NEXT GENERATION
WEALTH MANAGEMENT

September 2021

Document Retention: Keep or Shred?

Despite the ongoing shift to an increasingly digital world of automatic electronic verification of everything from transactions to identity, the reality is that, today, there are still a number of documents that individuals must be able to provide to various companies, regulators, or government agencies. In some cases, those entities will accept digital copies of the relevant paperwork or supporting documentation, while in other cases the original hard-copy versions are required. Knowing the requirements has made it extremely difficult for many households to figure out what to keep in physical form, what can be scanned and retained digitally, what can be discarded, and what must be shredded. The following sheds some light on this otherwise confusing topic.

Failure to store essential documents can have serious negative financial impact.
Failure to maintain proper records can result in IRS penalties in the event of a tax audit. Financial records are needed when applying for a loan. Deeds and other title documentation may be needed to prove legal ownership of an asset if challenged. In litigation and other legal disputes, certain documents may be needed to prove a case or claim. In some cases, the legal dispute could come down to an individual's personal file organization to prove his or her case.

But not all sources agree on document retention periods.
The reasons for knowing which documents to store are endless. Unfortunately, not all sources agree on the list of key documents and their retention periods. For example, the Federal Trade Commission suggests that W-2s should be retained for seven years (to cover the statute of limitations for an IRS audit), yet the IRS states that W-2s should be retained until someone begins collecting Social Security (in the event there is a correction needed to their Social Security earnings history to properly determine their benefits). Keeping everything 'just in case' can become cumbersome as the years pass and the documents accumulate. The solution is to start purging no-longer-needed documents. Which means getting more financially organized starts with getting clarity about what you should keep and for how long.

Source: https://www.kitces.com/blog/checklist-important-financial-legal-documents-keep-shred-digital-retention-safe-deposit-box/

Tax Documents

Generally, households should retain copies of their income tax returns for at least three years, in accordance with the general statute of limitations for the IRS (which allows it to go back three years in an audit). Notably, though, it's not just the tax returns themselves that must be kept on file, but also any/all supporting documents that were used to arrive at the figures (income or expenses) reported in the returns. The chart below outlines the types of supporting documents that should be retained along with an income tax return.

TYPE	DOCUMENT	RETENTION
Tax Document	Tax Return	3 to 7 Years
Income	Form(s) W-2	
	Form(s) 1099	
	Bank statements	
	Brokerage statements	
	Form(s) K-1	
Expenses	Sales slips	
	Invoices	
	Receipts	
	Canceled checks & other proof of payment	
	Written communication from qualified charities	
Real Estate	Closing statements	
	Purchase and sales invoices	
	Proof of payment	
	Insurance records	
	Receipts for improvement costs	
Investments	Brokerage statements	
	Mutual fund statements	
	Form(s) 1099	
	Form(2) 2439	

However, there are exceptions to the three-year retention rule. In the event that there is a substantial misstatement of income, the statute of limitations is extended to six years, which is arguably a better baseline for retaining tax documentation. And if a claim is filed for an investment that was deemed worthless (not just sold for a loss, but written off entirely as a total loss), the statute of limitations (and suggested retention period for any documentation associated with the worthless investment that was 'abandoned') is seven years. This covers the spectrum of state retention requirements as it relates to how far back they can look to audit state tax returns.

- Federal Trade Recommendations
- IRS Recommendations

Tax Documents (cont.)

It should be noted that there are several other tax forms and supporting information that should be retained longer or even permanently. See examples listed below.

- If the individual made taxable gifts or received an inheritance, they will need to keep associated filings in their permanent file. This includes Forms 709, 8971, and 706 to either document the step-up in basis of the inheritance received, or the gift and estate tax exemption amount still remaining after prior gifts.
- If the individual has made nondeductible IRA contributions, they should retain Form 8606 to document both the nondeductible IRA contributions and subsequent distributions.
- If the household completed any Roth IRA conversions, Form 8606 documentation should also be retained to prove the conversion amount (until all distributions have been made from the IRA).
- The IRS even suggests in Recordkeeping for Individuals (Publication 552. Revised January 2011) that all 1099-Rs (distributions from IRAs, profit-sharing plans, etc.) should be retained until all distributions from the plan have been made in case prior after-tax distributions need to be reconciled to ensure basis is recovered.
- Form W-2s (for annual wage income from an employer) should be retained until the individual begins collecting Social Security benefits, in case they need it as proof to correct an error in their work history in order to maximize benefits.

