2012-2013 BROKER-IN-CHARGE ANNUAL REVIEW

RECORD RETENTION REQUIREMENTS

Outline:
Introduction
Record-Keeping Requirements under Commission Rules
Minimum Requirements
Who Must Retain the Records?
How Long Must Records Be Retained?
Record Retention Under the Internal Revenue Code
Civil Litigation and Statutes of Limitation

Learning Objective: Upon completing this section, licensees should have a better understanding of what records they must retain for what period of time, both under License Law and Commission rules, as well as for tax purposes.

INTRODUCTION

All licensees have an obligation under Commission Rule A.0108 to preserve and retain records arising from brokerage services they offer the public. The broker-in-charge bears additional responsibility for preserving and retaining records related to brokerage transactions performed by agents associated with that broker-in-charge's office. **Rule A.0110(a)** states in relevant part:

> ... The broker-in-charge *shall* ... assume the responsibility at his or her office for:
> (4) the proper maintenance at such office of the trust or escrow account of the firm and *the records pertaining thereto*;

(5) the *proper retention and maintenance of records* related to transactions conducted by or on behalf of the firm at such office, including those required to be retained pursuant to Rule .0108 of this Section.

Because record preservation is one of a broker-in-charge's seven specific duties, this Section will review the applicable rules, discuss what records must be retained, for how long, and in what form, and will then provide a few examples to assist brokers in determining when the period begins, i.e., when does the clock start to tick? Those who are brokers-in-charge of only themselves or have one or two associated brokers may choose to store the original paper transaction files whereas those brokers-in-charge who are supervising 10, 15, 40, 100 or more affiliated agents may prefer to store records electronically. Note too that the broker-in-charge not only is responsible for ensuring that all required documents are in the transaction file, but for preserving that file as well as all trust account records as required by Rule A.0107.

RECORD-KEEPING REQUIREMENTS UNDER COMMISSION RULES

Minimum Requirements

What records must be kept and for how long? The basic requirements are found in **Rule A.0108, Retention of Records,** which as of October 1, 2012 states:

> Licensees shall retain records of all sales, rental, and other transactions conducted in such capacity, whether the transaction is pending, completed or terminated prior to its successful conclusion. The licensee shall retain such records for three years after all funds held by the licensee in connection with the transaction have been disbursed to the proper party or parties or until the successful or unsuccessful conclusion of the transaction, whichever occurs later. Such records shall include the following:
> (1) contracts of sale,
> (2) written leases,
> (3) agency contracts,
> (4) options,
> (5) offers to purchase,
> (6) trust or escrow records,
> (7) earnest money receipts,
> (8) disclosure documents,
> (9) closing statements,
> (10) brokerage cooperation agreements,
> (11) declarations of affiliation,
> (12) broker price opinions and comparative market analyses prepared pursuant to G.S. 93A, Article 6, including any notes and supporting documentation, and
> (13) any other records pertaining to real estate transactions.
> All such records shall be made available for inspection and reproduction by the Commission or its authorized representatives without prior notice.

Required Records

Rule A.0108 explicitly requires the retention of the various documents discussed below that are grouped by category, rather than the numbering in the new rule. This rule was revised as a result of legislation passed in June 2012 that, as of October 1, 2012, allows brokers to perform broker price opinions under certain specified circumstances. Hence the inclusion as of October 1, 2012 of a new #12 requiring retention of various documents related to BPOs or CMAs performed under the new legislation, which is discussed in greater detail in the final version of the 2012-2013 Real Estate Update Course materials.

1. ***Offers to purchase and sales contracts***. Brokers-in-charge should make sure that all affiliated agents understand that *any and all offers* received must be retained in the transaction file. Many licensees mistakenly believe that the only offer that must be retained is the one that becomes a contract. Not true. A written offer *is* "an offer to purchase" and, no matter how unacceptable its terms may be to a party, it nonetheless must be preserved. An agent who prepares an offer on behalf of a buyer client should make a copy of that offer *before* sending it to the listing agent. Failure to do so violates the rule, as that file lacks a copy of one offer to purchase. The fact that the buyer's original offer may be returned with various changes made by the seller who signs the offer *does not remedy the problem* because the seller's counteroffer is actually a new offer, Offer #2, and a copy should be made of it *before* the buyer starts making changes to the document. Once the buyer starts making changes to the seller's counteroffer, the document becomes the buyer's counteroffer, or Offer #3. The point here is that most transaction files should have multiple offers, the final contract of sale, and any back-up offers or contracts.

2. ***Written leases.*** If the lease agreement is in writing (which is highly recommended and required by the Statute of Frauds if the agreement will terminate more than three years from its making), then a copy of the lease agreement (i.e., *contract*) must be in the transaction file. This applies to brokers who are providing property management services on behalf of the lessor, as well as to brokers who are procuring a tenant for a property, whether acting as an agent of the tenant or of the lessor/landlord. If as part of procuring the tenant, the broker is involved in negotiating lease terms, then that broker should retain a copy of the lease agreement in his/her transaction file.

