AdamsSamartino
CERTIFIED PUBLIC ACCOUNTANTS

Dear Client and Friends:

You have asked for guidance on how long you should retain your personal income tax records. These records may have to be produced if IRS (or a state or local taxing authority) was to audit your return or seek to assess or collect a tax. In addition, lenders, co-op boards, or other private parties may require that you 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, 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 your 2009 individual income tax return is filed by its original due date of April 15, 2010, IRS will have until April 15, 2013 to assess a tax deficiency against you. If you file your return late, IRS generally will have three years from the date you filed the return to assess a deficiency.

However, the three-year rule isn't ironclad. The assessment period is extended to six years if more than 25% of gross income is omitted from a return. In addition, where no return was filed for a tax year, IRS can assess tax at any time (even beyond three or six years). If IRS claims that you never filed a return for a particular year, keeping a copy of the return will help you to prove that you did.

While it's impossible to be completely sure that IRS won't 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. If you file your returns electronically, be sure to get copies from the company that prepared and/or filed your return; it is required to provide you with a paper copy of the return.

Records relating to property may have to be kept longer.

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 1986 for $100,000 and made $20,000 of capital improvements in 1993. To determine the tax consequences of the sale, it's necessary to know your basis (i.e., original cost plus later capital improvements). Thus, if you sell your home in 2010, and your return for that year is audited, you may have to produce records relating to the purchase in 1986 and the capital improvement in 1993 to be able to show what your basis is. Therefore, those records should be kept for at least six years after your 2010 return is filed instead of just six years after the transactions they relate to occurred. (Even though as much as $250,000 of home-sale gain can 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 that the home-sale 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 bought a car for business use in 1999 and you traded it in on a new car for business use in 2002. If you sell that car in 2009, your basis in the car will determine whether you have a tax gain or a tax loss on the sale, and your basis in the car is determined, at least in part, by your basis in the car you traded in for it in 2002. Accordingly, records relating to your old car should be kept until 2016 (six years after your 2009 return is filed in 2010).

Similar considerations apply to other property which is likely to be bought and sold—for example, stock in a business corporation or in a mutual fund, bonds (or other debt securities), etc. In particular, remember that if you reinvest dividends to buy additional shares of stock, each reinvestment is a separate purchase of stock. 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.

In case of 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. Copies of all joint returns filed and supporting records are important, since both spouses are liable for tax on a joint return, and a deficiency may be asserted against either spouse.

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. 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 that 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 a period of ___ 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 third parties will actually have the records you need, the safest course of action is to keep them yourself, in as safe a place as possible.

If you have any questions or wish to discuss this matter further, feel free to give me a call.

Sincerely,
Adams Samartino & Co., CPAs