Digital copies are acceptable.
It's important to note that the IRS has made it clear under Revenue Procedure 97-22 that digital copies of tax returns and the supporting documentation are acceptable. One does not need to keep physical copies of previous tax returns as long as there is a digital copy that is an "accurate and complete" replication of the hard copy.

Health Care Documents & Medical Expense Receipts

When it comes to healthcare documents and the receipts for medical expenses (and their associated reimbursements), the retention of records again depends on the context. The primary reason that records of medical expenses and reimbursements are kept is to substantiate any deductions for medical expenses. In practice, though, if medical expenses were written off on the tax return, then these medical expenses would be treated as supporting tax documentation and should be retained as long as the individual must retain their tax return records. Notably, this also means that a digital version of such receipts would be sufficient.

Health Savings Accounts (HSAs)

One popular tax strategy for Health Savings Accounts is to pay medical expenses initially out-of-pocket while contributing to the HSA, and then later taking distributions from the HSA (after years or even decades of tax-free growth) to repay oneself (and/or using the HSA as a supplemental saving vehicle for retiree medical expenses). As long as the individual has kept a record of who they paid, the amount, and the date the payment was made, the strategy is permitted. Though doing so means that as long as there is a balance in the HSA (and any expectation of wanting or needing to rely on prior medical expenses to validate future HSA distributions), documentation of qualified medical expenses should be kept for years or decades, though, again, digital format is permissible (per standard IRS policy on tax documentation under Revenue Procedure 97-22).

Insurance Claims & Medicare

When it comes to keeping documentation of medical expenses simply to make a claim for insurance purposes, the documentation retention period is either the maximum time period to submit for a claim or reimbursement (which may vary by insurance carrier, and insurers may vary on whether they accept digital or only hard-copy documentation), or for a claim that has been submitted, until that claim is paid and the insurance company reports it as closed. After which the detailed expense documentation is a moot point and can be disposed of, if not otherwise needed for the aforementioned tax purposes or strategies.

For those on Medicare, it is suggested to retain their Medicare Summary Notice for at least one year. Since this is mailed out every three months, the individual should plan on keeping the four most recent Medicare Summary Notices on hand. And, if they are enrolled in a creditable employer drug plan, they should retain the most current “Notice of Creditable Coverage”, which would be needed when the individual enrolls in Medicare Parts B and D to avoid paying any Medicare Late Enrollment penalties.

Legal & Personal Identification Records

Key legal documents, including important business records, substantive personal transactions, and the core components of an individual's estate plan (including the most current Will, any trusts, general and healthcare Powers of Attorney, a living Will, and any beneficiary designation forms) are some of the most important documents for households to retain in their own files. In practice, many will keep such documents in a home safe for further safekeeping (though a safety deposit box is not recommended, as heirs may not be able to access the legal documents in the box without the documents to prove they have permission to access in the first place!). Alternatively, some may keep copies in their attorney's files as well or even as originals in a law firm's safe.

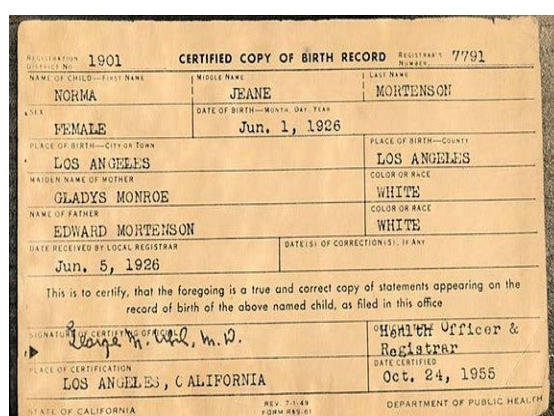
Because key legal documents – particularly key binding contracts – are also a document that may need to be not only produced to 'document' a transaction but also substantiate it (i.e., that it is not fraudulent or forged). Legal documents that were not formally and legally e-signed should be kept as physical paper copies and not merely scanned to retain a digital copy.