3. ***Options.*** As with written leases and sales contracts, an option, whether to lease or purchase, is a contract and a copy of the parties' agreement should be retained in the transaction file by a broker representing either party.

4. ***Agency contracts.*** Brokers are required both by state law (G.S. 93A-13) and by Commission rule (A.0104) to have an *express* agency agreement with every seller, buyer, lessor, or lessee who wants to hire the broker as his/her agent ***before*** the broker begins providing services to or on behalf of the client. *No exceptions.* When the broker represents a *property owner* in any capacity, whether in a sales or lease transaction, the required agency agreement *must be in writing before any services are provided*. When representing a buyer or tenant, the rule permits the broker and buyer/tenant to orally agree to the terms of representation initially (if

permitted by office policy). Even so, the oral agency agreement must be reduced to writing *prior to* any offers being presented.

Thus, when periodically reviewing transaction files, a broker-in-charge should ***never*** see a listing file or file for property being managed by the office that does not contain a written agency agreement (since that agreement must be in writing from the inception of the relationship). Similarly, if the company is acting as a buyer/tenant agent, a broker-in-charge should never see a transaction file that has 1 or more offers in it, but no written buyer/tenant agency agreement. In either case, the broker-in-charge should *immediately* confer with the agent handling the transaction to correct the omission. Failure to do so may result in disciplinary action against both the individual agent and the broker-in-charge, as well as possible forfeiture of any commission.

***Caveat*:** where an owner or buyer hires a broker to handle multiple properties over an extended period of time, there often may only be one agency agreement, even though the broker may help the owner sell, or the investor buyer-client purchase, 20 properties in a particular geographic area during the 18 month or 24 month duration of the agency agreement. In this case, the 20 individual transaction files may either contain a copy of the agency agreement or contain a reference to where the written agency agreement may be found. The written agency agreement eliminates any doubt that the consumer-principal has hired and authorized the broker to act as the principal's agent and the scope of that agency. Without a principal, a broker cannot function as an "agent."

5. ***Brokerage cooperation agreements and declarations of affiliation.*** These two documents refer primarily to North Carolina brokers who have agreed to supervise non-resident brokers who have obtained a limited non-resident commercial license in North Carolina that allows them to come into this state, do a commercial deal, go back to their out-of-state office and be paid for that brokerage activity. Brokers-in-charge of offices that handle primarily residential transactions rarely will encounter these two documents. Nonetheless, any written agreement between brokers to cooperate and share fees with each other should be retained to evidence the terms of that agreement.

6. ***Earnest money receipts and closing statements.*** One may not have a "receipt" unless the buyer paid the earnest money deposit in cash; regardless, the amount of the earnest money deposit is reflected in the parties' contract that must be part of the transaction file, and any broker holding the deposit will have a ledger sheet on which the buyer's payment is recorded. If the earnest money deposit is being held by a non-broker (closing attorney, title insurance company, etc.), then neither broker will have any evidence of payment of the earnest money deposit other than as stated in the parties' contract and the signature of the escrow agent on the last page. All sales transactions will have a closing statement, whether it is a HUD-1 form or some other form. Whatever record there is of the consummation of the parties' sale and the monies and expenses paid incidental thereto, that record or records must be retained as part of the file for the requisite period.

7. ***Disclosure documents.*** **All** disclosure documents must be retained for three years, *regardless of whether there is a "file*." Mandatory disclosure documents ***include*** the *Working with Real Estate Agents* brochure that must be provided to all sellers and buyers at first substantial

contact, as well as the *Residential Property Disclosure Statement*, the applicable *Lead-Based Paint disclosure statement* for pre-1978 properties in all *residential sales or lease transactions*, along with some documentation that not only was the lead-based paint disclosure given, but the required EPA pamphlet, "Protect Your Family from Lead in Your Home" as well. Note that ***the rule does not limit record retention to "mandatory" disclosure documents; it merely states "disclosure documents."*** Brokers must also retain any other disclosure documents either party provides the other to have a record of the representations that were made in the transaction.

Comment: While most disclosure documents will be created after a consumer has hired a broker to provide services, thus creating a file, it often may be the case that the *Working with Real Estate Agents* brochure is timely provided to the consumer, e.g., at the listing presentation or *before* putting a prospective buyer in the car to show them property, and the property owner decides to list with another company or the buyer under an oral buyer agency agreement terminates their property search after two weeks without making an offer on any property. In either situation, there may not be a "transaction file" in which to store the signature panel from the disclosure form, yet the panel must be retained for three years following the termination of the relationship (primarily to protect the broker in evidencing compliance with Rule A.0104©)). Thus, brokers-in-charge should consider how they wish to retain all these miscellaneous signature panels for all agents affiliated with the office.

