have access to any tax records affecting you that are kept by your spouse. Or better still, make copies of the tax records, since in such situations, relations may become strained and access to the records difficult.

Your records should include a copy of the divorce decree or agreement of separate maintenance, which may be needed to substantiate alimony payments and distinguish them from child support or a property settlement. Copies of all joint returns filed and supporting records are important, since the liability for tax on a joint return is joint and several and a deficiency may be asserted against either spouse. Your records should also include agreements or decrees over custody of children and any agreements as to who is entitled to claim an exemption for them. Retain records of the cost of all jointly-owned property. Also, get records as to the cost or other basis of all property your spouse or former spouse transferred to you during your marriage or as a result of the divorce, because your basis in that property is the same as your spouse's or former spouse's basis in it was.

 # LOSS OR DESTRUCTION OF RECORDS

To safeguard your records against loss from theft, fire or other disaster, you should consider keeping your most important records in a safe deposit box or other safe place outside your home. In addition, consider keeping copies of the most important records in a single, easily accessible, location so you can grab them if you have to leave your home in an emergency.

If, in spite of your precautions, records are lost or destroyed, it may be possible to reconstruct some of them. For example, a paid tax return preparer is required by law to retain, for a period of three years, copies of tax returns or a list of taxpayers for whom returns were prepared. Most preparers comply with this rule by retaining copies (sometimes for a longer period than the legally required three years) and can furnish a copy if yours is not available. (In the case of my own clients, I retain copies of returns for three years after the last year of service.) Similarly, other professionals who assisted you in a transaction may retain records relating to the transaction. For example, a stockbroker through whom you bought securities may be able to help you to determine the basis of the securities, and an attorney who represented you in the purchase of your home may retain records relating to the closing. Nonetheless, because you can never be sure whether those persons will actually have the records you need, the safest course of action is to keep them yourself, in as safe a place as possible.

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