Marriage Certificate & Divorce Paperwork

If the individual is married, copies of the marriage certificate should be retained permanently, along with any prenuptial agreements. If the individual has gone through a divorce, they should keep copies of the official divorce paperwork as well, including the written separation agreement and all other orders and decrees. If the individual was widowed, they should still retain their late spouse's death certificate, and all estate settlement paperwork indefinitely in case there is ever a need to prove that the estate was in fact settled, and that there are/were no reasons to contest the Will.

Proof of Birth & Citizenship

There are also several key personal identification documents that can be grouped together to prove citizenship and birth. Each of these must be kept permanently. They include a Social Security card, birth certificate, and the (most current) passport. For parents, it is important to ensure that the document retention policy includes the important documents related to their children as well (including adopted children).



Registration District No. 1901 CERTIFIED COPY OF BIRTH RECORD Registrar's Number 7791

Name of Child—First Name: NORMA | Middle Name: JEANE | Last Name: MORTENSON

Sex: FEMALE | Date of Birth—Month, Day, Year: Jun. 1, 1926

Place of Birth—City or Town: LOS ANGELES | Place of Birth—County: LOS ANGELES

Maiden Name of Mother: GLADYS MONROE | Color or Race: WHITE

Name of Father: EDWARD MORTENSON | Color or Race: WHITE

Date Received by Local Registrar: Jun. 5, 1926 | Date(s) of Correction(s), if Any:

This is to certify, that the foregoing is a true and correct copy of statements appearing on the record of birth of the above named child, as filed in this office

Signature of Certifying Official: [illegible], M.D. | Official Title: Health Officer & Registrar

Place of Certification: LOS ANGELES, CALIFORNIA | Date Certified: Oct. 24, 1955

State of California | Rev. 7-1-49 Form RBS-61 | Department of Public Health

Ownership & Borrowing Document Retention

Several important documents are associated with owning assets and having debts. At its core, documentation can not only substantiate ownership itself (i.e., proper records can help to prove ownership in case it is ever challenged), but also the terms of ownership or commitments (e.g., the terms of a purchase or a loan). Documentation of assets and debts also helps to track pertinent information about those assets and debts over time, from the balance/value/performance of the holdings, to their cost basis for tax purposes (in case the IRS audits a tax return). Because different types of assets and debts have different characteristics, the associated document retention obligations vary. The three core categories of documentation for assets and debt include: intangible assets, tangible assets, and liabilities.

Intangible Asset Document Retention

Intangible assets are those for which we contractually have ownership but there is no physical, tangible manifestation of the asset. Most commonly, this includes various types of financial (e.g., bank or brokerage) accounts, though it may include other types of property (e.g., intellectual property in the form of patents or copyrights). Proving ownership of a bank or brokerage account is typically not necessary (it's the financial institution's job to hold such accounts on behalf of their customers), but the tax consequences of the investments in those accounts, as they grow or are bought and sold, do necessitate that documents be retained to prove out cost basis. Owners of investment accounts should retain the document types listed below.

- Current statements should be kept on file for that particular year, but can typically be disposed of at the end of the year (in lieu of an end-of-year summary statement).
- The End of Year statement (or December statement) should be retained in conjunction with the supporting tax records (typically six years).
- For investments purchased prior to 2012, the investor is responsible for maintaining and documenting cost basis records and reporting to the IRS when sold. Investments purchased in 2012 and later will have their cost basis tracked by the financial institution (found on the 1099 when sold).

Note: Pre-2012 end-of-year statements are valuable to retain to document cost basis until all such investments have been sold. As the IRS six-year statute of limitations for tracking the tax consequences of an investment sale don't begin until the investment is actually sold, so retaining documents could stretch years or decades prior for an investment that has been held for a long time. Documentation for cost basis purposes does not require the original physical statement as proof; a fully intact digital copy is sufficient in normal circumstances. As a result, it is permissible to scan prior investment records and shred original paper copies.

Ownership & Borrowing Document Retention (cont.)