8. ***Trust or Escrow Records.*** Rule A.0108 doesn't specify the various trust account records that must be maintained — it merely says "trust or escrow records." *To learn what specific records must be maintained and preserved, one must look to the trust account rule*, **Rule A.0107, "Handling and Accounting of Funds,"** specifically subparagraph (e), that requires the following records:
    - bank statements;
    - canceled checks;
    - deposit tickets;
    - payment records sheets for owner associations;
    - ledger sheets;
    - journal or check stubs;
    - contracts, leases, and management agreements;
    - closing statements and property management statements;
    - covenants, bylaws, minutes, management agreements and quarterly statements for owner association management;
    - invoices, bills and contracts paid from the trust account; and
    - *any other documents necessary to explain record entries*.

    The **bottom line** is that *for every deposit into the trust account and every disbursement out of the trust account there should be some "piece of paper" or electronic record that explains why the broker received funds belonging to others or paid monies out of the trust account*. The parties' contract, sales or lease, will reflect the amount of the earnest money deposit or rents the broker should be receiving. The agency agreement provides not only the amount of compensation the broker is entitled to receive for his/her services, but may also authorize

the broker to pay specific expenses on the client's behalf. All checks, deposit tickets and ledgers must indicate:

- the date of deposit or disbursement;
- the amount received or disbursed;
- the purpose of the deposit or disbursement;
- the subject property address; and
- the payor or payee.

9. ***Broker price opinions/comparative market analyses prepared under the new law, including any notes and supporting documentation***. Licensees should read the subsection titled "Broker Price Opinion (BPO) Law and Rules" in Section 4 of the *2012-2013 Real Estate Update* materials to better understand the requirements attendant to performing a BPO/CMA for a fee under the new law effective October 1, 2012. Documents that must be retained under the new law and rules include: the written assignment from the person or entity requesting the BPO/CMA, information relied upon to support the conclusion of probable sale or lease price, including market data or capitalization computations, the minimum of three comparables selected by the broker, and, obviously, the BPO/CMA itself that must contain the information required by Commission Rule 58A.2202.

10. ***Any other records pertaining to real estate transactions.*** The final catch-all provision in Rule A.0108, similar to that noted above in Rule A.0107, requires retention of "any other records pertaining to real estate transactions." What does this mean? There is no explicit guidance in the rule. Applying the "ORPP" standard (ordinary reasonable prudent person/broker), it would seem that *any writing that makes assertions/representations concerning the property or a party's ability to enter into the transaction, or contains conditions under which a party will enter into a transaction, or delineates the legal rights and obligations of either party clearly should be retained for the requisite period as such writings are material to the transaction*.

    Similarly, any reports concerning the results of any tests, inspections or site evaluations should be retained, as well as surveys. If the broker receives copies of the applicable restrictive covenants, association bylaws or statements of pending or confirmed assessments these too should be retained as material to the transaction.

Additional Comments

Advertising/MLS listings

Should a broker retain copies of any public dissemination of information about the property, often referred to as advertising or marketing, in the transaction file? ***Yes***. The statements in the marketing or promotional materials are representations about the property upon which the public may reasonably rely absent the presence of any red flags that may be discovered by a site visit.

Letters of Intent (LOIs) or Lease Negotiations

While letters of intent technically may not be "offers to purchase," particularly when attempting to negotiate a leasehold interest, they nonetheless evidence both the terms and conditions under which a party is willing to enter into a transaction and the chain of the parties' negotiations,

as do offers and counteroffers. Similarly, while exchanges of offers to lease are not specifically mentioned in the rule, they do reflect the conditions under which the party is willing to enter into an agreement and changes in a party's negotiating stance, regardless of whether the parties enter into a lease agreement. Both letters of intent and offers to lease fall within the "any other records pertaining to real estate transactions" and should be retained as part of the file for the requisite period.

Correspondence and Personal Notes

Must a broker retain copies of all communications related to a transaction, whether by postal mail or email or notes the broker made during conversations with various individuals? It depends. Any letter or email that confirms that some act was or was not performed, or that authorizes the broker to undertake some act certainly should be retained as proof of the assertion or of the authority conferred. Other personal notes or emails may not be as relevant, but help document nonetheless communications between the broker and others. Purging files of these notes, memoranda or emails decreases a broker's ability to defend against claims that the broker did or did not tell someone some thing.

For example, a several page complaint was filed with the Commission against a broker. One of the allegations was that the broker had failed to communicate with her buyer-clients (who were rather demanding folks) for a three week period between stated dates. The broker was able to retrieve her emails and demonstrate that she and her clients had exchanged a total of 56 emails during this three week period of "no communication," thereby casting doubt on the validity and credibility of the other allegations.

