

How Long Should I Retain My Tax Records?

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While one of your more more excitable high school classmates will tell you that purchasing and holding onto your senior yearbook in perpetuity is a graduate's duty to their fellow classmates, maintaining tax records is actually a real part of your duties as a taxpayer. But unlike hauling around an 8.5" x 11" yearbook, keeping track of and maintaining tax records is time-consuming and a real hassle.



And if you haven't made the transition yet to electronic documents, your tax records can take up valuable physical storage space. Clearing some of the clutter by destroying old tax records may seem like an attractive option, but in the event of an audit, you could live to regret that decision.

So, what's the least you can do to maintain your records and minimize storage requirements while protecting yourself in the event of an audit? In this SWC singlette, we review tax record retention requirements and related issues to help you answer these questions for yourself.

Tax Record Retention Requirements

Every taxpayer is required by Internal Revenue Code (IRC) Section 6001 to maintain adequate tax records and to make those records available to the IRS upon request. The

Section 6001 regulations also require taxpayers to keep the records for as long as they may be material to tax law administration. In that regard, the IRS stated in Revenue Procedure 98-25, “*at a minimum, this materiality continues until the expiration of the period of limitations for assessment, including extensions, for each tax year.*”

Unfortunately, the IRS has issued no binding guidance specifically stating how long tax records must be kept.

Therefore, when determining how long to keep tax records, we typically look at the relevant *statute of limitations periods* – the period of time a taxpayer can amend a return to claim a credit or refund or the IRS can assess additional tax. The statute of limitations begins running from the return’s original due date, or the date filed, if later, but the period varies depending on the situation:

- Three years, generally, for income tax returns, according to IRC Sec. 6501(a). For example, if you filed your 2015 Form 1040 on or before April 18, 2016, the IRS had until April 18, 2019, to audit the return and assess a deficiency.
- Six years if there’s a substantial (more than 25 percent) understatement of gross income, according to IRC Sec. 6501(c).
- No statute of limitations for fraudulent returns or if no return is filed, according to IRC Sec. 6501(c).
- Special statutes of limitation for certain deduction types; for example, IRC Sec. 6511(d)(1) provides a seven-year statute of limitations with respect to any deductions you claim for bad debts or worthless securities.

We recommend adding one year to the statute of limitations. Using this approach, we arrive at the following tax record retention guidelines:

- Keep most of your income tax records for a minimum of four years.
- For additional protection, retain them for at least seven years.
- Consider applicable state tax statutes since they may include unique record retention requirements. (Assuming you filed your federal and state returns at the same time, compliance with federal tax record retention guidelines should be sufficient for state compliance as well.)
- If a federal, state, or local return is filed fraudulently or if no return is filed, the period for assessment generally remains open.
- Retain certain records longer (in some cases, indefinitely):
 - Records substantiating the cost basis in property that may be sold (such as fixed assets or investments) should be retained based on the record retention period for the year the property is sold.
 - Depreciation records for a fixed asset should be kept based on the record retention

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period for the last year depreciation expense on the asset is claimed.

- Tax returns, IRS and state audit reports, general ledgers, and financial statements should normally be kept indefinitely.
- Records needed for nontax reasons, such as insurance policies, leases, real estate closing statements, and employee payroll records may need to be kept indefinitely. Consult your attorney to determine how long to retain legal documents.

Establishing Document Destruction Policies and Procedures

If you own a business, put your documentation destruction policies and procedures in writing. Why? For two good reasons:

- Written policies prevent the loss of important data.
- If you destroy tax documents that the government needs later for audit or litigation purposes, written policies can help you prove that the documents were destroyed in the ordinary course of business and not for the purpose of eliminating potentially incriminating information.

Pro Tip: Consult your attorney when writing your *document destruction policies and procedures* to ensure compliance with federal, state, and local assessment and record retention periods.

Complying with Computer Records Maintenance Requirements

In Revenue Procedure 98-25, the IRS provides specific rules on how to retain accounting and financial data on a computerized system for later review or audit. These rules apply to almost any type of federal tax record that is not maintained on a manual system.

The computerized record retention rules apply to all taxpayers with at least \$10 million of assets at the end of a tax year. For taxpayers with less than \$10 million of assets, the rules apply if at least one of the following conditions exists:

- Information to support an amount of income, deduction, credit, or other item on a return is not available in hard copy but is available in a computerized format.
- Computations were made on a computer and cannot be reasonably verified or recomputed without the use of a computer; for example, last-in, first out (LIFO) inventory calculations from a software program.
- The IRS notifies the taxpayer that computer records must be retained.

