



## TAX SAVING STRATEGIES NEWSLETTER

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### HOW LONG SHOULD YOU KEEP TAX RECORDS?

This newsletter will help you answer the question of how long you should keep your Federal and California income tax records. **Here Is Something To Think About:** Good records can shift the power from the tax authorities to the taxpayer. Taxpayers must support any tax deductions or they can be disallowed—the burden of proof is on the taxpayer. When you have tax records the burden is shifted to the tax authorities—the Internal Revenue Service (IRS) has to disprove your tax deductions. By keeping tax records the power shifts from the tax authorities to the taxpayer.

#### Basis Rules

- Keep income tax returns, gift tax returns, estate tax returns **indefinitely**
- Keep documents supporting tax filings **for six years or seven years** if you filed California income tax returns

In general, except in cases of fraud or substantial understatements of income, the IRS can only assess tax with respect to a year within three years (four years for California) after the return was filed or originally due if later. For example, if you filed your 2007 individual income tax return on or before its original due date of April 15, 2008, the Service could assess tax until April 15, 2011. If you filed your return after the original due date, it

has three years from the date you filed. The assessment period is extended to six years if more than 25% of gross income is omitted from a tax return. The IRS can assess tax for an indefinite time period if no income tax return was filed. They can question you about your income tax returns indefinitely, but they can only assess tax during these time periods. Therefore, if the IRS claims that you never filed a return for a year, it can assess tax for that year at any time (even beyond three years or six years), unless you can prove that you did file the income tax returns. Proving that you filed would be difficult if you do not have the income tax return.

Therefore, while it is impossible to be completely sure that the Service will not at some point seek to assess tax, retaining tax returns indefinitely and supporting records for six years (seven for California) should be adequate.

#### Special Considerations for Real Estate in General

Records relating to property may have to be kept longer than other records. Keep in mind that 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 that you bought years earlier.

For example, suppose you bought your home in 1985 for \$200,000, and made an additional \$20,000 of capital improvements in 1988. You then sell your home in 2007. In order to determine the tax consequences of the sale, it is necessary to know your tax basis (usually how much you paid for the house) which depends on the earlier transactions. If your 2007 return is audited, you may have to produce records relating to the purchase in 1985 and the capital improvement in 1988 in order to substantiate your tax basis. In effect, therefore, such records should be kept until six or seven years after the 2007 tax returns were filed or originally due, if later—even though they relate to years long past.

Another example—is where property is "rolled over" in a transaction in which the new property takes the same basis as the old property. Records relating to the old property should be kept for a time period based on the year in which the sale of the new property is reported. Suppose you bought a rental property in 1985, and then in 2005 you exchanged it in a tax free exchange for another rental property. You sell the new rental property in 2007. Your tax basis in the new rental property (which would determine your gain or loss on the 2007 sale) would include your basis in your old rental property. In that case, you should retain records from the 1985 purchase for six or seven years after the 2007 tax return was originally due or was filed, whichever is later. If the 2007 income tax return was filed on April 15, 2007 the records relating to this tax year should be kept until April 15, 2013 or 2014.

## **Special Concerns for Rental Real Estate and Other Depreciable Property**

For rental real estate or depreciable business property, keep records of the property's cost, the purchase date, the method used to calculate depreciation and a schedule of all depreciation claimed on the property. Keep these records for the time period related to the tax return where the sale is reported.

## **Special Concerns for Other Types of Property**

The time period for keeping records for property which is likely to be sold (for example, stock and other securities such as mutual funds etc.) should be based on the tax return in which the sale is reported. You should keep records that show your tax basis in Individual Retirement Accounts (IRA's) or Roth Individual Retirement Accounts (ROTH IRA's). If you made nondeductible contributions to your IRA, keep the records about your nondeductible contributions for the time period related to the last income tax returns in which you reported income from the IRA or Roth IRA.

## **Separation or divorce**

In the case of separation or divorce, be sure you have copies of the tax records, since relations may become strained and access to records held by your former spouse may be 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 of who should claim an exemption for them. Retain records of the cost of all jointly-owned

property. And get from your spouse or former spouse records on the cost or other basis of all property transferred to you by them during your marriage or as a result of the divorce, because your basis in this property is the same as your former spouse's basis.

### **How To Safeguard Your Records**

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

### **If Your Records Are Lost Or Destroyed**

If your records are lost or destroyed, it may be possible to reconstruct 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 at least six years.) 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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