IN SUM, the *documents that **must** be retained are those required by Rules A.0107 and A.0108* as discussed above. Whether other sticky notes, personal notes or other documents should be retained should be determined by looking first to the catch-all provision of the Rule; if this doesn't seem to address the particular record in question, then look to the office policies and procedure manual and what is reasonable under the circumstances. If one wishes to keep it simple, the policy might be that whatever was in the file stays in the file *and* that each broker either downloads, prints, or transfers to a portable storage device all emails related to the transaction for inclusion with the transaction file that is going into storage.

Must One Keep Originals & Where?

Even in this day and age when more and more transactions are negotiated electronically and offers are faxed or emailed to the other party, most transactions still generate some paper hard copies, whether it's surveys or contracts or agency agreements or disclosure documents, as well as Warranty Deeds, Deeds of Trust, Opinions of Title, and closing statements. To the extent that a file contains paper copies of various documents, must those documents be retained in that form for the requisite period? *No.* Nowhere in Rule A.0108 does it say that a broker must retain the originals. What it *does* require is that the *broker must be able to provide a hard copy to the Commission or its authorized representative upon request*.

The broker-in-charge should specify in the office policies and procedure manual what his/her storage policies are. Some offices may find it just as easy to store the actual paper transaction files in a filing cabinet or in storage boxes. Other firms may find that storing the actual paper files

consumes too much physical space and that it is more convenient to scan the entire transaction file, or at least the documents the rule and office policy require to be retained, and save the contents electronically on computer or office network or other secure location protected by a back-up system. Some larger firms are maintaining their entire transaction files electronically in a central system that may be accessed by any associate at any particular office during the pendency of the transaction. If one chooses to store files electronically, it is highly recommended that they be stored in a secure location protected by a back-up system, rather than on the computer hard-drive, in case the computer system crashes.

Stored records need not necessarily be maintained onsite at the office. Records that are retained electronically require very little space and there is no reason not to have the stored files available at the office. However, where a broker chooses to store paper, it is perfectly acceptable to store these files off-site, *so long as* they are reasonably accessible upon request, e.g, retrievable upon request. Whether a broker contracts with a storage company to hold the files or finds space within their home or office is up to the broker.

Who Must Retain the Records?

Who has the ultimate responsibility for maintaining and preserving the required records for the requisite period? Good question. Rule A.0108 flatly states that "*licensees* shall retain records of all sales, rental and other transactions ... whether the transaction is pending, completed or terminated prior to its successful completion ...," which imposes the duty on *all* licensees. In addition, the broker-in-charge rule clearly imposes the duty on the broker-in-charge, as noted in the Introduction. The broker-in-charge is responsible for "... the proper retention and maintenance of records related to transactions conducted by or on behalf of the firm at such office, including those required to be retained pursuant to Rule A.0108 ...."

A broker-in-charge who only has him/herself to supervise and no other associated brokers clearly will be the lone person responsible for record preservation and retention, whether under his/her licensee hat or broker-in-charge hat. It makes no difference whether that broker is conducting his/her brokerage activity as a sole proprietor or as a one-person limited liability company or corporation (assuming the latter two have a firm license), as in all three instances "the company" still only has one affiliated broker/employee who also must be a broker-in-charge.

What about brokers-in-charge of offices with affiliated brokers, whether 1, 2, 50 or more? Recall that *all licensees* have a duty to maintain and retain those documents required by Rules A.0107 and A.0108 both during the pendency and after the conclusion of the transaction. However, once a transaction is concluded, an affiliated broker usually may rely on the broker-in-charge to handle the affiliated broker's record-retention responsibilities *unless* circumstances show such reliance to be unreasonable, e.g., a broker knows the broker-in-charge isn't maintaining good records. This responsibility of the broker-in-charge to retain the records for his/her office flows logically from the fact that *the affiliated brokers* are not conducting their brokerage activity under their own umbrellas, so to speak, but *are acting as* ***agents of the real estate company***. The consumer hires *the real estate company*, not an individual, to act as the consumer's agent and it is

the *company* that is a party to the agency agreement. Similarly, any trust monies received are deposited into a *trust account in the company's name*, not a trust account in the name of any affiliated agent. The company may also be civilly liable for the acts of its agents and most certainly will be named as a party in any lawsuit filed against any of its affiliated agents.

For all of the foregoing reasons, *the company has an interest in keeping within its possession copies of all records related to transactions in which it acted as an agent* in case it either is audited by the Commission or is sued some time after the transaction concluded (whether successfully or unsuccessfully). As the representative of the company who is responsible for managing a particular location and the agents affiliated with that office, it is the broker-in-charge who generally will be held accountable by the Commission for the company's compliance with the record maintenance and retention requirements of Rule A.0108.

