Which Tax Documents Should I Save, Which Should I Shred?

You’ll need supporting documents in case you’re audited, but you don’t need to save them forever.

by: **Rivan V. Stinson**
February 24, 2022

The IRS, which is dealing with a backlog of unprocessed tax returns dating back to 2020, has urged taxpayers to file their returns electronically. But filing electronically doesn’t stop the clock on potential audits, nor on your right to file an amended return.

Generally, the IRS has three years from the date you file to audit your return. You also have three years to file an amended return. That means for the 2021 tax season, for instance, you should hold on to your Form W-2s and any 1099 forms generated from freelance income, unemployment benefits or investment income (such as taxable dividends, capital gains and interest), records relating to a 401(k) rollover or other retirement information, and receipts for deductible expenses until at least 2025. Some experts suggest keeping your documents for four years to be on the safe side.

Although your chances of being audited are slim—the IRS singles out less than 1% of all individual tax returns—you may need these documents to file an amended return if you overlooked a deduction or credit that could have lowered your tax bill or increased your refund.

For example, suppose you itemized deductions on your original return but didn't claim the medical expense deduction because you didn't think your expenses exceeded 7.5% of adjusted gross income (the threshold required to claim that deduction). If you realize later that you had enough medical expenses to cross the threshold, you could file an amended return on IRS Form 1040X and claim the deduction.

Non-itemizers, meanwhile, may discover that they overlooked a contribution to charity. For 2021, taxpayers who claim the standard deduction can deduct up to $300 of cash donations to charity. The $300 amount is per person, so if you're married, you can deduct a total of $600 (the limit was $300 per tax return in 2020). The standard deduction for 2022 is $12,550 for single filers and $25,100 for a couple filing jointly.

There are important exceptions to the three-year audit rule. The IRS has six years from the date you file your return to audit you if you underreport your income by more than 25%. This sometimes happens to freelancers who lose track of a stray 1099 or individuals who win the lottery or some other type of cash prize and fail to report all of their winnings.

Even if you're confident you'll never be audited, you may need to keep tax documents for other purposes. You might need to keep a W-2 for more than three years to document your income if you plan on buying a home. If you invest in stocks and mutual funds in taxable accounts, you may also need to keep documents showing your purchases until you sell—which may be much longer than three years. For advice on how to store documents in a digital format, see below.

Homeowners: Save Everything

The housing market is still making headlines as it sizzles for sellers. Home prices logged a nearly 17% annual gain in 2021, with some cities seeing even faster

price appreciation, according to the National Association of Realtors. Owners who have lived in their home for decades may be enticed to downsize and cash in their gains.

Taxpayers who sell a primary residence they've lived in for at least two out of the past five years can exclude up to $250,000 in profits from taxes, or $500,000 for a married couple filing jointly. Any profits that exceed this amount are subject to a capital gains tax of 0%, 15% or 20%, depending on your taxable income. However, you may be able to eliminate or reduce the tax bill if you've made significant upgrades to your home—and for that, you need documents.

Clients often panic when they realize they may owe taxes on a home sale and don't have records of improvements, says Mari Adam, a certified financial planner for Mercer Advisors in Boca Raton, Fla. One of her clients in California, for example, had invested about $1 million in home renovations over the years but didn't have the receipts to prove it, she says.

Here's why documents matter: Suppose you and your spouse purchased your home 20 years ago for $200,000 and have since added a new roof, remodeled the kitchen and bathroom, replaced your garage door, and made other improvements for a total cost of $100,000. If you can prove you've made those upgrades, you can increase your cost basis to $300,000.

Say you sell your home for $800,000 and make a profit of $600,000. With the $300,000 basis, your capital gain would be $500,000 and you would avoid paying taxes on all of your profits (assuming you're filing a joint return). Even something as small as replacing a garage door can add value to your home (but home maintenance, such as painting and repairs, don't count).

For those who have recently inherited a property, keeping track of your parents' or grandparents' past home improvements isn't necessary for tax purposes because the home's cost basis is "stepped up" to the fair market value at the

time of the original owner's death. However, if you decide to use the property as your primary residence, you need to keep track of any improvements you make once you move in. Those costs are then added to your stepped-up value to determine whether you owe any capital gains taxes when you eventually sell the property.

You can shred these documents four years from the date you've filed the tax return that includes your home sale. If you sold your home in 2021, for example, you would keep records until 2026.

Investments: Check With Your Broker

Even though the stock market has wavered recently, there's a good chance your portfolio shows significant gains over the past few years. And if you have cashed in some of those gains (or harvested your losses), you—not your broker or financial institution—are responsible for keeping records of those transactions.

