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FOR THE RECORD

WHEN TO TOSS OLD TAX RECORDS

BY JERROLD J. STERN

How long should tax records be kept? The answer depends on the type of records and other circumstances.

There are tax and nontax reasons for keeping records. For tax purposes, income sources and amounts need to be identified through W-2 wage statements, Forms 1099 (interest income, mutual fund income, stock transactions) and other documentation.

Records also may be needed for insurance purposes or to obtain a loan. Individuals should compare annual earned income with the earnings shown on their annual Social Security statements (for workers older than 25).

Expenses need to be documented to support deductions in the event of an IRS audit. Documentation can be in the form of a cash receipt, credit card statement or cancelled check. Interest and penalties may be levied if deductions are disallowed for lack of records.

Keeping tax returns is helpful to guide the preparation of future tax returns and for filing an amended tax return. The IRS can furnish copies of your prior-year tax returns if necessary.

Records should be kept to document the cost (basis) of real and personal property. In particular, the cost of improvements

to real estate increases the basis of the property and, thus, decreases the amount of taxable gain when the property is sold. Such records are also necessary to support insurance claims and casualty loss deductions, as well as depreciation deductions for business and investment structures and improvements.

Statutes of Limitations

IF you . . .	THEN the period is . . .
1. Owe additional tax and (2), (3), (4) and (5) do not apply to you	Three years
2. Do not report income that you should and it is more than 25% of the gross income shown on your return	Six years
3. File a fraudulent return	No limit
4. Do not file a return	No limit
5. File a claim for a loss from worthless securities	Seven years

Source: IRS Publication 552 - Recordkeeping for Individuals

Records associated with tax returns should be kept at least until the statute of limitations runs out. The statute of limitations is the time during which the IRS is allowed to audit a tax return. The table above shows various lengths of statutes of limitations. The minimum, which applies to most people, is three years.

Statutes of limitation periods and associated penalties for errors vary. As indicated in the table, omitted income that exceeds 25 percent of gross income results in a six-year statute of limitations. For example, assume a taxpayer has $100,000 gross income from real estate commissions. If the Realtor withdrew $30,000 of taxable funds from a pension plan (either the taxpayer's or an inherited plan) and unintentionally neglected to include that income on the tax return, the six-year statute of limitations would apply. As long as the omission was unintentional, a "negligence" penalty of 20 percent of the tax due, plus interest, would have to be paid.

Assume the Realtor is in the 28 percent tax bracket. The additional tax would be $8,400 ($30,000 × 28 percent). A $1,680 penalty also would have to be paid ($8,400 × 20 percent) plus interest on both the tax and the penalty.

Fraud is another matter. Fraud exists if there is a deliberate attempt to evade tax. Typically, fraud exists when large amounts of taxable income are not included on the tax return.

Fraud can be found to be a criminal act depending on the circumstances. For example, famed baseball player Pete Rose did not report sizeable amounts of income from gambling and sales of memorabilia. He served five months in prison for criminal fraud.

For most people, tax records other than those pertaining to assets (real estate and securities, for example) could be discarded after three years. Even so, a longer period — seven or more years — would be prudent.

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THE TAKEAWAY

At a minimum, tax records should be kept three years. However, a period of seven or more years is recommended. Tax and nontax factors play a role in the decision.

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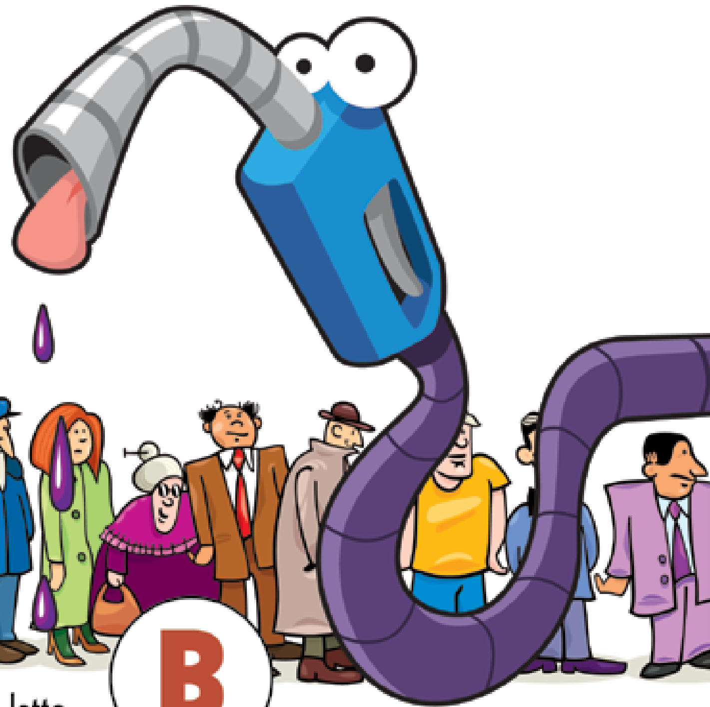

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