The company's record retention policy should be explained in the office policies and procedures manual. The policy should also address how to handle requests from affiliated brokers who want to retain a copy of the file to fulfill their Rule A.0108 obligation. One option is to provide in the policy manual that the company will assume and fulfill this obligation and will make the records available to the (former) associate if needed in the future to answer a complaint filed with the Commission or defend against a lawsuit (either of which most likely will include the company anyway). Another option would be to allow the associate to have a copy of the file, with the company retaining the original file. If the company's policy is to scan all records at the conclusion of the transaction and retain the records electronically, it might agree to allow the associate to retain the original paper file that no longer is needed.

Successor BIC's Liability for Predecessor?

If a broker agrees to become broker-in-charge of an existing office, replacing the former broker-in-charge for whatever period of time, *what liability does the successor broker-in-charge have for the completeness and accuracy of transaction files and trust records amassed under his/her predecessor's reign*? Generally, a new broker-in-charge will not be held accountable for errors or omissions that occurred prior to assuming BIC responsibilities. The new BIC must afford the Commission access to closed files upon request, but responsibility for deficiencies in closed stored files typically will lie with the broker who was the BIC at the time the transaction occurred. Additionally, while the new BIC may not be responsible for problems or issues that occurred under the prior BIC, *if these problems or issues have not been fixed, then they may persist and the new BIC will be required to address these issues to avoid a new violation*.

The incoming BIC *should review* all open/active/pending transaction files and if there are deficiencies in the paperwork, redress those. S/he need *not* go through all the closed transaction files that are in storage awaiting the expiration of the record retention period. A prudent BIC also will personally review the trust account records, if applicable, prior to accepting the position. A review of the preceding six months or more will allow the broker to confirm that the journal, ledgers and monthly reconciliations have been performed and that s/he does not appear to be inheriting a problem. *What about the* ***qualifying broker's duty*** *to secure and preserve the transaction files and trust records* ***every time an office changes BICs*** *and to report any trust account imbalances or failure to reconcile records to the Real Estate Commission*? This duty provides a safeguard for the

new broker-in-charge, but does not entitle the new broker-in-charge to turn a blind eye to obvious trust account problems.

> [**Note:** The begin and end dates of each BIC's "bicship" will be reflected in the Commission's records, and if there is any period of time when an office doesn't have a BIC according to REC records, then the office will cease to exist and all affiliated agents will be removed and placed at their home addresses. One establishes or recreates an office by declaring a BIC by sending the Commission REC Form 2.04 and the BIC must then submit an affiliation form (REC 2.08) to re-associate each agent with the office.]

How Long Must Records Be Retained?

> Rule A.0108 states:
> "... The licensee shall retain such records for *three years after all funds* held by the licensee in connection with the transaction *have been disbursed* to the proper party or parties *or* until the *successful or unsuccessful conclusion of the transaction,* ***whichever occurs later***." [Emphasis added.]

Thus, the three year clock starts to tick after the transaction has concluded *and* all funds (if any) have been disbursed from the broker's trust account. *If a broker is not holding any funds related to the transaction, then his/her three year clock starts upon the termination of the transaction*. The fact that trust monies in a given transaction were held by an attorney and have not been disbursed does *not* delay the commencement of the *broker's* record retention period.

Practical Application

Case #1:

Seller and buyer were represented by brokers from different companies. They successfully negotiated an agreement and entered into an offer to purchase and contract in August 2007 utilizing then Alternative 1. The $2,000 earnest money deposit was held by the listing company. The buyer ordered a home inspection that revealed several legitimate repair requests and recommended further investigation of a couple of issues. Buyer made a written request to Seller to repair several items, followed by an additional repair request resulting from the follow-up investigations. After some negotiation, the seller declared that he would do some, but not all, of the requested repairs and if the buyer didn't like seller's offer, then the parties could terminate the contract. The buyer decided to terminate and on September 30, 2007 the parties entered into a written Termination of Contract Without Release of Earnest Money Deposit. The buyer abandoned her property search and the seller's house went back on the market and ultimately sold on April 20, 2008.

In December 2007, the seller attempted to sue buyer #1 in small claims for the earnest money deposit, but failed to plead the case properly and the case was dismissed.

When did the buyer agent's three year record retention period begin? End?

Did the listing company's record retention period begin at the same time as the buyer agent's? Did listing company's record retention period begin in April/May 2008?

What about the EMD from transaction #1?

It was not until September 9, *2009* that the listing company finally decided to utilize the GS 93A-12 procedure and mailed the parties the 90 day notice letter informing them that if they did nothing during the next 90 days the company would deposit the disputed earnest money with the Clerk of Court of that County and the parties would then have one year within which to initiate a lawsuit. The parties did nothing, and on December 17, 2009 the broker-in-charge delivered a trust account check in the amount of $2,000 to the Clerk of Court.

When did the listing company's three year record retention period begin? End? Note the contrast between the buyer agent's and listing company's beginning and end dates for their respective retention periods, even though their files were created at the same time.