Tangible Asset Document Retention

Tangible assets are real physical assets (e.g., furniture, automobiles, real estate), which come with their own important documents that must be retained. In the context of tangible assets, proving ownership is rarely an issue, but can be a substantive one if and when it's required. As a result, individuals should keep any documents related to the ownership of the property until it is eventually sold. This includes any deeds, titles, settlement statements, or bills of sale. From a tax perspective, it's also important to document any expenditures associated with tangible property (particularly real estate) that may contribute to the cost basis of the asset. Accordingly, documentation of any expenditures for substantial improvements to the real estate, along with documentation of any transaction-related fees that were capitalized when purchasing the property, should be retained until the property is eventually sold.

When it comes to homeownership (i.e., primary residence), it is similarly important to retain documentation of any home improvements that may affect the cost basis of the house which could result in reducing the tax liability when it is eventually sold. These records should be maintained throughout the ownership of the home. However, there are a few additional circumstances where documentation may be required and documents should be retained.

- Home offices trigger the need to maintain additional documents to prove the Home Office Deduction. Any receipts relating to the Home Office Deduction (such as utility bills) should be retained for as long as the individual keeps their tax returns.
- If the individual owns homes in two different states (e.g., a primary residence and a vacation home), he or she should retain receipts and travel itineraries to prove which home is their primary for residency purposes. This is very important for those who are trying to manage (and mitigate) state tax liability by claiming residency in a state with lower tax rates.

Debt/Liabilities Document Retention

When it comes to those who are carrying debts, the primary issues of documentation are being able to substantiate the terms of the loan (e.g., payment obligations, interest rates, etc.) and when the liability has ultimately been extinguished. Accordingly, it is important to keep any loan documents or borrowing agreements on hand until the loan is paid off. Once the loan is paid off and a notification has been provided that the debt is extinguished, it is no longer necessary to retain any documentation (though in practice it may be desirable to retain documentation that the loan has been paid off).

Other Important Document To Retain

While not previously covered in this article, there are a few other important documents to keep on file.

College Transcripts & Certifications

College transcripts and higher education records (such as a certification) should be retained to prove that the course work was completed, in addition to the associated educational expenses themselves. In many cases, expenses related to education may afford you, the individual, certain tax credits and deductions when filing the tax return. After the (generally six-year) retention window for tax-related documents, though, maintaining college transcripts and other proof of education is generally unnecessary, as such documents can most likely be ordered directly from the educational institution. However, it may be helpful to retain documentation in case the institution fails to properly retain records or the educational institution itself ceases to operate.

Insurance Policies

Insurance policies (including homeowner, auto, health, disability, and life insurance) should be retained for all current policies. While replacement policies typically can be obtained directly from the insurance company, because insurance policies are ultimately legal contracts, they should be retained as long as they are relevant (i.e., in force as insurance) like any other legal document.

Military Documents

For those who have previously served in the military, it is important to retain copies of discharge papers to prove future eligibility for veterans' benefits.

Non-Compete Agreements

Finally, for those who are employed and signed a non-solicit or non-compete agreement, it will be very important to retain a copy for the entirety of their time with that employer, and for the subsequent years that the agreement covers following their departure.

Safe Document Storage

Once the important documents are pulled together, the next step is to properly store them. There are a few different considerations to make at this point. Depending on personal preferences, there may be an inclination to keep virtual records of important documents versus physical versions. In reality, some records can still only be stored physically, so any personal document retention policy should include steps for handling virtual and physical documents as most households will end up having a mixture of both.

Safe Document Storage: Digital

Virtual Document Storage Considerations

For those who do want to convert physical documents to a digital format for retention purposes, it's necessary to consider both how to digitize documents, how to store digital documents, and ultimately how to dispose of digitized documents if/when they no longer need to be retained.

Document Digitization & Storage

After collecting the important documents to be retained virtually, the first step is to begin actually digitizing them. While over the past two decades most people have used scanners to turn physical documents into digital ones, at this point a physical scanner is no longer needed to scan important documents having been replaced by smartphone apps that can capture clean and precise scans of documents just as well as traditional scanners. Once scanned, important documents can be stored in one of two ways: personal storage devices and cloud storage systems.