Generally, you should keep your stock or mutual fund statements for four years after selling an investment. (If you sell worthless stock, keep the statements for seven years—that's how much time you have to claim a loss.) You'll need to report the purchase date and price when you file your taxes for the year an investment is sold to establish your cost basis, which will determine your taxable gain or loss.

Your broker or financial institution may be able to help. It's required by law to report the cost basis of stock purchased in 2011 or later and for mutual funds and exchange-traded funds bought in 2012 or later. In addition, some financial institutions may archive records for you.

Charles Schwab, for example, keeps 10 years of archived brokerage statements. These statements show the year you bought an investment, dividend information and the sale price (if applicable). Schwab also keeps any 1099 forms

for 10 years. Fidelity keeps account statements and trade confirmation records for 10 years but keeps 1099 forms for seven years.

If you are unsure of how long your firm keeps records, call and ask. But any recordkeeping that your firm provides will likely disappear if you decide to switch to another institution. So before closing an account, download your archived statements and any other documents connected to that account.

If you're investing in cryptocurrency, keep your purchase statements. Some cryptocurrency platforms are sending investors statements that provide a record of their transactions, but not all do. When you sell your cryptocurrency—or even use it to buy a pizza—any gains are taxable, so you'll want a record of the purchase price to establish your cost basis. Keep records of your sales for at least four years.

For 2021, the capital gains tax for investments—including stocks, mutual funds, cryptocurrency—held for more than a year is 0%, 15% or 20%, depending on your income. If you've held your investments for one year or less, then any gains are taxed at your ordinary income tax rate.

Retirement Accounts: Focus on Roth Records

If you've been contributing to your retirement account or a health savings account, your provider should send you an annual statement detailing contributions made within that year. Keep these forms for four years. That's particularly important with respect to contributions to Roth IRAs and Roth 401(k) plans because you want to be able to show that you've already paid taxes on those contributions when you take the money out.

And if you've made contributions to a nondeductible IRA, you may want to keep statements related to those accounts longer—or possibly forever. If you decide to roll the money into a Roth IRA—something high-income savers sometimes do because they earn too much to contribute directly to a Roth—the past statements will confirm that you've already paid taxes on the money. Adam had a client who needed to track down six years of documents to prove that her IRA contributions were nondeductible before rolling the money over to a Roth. "You may just want to err on the side of caution and keep your documents longer on big-ticket transactions that might invite IRS scrutiny," she says.

If your employer shuttered your 401(k) plan or switched providers, you'll more than likely want to roll over the funds into an existing IRA, a new IRA or a new 401(k) plan. In that instance, your former provider should issue you a Form 1099-R detailing the transaction. You'll also receive a 1099-R if you leave your job and roll the money from your former employer's 401(k) into an IRA or your new employer's retirement savings plan. An incorrect rollover could trigger a huge tax bill, so make sure you keep this document for at least four years in case the IRS questions the transaction.

Digitize Your Paper Files

If you're in the habit of getting electronic statements from your bank, it may make sense to go digital with your tax documents as well. Digitally stored documents are less likely to be lost or destroyed than paper copies stuffed in a file cabinet.

For example, when you sign up for a brokerage account, the company may ask you how you would like to receive your documents. If you go paperless, the firm will let you know when tax documents are available to download. The same may be true for your health savings account and retirement accounts.

If your company uses a major payroll provider such as ADP, you may be able to digitally access and store your W-2 forms, too. If not, you can use a scanner attached to your printer or smartphone to digitize and store your W-2 forms.

For any other paper documents, the quicker you scan and upload them, the better, because the ink may fade after years of storage. If you're self-employed, scan all receipts connected to utilities, office supplies and anything else that you claim as a business expense. For homeowners who are making upgrades, scan receipts for improvements into appropriate files.

In some cases, you may need to keep older documents in paper form. For example, if you've scanned the original trade confirmation of an inherited stock and the reproduction is blurry, a tax professional may ask to see the actual document.

There are several ways you can store your documents digitally, including Google Drive, iCloud storage or Dropbox. Store the documents in a folder labeled with the correct tax year. You can also use those folders to save digital copies of your tax returns. Make sure your digital files are protected with a secure password and two-factor authentication—and it's not a bad idea to back them up on an external hard drive or flash drive in case you lose access to your cloud storage service.

Source:

https://www.kiplinger.com/taxes/tax-planning/604270/what-to-save-and-what-to-shred