If both the seller and buyer had been represented by the same company acting as a dual agent, would that have altered any of the foregoing record retention periods?

Case #2:

An investor-buyer hires a broker to be his exclusive buyer agent. The broker reviews the *Working with Real Estate Agents* disclosure and the parties enter into a written agency agreement wherein the buyer agrees that the broker will be his exclusive buyer agent for locating and purchasing multiple properties as described in the agreement in a four county area during the next 24 month period. The agency agreement terminates August 1, 2015. Between August 2013 and August 1, 2015, the buyer purchases a total of 21 different investment properties in separate transactions.

Does the broker's record retention period begin as to all the transactions on August 2, 2015 following the termination of the agency agreement?

When does the broker's record retention period begin for each of the 21 transactions s/he handled on behalf of the buyer-investor?

What if the buyer has a pending contract to purchase on August 1, 2015, the buyer agent is holding the earnest money deposit, but the parties reach an impasse and ultimately enter into an Agreement to Terminate Contract without Release of Earnest Money Deposit on August 24, 2015. When does the broker's record retention obligation begin and end in this case?

Case #3: Property Management

Property management can lead to more complex considerations in determining when the three year period begins. A broker enters into a property management agreement with an owner in August 2002. The initial agreement terminates on August 31, 2003, but provides that it will automatically renew for an additional one year term each year unless either party notifies the other

in writing within 45 days prior to the renewal that either the owner or broker is terminating the agreement.

The broker manages the property for the next 10 years, during which period there are 3 different tenants:

1) Tenant A rented from September 1, 2002 - August 31, 2005,
2) Tenant B rented from October 1, 2005 - May 28, 2007, and
3) Tenant C has rented the property from July 1, 2007 through the present.

Each tenant entered into a *one year written lease* at the commencement of their tenancy which lease provided that either party could terminate the lease by giving written notice to the other at least 30 days prior to the expiration date of the initial term, and if neither gave such written notice or the tenant held over, the tenancy would become a month-to-month tenancy terminable by either party upon 45 days written notice. The only agency agreement the broker has with his owner-principal is the original agreement from August 2002 that has automatically renewed each year.

Has the broker's record retention period commenced on any of these transactions?

If so, when did it commence and end for Tenant A? Tenant B? Tenant C?

Although the broker has been representing the owner for more than 10 years, each tenancy during that period represents a separate transaction for record-keeping purposes. Tenant C's case is illustrative. Has the broker been able to purge any of his records for Tenant C from 2009 or 2010? *No*. But it's been more than three years? Yes, but *the transaction has not concluded*, because the tenant is still in the property pursuant to the terms of the original lease entered into in July 2007. Thus, *the broker's records must include the original lease and all payments, late fees, repair or maintenance expenses received, due or paid by the broker, net rent paid to the owner, management fees paid to the broker, and any other pertinent documents related to this transaction since its commencement in 2007*. Note: all monies received and disbursed from this tenancy should be recorded on the ledger sheet(s) for this property.

Is there any way to avoid this result? Not really. Even if the parties enter into a new lease agreement each year, it still is a continuation of the same tenancy between the same landlord and tenant - nothing has changed, except, perhaps, for the amount of rent. Typically there is no accounting for and disbursement of the tenant security deposit or property inspections and assessment of damages upon such renewals; rather, these matters are addressed at the conclusion of the tenancy when the tenant finally vacates the property. Thus, with Tenant C, the broker's record retention period will begin after the tenant vacates the property *and* the broker pays the tenant security deposit to the appropriate parties with a written accounting. At that point, the broker's records will go back to July 1, 2007 and will include all lease agreements, all monies received and disbursed, from or to whom and why, all late fees, and all other records required by Rules A.0107 and A.0108. ***The general rule and safest course is to retain all records for any given tenant from the inception of their tenancy until they finally surrender possession of the property***. If the file becomes too voluminous, scan the paper documents and save the records electronically.

***Residential* Tenant Security Deposits**

Unlike sales transactions where the commencement of the record retention period may be delayed because the broker is holding a disputed earnest money deposit as in Case #1 above, the *commencement of the record retention period in residential leasing* ***rarely*** *will be delayed because the broker still is holding a tenant security deposit*. Often the three year period begins within days of the tenant vacating the property, *but at the latest*, it should commence within sixty days after the tenant has vacated the property in long-term rentals and within forty-five days for vacation rentals, as those are the maximum time limits established *by state law* for disbursing the tenant security deposit to either the property owner or tenant or partial to each *and* accounting to the tenant for the disposition of his/her deposit. Recall that the ***disputed funds rule*** *(A.0107(g))* ***does not apply to residential tenant security deposits****, because state law requires disbursement according to statute within a specific time period*. [See GS §42-51, §42-52, and §42A-18.]