Personal Storage Devices

Storing the files on a personal computer, thumb drive, or external hard drive that physically remains in the individual's possession. The benefit is that the information can be well organized and doesn't take up much physical space. The downsides are that the digital files could still be damaged (e.g., if the hard drive fails), or the storage device could be stolen. If this is the option that is chosen, consider using third-party encrypting software to add an additional layer of protection in case the files are stolen. Also consider redundant backup options.

Cloud Storage Systems

For those who are comfortable uploading their important documents to the cloud, services like DropBox, Google Drive, and Microsoft's One Drive are available, as are password management tools like LastPass. For clients of advisors, there are also document vaults connected to some financial planning and reporting software (e.g., eMoney and Black Diamond vaults), or file-sharing services (e.g., ShareFile). The benefit of this approach is that the documents can remain in the cloud, with the protection of robust backup and security protocols to ensure client documents are properly protected. From the advisor's perspective, advisor-driven document-sharing services also facilitate sharing more easily when the client needs them, and in some cases, like eMoney's Vault, the advisor or a trusted contact can access some of the documents in the event of an emergency.

Safe Document Storage: Digital (cont.)

Digital Document Disposal

Deleting digital files is generally a straightforward process, with one exception. There is a distinction between "Delete" and "Permanently Delete." Depending on the storage system used (external hard drive or cloud storage), the file must be deleted and then deleted a second time. Oftentimes, the user will be prompted to confirm "Permanently Delete." The purpose behind this is to allow users to have the ability to recover their files even if they deleted them, which is helpful if a file is accidentally deleted, but not good for those who want to delete files and not risk having a thief recover the file from a stolen hard drive. Permanently deleted files cannot be recovered in the future.

Safe Document Storage: Physical

When it comes to maintaining physical documents for storage – particularly those legal documents that must be maintained in original physical form – it is again important to be mindful of both how the document is stored, and how it is disposed of when it is no longer necessary to store. There are two main types of storage systems for physical documents: in-house storage and safe deposit box storage.

In-House Storage

This approach can provide a high level of protection, but for the most important documents that must remain secure, it can be expensive. While many people prefer to keep physical documents on hand to keep them "safe" – potentially even in an actual physical safe – keeping physical documents on-site requires protecting them against the three most common perils: fire, water, and burglary. Especially recognizing that victims of a burglary may simply find that the entire safe is stolen. In addition, documents that must be retained are also at risk for natural disasters (i.e., fire, flood, etc.). As a result, the most important documents that are stored at home need additional safe precautions.

- Article: Best Fireproof Document Safe

Safe Deposit Box

This approach provides a physical place to save important documents outside of the individual's home. While there is a fee for this service, some prefer this over a safe in their home, as it may provide a higher level of security. Note: it is important to share information regarding the location of and access to the safe deposit box with trusted contacts, so it is not lost in the event that the owner is unexpectedly incapacitated. Also, avoid storing original documents such as Wills and POAs as the executor may not be able to access the safe deposit box until they can prove they are the executor or have a power of attorney.

Safe Document Storage: Physical (cont.)

Physical Document Disposal

When it's time to dispose of important documents, shredding may be the most straightforward approach. It ensures that no one can view the information after it has been discarded. There are key pieces of information in many of these documents that criminals can use to steal a client's identity. Below are some examples of sensitive information that, if listed in the documents, should be shredded:

- Social Security Numbers
- Date of Birth
- Driver's License Numbers
- Medical Information
- Account Numbers
- Phone Number
- Passwords
- Financial Information
- Signatures
- Email Address
- Pin Number
- Legal Information
- Bar Codes
- Prescription Labels

Getting Started With Document Retention

In practice, implementing best practices in document retention often serves as an opportunity to get organized in the first place. In turn, for financial advisors, having a conversation about document retention is an appealing opportunity to help clients get their records in order.

Importance of Establishing and Maintaining A Retention Policy

At least initially, the process of creating a personal document retention policy can be time intensive but it's very important. Unfortunately, some households are not organized, and/or are unprepared to be able to find and access documents when they're really needed. It's no fault of the individuals because, in practice, the rules over the years have been vague, inconsistent, and in flux. Keeping a calendar and using checklists are useful tools to ensure the retention policy is retained.

- <u>Checklist: What Documents Do I Need To Keep On File?</u>

END