If you use accounting software, your business is likely to meet at least one of these conditions, so even if you don't have at least \$10 million of business assets your business is likely to be subject to the computer record retention rules. However, regardless of whether your business is subject to computer record retention rules, you still have an obligation to retain hardcopies of the same information.

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Here are the computer record retention rules in a nutshell:

- Your computerized records must support and verify entries made on your tax return and be sufficient for determining your correct tax liability.
- Your computerized records must reconcile with your books and your returns and provide an audit trail.
- Your computerized records must contain enough transaction-level detail to identify the source documents.
- You must make all computerized records available to the IRS upon request in a form that the IRS can process.
- You must provide the IRS with the resources to process the computerized records, such as hardware and software, terminal access, computer time, and personnel.
- You must provide to the IRS, upon request, documentation of the business processes that (a) create, modify, and maintain the records; (b) support and verify entries made on your return and determine the correct tax liability; and (c) provide evidence of the authenticity and integrity of your records.
- If you're using a computer-to-computer exchange of information (Electronic Data Interchange or EDI), you must retain the records that alone, or in combination with any other records, contain all the information that the IRS requires of hardcopy books and records. For example, a taxpayer using EDI technology to receive electronic invoices from suppliers may not have product descriptions on the EDI transactions. To have complete records, the taxpayer would have to supplement its EDI records with product code description lists.
- You must promptly notify the IRS if any computerized records are lost, stolen, destroyed, otherwise no longer capable of being processed, or found to be incomplete or materially inaccurate.

The IRS can modify or waive any part of the computerized record retention requirements you're subject to by way of a record retention limitation agreement.

Failure to comply with the record retention requirements for computerized systems can potentially result in the imposition of the Section 6662 accuracy-related penalty. If the failure is caused by an intentional disregard of the rules under IRC Section 7203, the penalty can be a fine of up to \$100,000 or imprisonment for not more than one year (or both) along with the costs of prosecution.

Complying with Electronic Storage Systems Requirements

If you have a business other than farming, the IRS requires that you maintain a bookkeeping system, in which case you can take advantage of the electronic storage system rules in Revenue Procedure 97-22. These rules permit you to convert paper documents into

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electronic images for storage and then destroy the originals. Electronic storage enables you to view or reproduce the documents without using the program used to create them (this is in contrast to “computer storage,” which applies to accounting programs).

According to the IRS requirements for an electronic storage system, the system must:

- Ensure an accurate and complete transfer of the hard copy or computerized books and records to an electronic storage medium.
- Index, store, preserve, retrieve, and reproduce the electronically stored books and records.
- Include reasonable controls to ensure the integrity, accuracy, and reliability of the electronic storage system and to prevent and detect the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of the electronically stored books and records.
- Include an inspection and quality assurance program evidenced by regular evaluations of the electronic storage system, including periodic checks of electronically stored books and records.
- Exhibit a high degree of legibility and readability when displayed on a video display terminal and when printed.
- Provide support for the taxpayers’ books and records. For example, the information maintained in an electronic storage system and the taxpayer’s books and records must be cross-referenced to provide an audit trail between the general ledger and the source documents.

For each electronic storage system used, the business must maintain, and make available to the IRS upon request, complete descriptions of the electronic storage system (including all procedures relating to its use) and the indexing and retrieval system.

At the time of an IRS examination, or for tests of a company’s electronic storage system that the IRS may periodically initiate, the business must retrieve and reproduce (including hard

copies, if requested) electronically stored books and records and provide the IRS with the resources (appropriate hardware and software, personnel, or documentation) necessary to locate, retrieve, read, and reproduce (including hard copies) any electronically stored books and records.

An electronic storage system cannot be subject to any agreement (such as a contract or license) that would limit or restrict IRS access to and use of the electronic storage system on the firm's premises (or any other place where the electronic storage system is maintained).

After you've verified that the storage system complies with and will continue to comply with the Rev. Proc. 97-22 requirements, you can destroy the original hard copies and computerized records (other than certain machine-sensible records that must be retained). However, because a state may have its own guidelines for storing and processing records in an electronic format, review applicable state law when using electronic storage systems.

Regardless of whether you rely on paper, computer, or electronic tax records, retaining and storing them in compliance with IRS requirements can become an onerous task that is full of uncertainty. If you're having trouble developing a manageable system that you're confident can deliver the required tax records if the IRS comes calling, we can provide you with more specific, personalized guidance. Just give us a call at [\(858\) 487-4580](tel:858-487-4580) or [schedule an appointment online](#).

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