About the only time a broker should have a *residential* tenant security deposit in his/her trust account more than 45/60 days after termination of the tenancy is where the broker mailed a refund to the tenant and it was returned by the post office as undeliverable. The broker should keep the envelope in the transaction file as proof of attempted compliance with the statute. Because the deposit never left the broker's trust account, its presence will postpone the commencement of the three year record retention period. State law requires the deposit be held for at least six months, but is silent about the disposition thereafter. Thus, the broker should retain the deposit for the six month period and if not claimed by the tenant at that point, might attempt to escheat the funds to the State Treasurer, since the owner of the funds is known, but not his/her current whereabouts. So long as the deposit remains in the broker's trust account, the three year record retention period will not begin.

> **NOTE:** there are no state laws governing *commercial* tenant security deposits; the maintenance and disposition of these deposits will depend on the terms of the lease. Because there are no state laws requiring disbursement of these deposits within any time period, ***the disputed funds rule*** **does** ***apply to commercial tenant security deposits***. Thus, if at the conclusion of a commercial tenancy the parties disagree on who is entitled to what portion of the tenant security deposit, the broker will be obligated to hold the deposit in his/her trust account pending written agreement of the parties or a court order or must utilize the GS 93A-12 procedure to deposit the funds with the Clerk of Court of the county where the property is located.

RECORD RETENTION UNDER THE INTERNAL REVENUE CODE

Are there other records you may need to keep besides those required under Real Estate License Law and Commission rules? ***Yes***. Note that *License Law and Commission rules only address records that must be maintained in* ***brokerage transaction files*** *and* ***trust account records***. Where License Law and rules are silent concerning business or personal records that should be maintained, another agency, the Internal Revenue Service, fills the void. This subsection will provide ***general information*** *concerning what records must be kept for tax purposes and for how*

long. It is neither definitive nor specific to any individual's situation. *If an individual has questions, s/he should always seek assistance from a competent tax professional*.

So, with the foregoing disclaimer, what records must be kept for tax purposes and for how long? Two IRS publications, from which much of the following information was drawn and which licensees may find helpful, are **Publication 552:** *Recordkeeping for Individuals*, and **Publication 583:** *Starting a Business and Keeping Records*. Unlike Commission rules that list specific documents licensees are required to maintain and retain, the *Internal Revenue Code* does not provide a detailed list of documents; rather, it broadly states that *records must "clearly show all income and expenses"* and then suggests various records that may facilitate that purpose.

Business Records

When you start a business, you must first determine what form of business to use (e.g., limited liability company, corporation, sole proprietorship, etc.) and whether to use a cash accounting method or an accrual accounting method. Because real estate companies generally utilize a cash accounting method (which means income and expenses are reported in the calendar year in which each was received or paid), these materials are written based on that assumption. If you use an accrual method, some requirements may differ from the principles expressed here. If you have more than one business interest, it is strongly recommended that you *maintain separate operating accounts and separate books and records for each business and* that all of the operating accounts be *separate from your personal checking account*. You will need records from each business to support that business's tax return.

Income and Expenses

Supporting records must:

• identify the source and amount of any receipts, which may include bank deposit slips, receipt books, closing statements that reflect commissions paid, etc;

• identify the amount, purpose and payee of all disbursements which may be evidenced by canceled checks, cash register or credit card sales receipts, invoices, credit card and bank statements.

The IRS highly recommends paying expenses by check or other negotiable instrument to have proof of payment, rather than paying cash. If you don't have a canceled check, then bank or credit card statements that show the date and amount of payment and the payee's name may be acceptable, particularly if you also retain adequate supporting documentation. The IRS suggests in Publication 583 that a recordkeeping system for a small business might include:

- business checkbook
- *daily* summary of *cash* receipts
- monthly summary of cash receipts
- check disbursement journal
- depreciation worksheet
- employee compensation records.

If the company owns any assets, such as furniture, equipment (copiers or computers), buildings etc. that you either claim as business expenses or depreciate over time, then you must keep records that indicate:

- when and how the asset was acquired and the purchase price;
- cost of any improvements;
- any required depreciation;
- casualty loss deductions;
- how the asset was used;
- when and how the asset was disposed of and the selling price; and
- expenses of sale.

Employment Records

If there is anyone associated with the company other than the owner, then the company must maintain employment records and must issue certain "***information reports***" each year, either *Form W-2 or Form 1099-Misc*, to both the IRS and to the agent/employee. If the individual is viewed as an "employee," then the employer must withhold social security and Medicare taxes and federal and state income tax from the employee's wages and pay federal unemployment tax (FUTA). Failure to withhold or timely deposit income, Medicare or social security taxes from an employee's wages may result in penalties, including liability for the unpaid taxes plus interest. If the person is treated as an independent contractor (as are most real estate brokers), then such person would receive a Form 1099-Misc report from the company and would be individually responsible for timely paying all federal and states taxes due.

