

Tax record-keeping tips

Nothing lasts forever, but you wouldn't believe it by looking at some people's record-keeping systems. Die-hard pack rats insist on keeping every scrap of paper, just in case.

And when it comes to tax paperwork, folks are even more adamant. These documents will save me, they argue, if an Internal Revenue Service auditor comes visiting.

But that's not necessarily the case, say tax and organizational experts.

There are limits

When it comes to tax-related documents, you should [hang on to records](#) that help you identify sources of income, keep track of expenses, determine the value of property, prepare tax returns or support claims made on those returns. However, common sense -- as well as storage space -- should be your guide.

The rule of thumb for tax papers is hold onto them until the chance of audit passes. Usually, this is three years after filing. But if the IRS suspects you underreported your income by 25 percent or more, it gets six years to check into your tax life.

That's why most accountants advise taxpayers, even those who are meticulous filers, to keep tax documents for six to 10 years.

Use it or lose it

This means 1040 forms and any accompanying tax schedules, along with the documents supporting the return, such as W-2s, 1099 miscellaneous income statements and receipts or canceled checks verifying tax-deductible expenses.

But don't go overboard. If you used something to claim a deduction, keep it. If not, shred it. For example, all those medical bills are useless -- and just taking up space -- if you didn't accumulate enough to meet the deduction threshold.

Some items, however, have a longer shelf life. These generally are assets that a taxpayer will eventually sell, triggering a tax bill. So if you have a pension plan, own a home or invest in the stock market, tax pros recommend keeping these records indefinitely. Or at least until three years after you dispose of the asset.

Housekeeping -- and selling -- records

For most taxpayers, the biggest asset -- and potential tax bill -- is a [home](#).

While the [tax rules for home sales](#) have changed in recent years, meaning sale profits don't automatically face IRS charges, any paperwork relating to a residence should be kept for as long as the home is owned.

Single home sellers now can net capital gains of \$250,000 (double that for married couples) before owing the IRS. To determine whether sale profits fall within the tax-free limits, the seller must accurately establish a [residence's basis](#). That means that records related to a home's value -- settlement papers and receipts for improvements and additions -- are critical.

And if you sold a house before May 7, 1997, that could affect your current home's basis. With home sales back then, taxpayers were able to defer tax on any gain by using the profit to purchase another home and filing IRS Form 2119. If the home you're now selling is the one your pre-1997 sale proceeds were rolled into, you'll need that information -- and those old forms -- to figure your current property's basis and any potential tax bill.

Taking stock of investments

Fast on the heels of home sales as tax triggers (and record-keeping headaches) are stock transactions.

A couple of years ago, it was harder for people to invest so a lot were more conservative and went to a bank for a certificate of deposit. But with online trading, people are investing more. Keeping track of a CD or two wasn't that difficult, but when you move on to stocks, the tax record keeping becomes critical.

Investment account statements contain financial data that a taxpayer will need as long as the stock or mutual fund is owned. On the stock side, there

may be splits that change the value of the holding and, therefore, the eventual worth of the stock, which is used to determine the taxable basis.

For mutual funds with reinvested dividends, owners pay tax each year on these earnings. These taxes are used to increase the funds basis so when the fund is sold, the final tax bill will be less. Without statements, it's easy to lose track of those payments, says Durand, and a fund owner could inadvertently pay double taxes on earnings.

Retirement record requirements

And then there are all those retirement savings plans, with all those different rules.

Contributions to traditional IRAs often are tax-deferred. But sometimes already-taxed money goes into these accounts, too. What happens to your taxes when you reach 59½ and start taking money out?

That depends in large part on your record keeping.

Statements from IRA fund managers should note whether contributions were tax-deferred or already taxed. The financial reports also keep track of the tax-deferred earnings, compounding year after year. These documents can help you make your case to the IRS when it comes time to pay the tax bill, so hang on to them all for as long as you have the account.

IRS Form 8606 also can help track retirement plan taxes. This form, which is filed only in the years that nondeductible contributions are made, calculates the taxable basis of an IRA. File and keep copies of each 8606 with your retirement plan data.

Business considerations

If you operate a small business, from a moonlighting job to a small operation with several employees, dealing with records becomes a bit more complex. But even then, it doesn't have to overwhelm you.

The IRS generally focuses on self-employed travel and entertainment expenses, scrutinizing returns to make sure all the expenses are really related to the business and can be proven. In these cases, complete and

accurate -- but not overdone -- contemporaneous records need to be kept until the audit threshold passes.

Unlike personal bank statements, business financial account records should be kept permanently. Similarly, anyone who has employees should hang onto employment information and related tax returns for as long as the business is running. And don't shred articles of incorporation, company bylaws, stockholder minutes, and trademark and copyright applications.

Pick a system, any system

Once you've identified critical records, the next step is to decide how to keep the data. Electronic bill paying can help keep track of your financial and tax life, but so can a plain old check register, as long as expenditures are entered faithfully.

It doesn't matter if it's a filing cabinet, cardboard boxes or a complex computer program. The key is to find your record keeping comfort level, pick a system and stick with it.

And when it comes to taxes, it's even more important to be proactive in record keeping. Start now rather than waiting until next April's tax filing deadline. Such diligent organization could make any IRS examination easier.

In any kind of audit, the IRS is more forgiving if you make an honest mistake rather than if you're sloppy or fraudulent.