Thinking of Tossing Old Tax Records? Read This First.

Article Highlights:

- Reasons to Keep Records
- Statute of Limitations
- Maintaining Records of Asset Basis
- Keeping Records for Carryforward Losses

Now that your taxes have been completed for 2016, you are probably wondering which old records can be discarded. If you are like most taxpayers, you have records from years ago that you are afraid to throw away. It would be helpful to understand why the records must be kept in the first place.

Generally, we keep tax records for two basic reasons: (1) in case the IRS or a state agency decides to question the information reported on our tax returns, and (2) to keep track of the tax basis of our capital assets so that the tax liability can be minimized when we dispose of them.

With certain exceptions, the statute for assessing additional taxes is **three years** from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states is one year longer than the federal law. In addition to lengthened state statutes that cloud the recordkeeping issue, the federal three-year assessment period is extended to six years if a taxpayer omits from gross income an amount that is more than 25 percent of the income reported on a tax return. And, of course, the statutes don't begin running until a return has been filed. There is no limit where a taxpayer files a false or fraudulent return to evade taxes.

If an exception does not apply to you, for federal purposes, most of your tax records that are more than three years old can probably be discarded; add a year or so to that if you live in a state with a longer statute.

> ***Examples -*** *Sue filed her 2013 tax return before the due date of April 15, 2014. She will be able to dispose of most of the 2013 records safely after April 15, 2017. On the other hand, Don files his 2013 return on June 2, 2014. He needs to keep his records at least until June 2, 2017. In both cases, the taxpayers may opt to keep their records a year or two longer if their states have a statute of limitations longer than three years. Note: If a due date falls on a Saturday, Sunday or holiday, the due date becomes the next business day.*

The big problem! The problem with the carte blanche discarding of records for a particular year because the statute of limitations has expired is that many taxpayers combine their normal tax records and the records needed to substantiate the basis of capital assets. These need to be separated, and the basis records should not be discarded before the statute expires for the year in which the asset is disposed. Thus, it makes more sense to keep those records separated by asset. The following are examples of records that fall into that category:

- <u>Stock acquisition data</u> - If you own stock in a corporation, keep the purchase records for at least four years after the year the stock is sold. This data will be needed to prove the amount of profit (or loss) you had on the sale.

- <u>Stock and mutual fund statements</u> (If you reinvest dividends) - Many taxpayers use the dividends they receive from stocks or mutual funds to buy more shares of the same stock or fund. The reinvested amounts add to the basis in the property and reduce gain when it is finally sold. Keep statements at least four years after the final sale.

- Tangible property purchase and improvement records - Keep records of home, investment, rental property, or business property acquisitions AND related capital improvements for at least four years after the underlying property is sold.

For example, because of the generous $250,000 ($500,000 for joint filers) home gain exclusion available to most homeowners, some taxpayers have become lax in maintaining home improvement records, thinking the large exclusions will cover any potential appreciation in the home's value. But that exclusion may not always be enough to cover sale gains, particularly in markets where property values have steadily risen, so records of home improvements are vital. Records can be important, so please use caution when discarding them.

If you sell securities (stocks, bonds or mutual funds) that result in a loss, after you've offset any capital gains from other sales, you may end up with a larger loss than can be deducted in one year (maximum $3,000 or $1,500 if married filing separate). In that case, you are allowed to carry over the excess loss to use in future years. When this happens, you will need to keep the purchase and sale records of the securities for four years after filing the return when the last of the carryover loss is used.

Similarly, if you have a net operating loss from a business that is being carried forward to future years, you'll need to keep the business records from the loss year until four years after the return on which all of the loss was used up.

What about the tax returns themselves? While disposing of the backup documents used to prepare the returns can usually be done after the statutory period has expired, you may want to consider keeping a copy of your tax returns (the 1040 and attached schedules/statements plus your state return) indefinitely. If you don't have room to keep a copy of the paper returns, digitizing them is an option.

If you have questions about whether or not to retain certain records, give this office a call first; it is better to check before discarding something that might be needed down the road.