If the company has employees, e.g., receptionist, office manager, secretaries, bookkeeper, etc., then the ***company must retain all employment tax records for at least four years after the date the tax becomes due or is paid, whichever is later***. These records should include the following:

- Your employer identification number (EIN).
- Amounts and dates of all wage, annuity, and pension payments.
- Amounts of tips reported to you by your employees.
- Records of allocated tips.
- The fair market value of in-kind wages paid.
- Names, addresses, social security numbers, and occupations of employees and recipients.
- Any employee copies of Forms W-2 and W-2c returned to you as undeliverable.
- Dates of employment for each employee.
- Periods for which employees and recipients were paid while absent due to sickness or injury and the amount and weekly rate of payments you or third-party payers made to them.
- Copies of employees' and recipients' income tax withholding allowance certificates (Forms W-4, W-4P, W-4(SP), W-4S, and W-4V).
- Copies of employees' Earned Income Credit Advance Payment Certificates (Forms W-5 and W-5(SP)).
- Dates and amounts of tax deposits you made and acknowledgment numbers for deposits made by EFTPS (Electronic Federal Tax Payment System).
- Copies of returns filed and confirmation numbers.
- Records of fringe benefits and expense reimbursements provided to your employees, including substantiation.

Licensees are referred to IRS Publication 15, *Employer's Tax Guide*, and Publication 15-A, *Employer's Supplemental Tax Guide*, for additional information. **NOTE:** *employers are responsible for ensuring that the company's tax returns and information reports are filed and deposits and payments are timely made even if the employer hires a third party to perform these functions.* ***The employer remains liable if the third party fails to perform a required action***.

Individual Record-keeping for IRS Purposes

As with businesses, the basic requirement is to keep whatever documents are necessary to prove all income and expenses. According to the Internal Revenue Service, "basic records are documents that everybody should keep" and include the following:

- *Income:* Forms W-2, Forms 1099, bank statements, brokerage statements, and Forms K-1;
- *Expenses:* sales slips, invoices, receipts, canceled checks or other proof of payment, written communications from qualified charities;
- *Home:* closing statements, purchase and sales invoices, proof of payment, insurance records, receipts for costs of improvements, any claimed depreciation, and any casualty losses deducted and insurance reimbursements;
- *Investments:* brokerage & mutual fund statements, Forms 1099 and Forms 2439.
- *Past tax returns*.

Recall too that *if you purchase property through a like-kind exchange, you must retain the records for the old property, as well as the new property,* ***until the new property is sold or exchanged***.

How Long Must Records be Retained and In What Form?

How long must you keep past tax returns and the supporting documents? According to the IRS:

> You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out. *The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax*.

[Italics added.]

The "**period of limitations**" is the same for individuals and small businesses. *The number of years refers to the* ***period after the return was filed***. Returns that are filed before the due date (April 15) are treated as if they were filed on the due date.

	The period is:
1. If you owe additional tax and 2, 3, & 4 do *not* apply	3 years
2. If you fail to report income and it is more than 25% of the gross income shown on the return	6 years
3. If you file a fraudulent return	No time limit
4. If you fail to file a return	No time limit
5. File an amended return to claim a credit or refund	Later of: 3 years or 2 years after the tax was paid

6. If you file a claim for a loss from worthless securities or a bad debt deduction 7 years

REMEMBER ***employment records must be retained for at least FOUR years after the date the tax becomes due or is paid, whichever is later***.

Must you maintain hard copy books and records? Not necessarily, but all requirements applicable to hard-copies apply equally to electronic records. According to IRS Publication 583, pages 11-12:

> An electronic storage system is any system for preparing or keeping your records either by electronic imaging or by transfer to an electronic storage media. The electronic storage system must index, store, preserve, retrieve and reproduce the electronically stored books and records in legible format. All electronic storage systems must provide a complete and accurate record of your data that is accessible to the IRS....If your electronic storage system meets the requirements mentioned earlier (above), you will be in compliance. If not, you may be subject to penalties for non-compliance, unless you continue to maintain your original hard copy books and records in a manner that allows you and the IRS to determine your correct tax.

For additional information regarding electronic storage system requirements, licensees are referred to Internal Revenue Bulletin 1997-13, Revenue Procedure 97-22.

CIVIL LITIGATION & STATUTES OF LIMITATION

How long should you keep your records in case someone files a civil lawsuit against you and/or your company arising out of a transaction in which you participated? An excellent, but complex question that does not have a simple answer, other than a lawyer's favorite answer of "it depends." T*he correct answer will depend on many factors, including what actually transpired and when (i.e., the facts of that case) as well as the role the company/agent played in the transaction*. Brokers should always seek legal counsel from a competent lawyer if litigation is looming to discern what their options are and the most prudent course to follow.

Broadly, however, statutes of limitation provide a time limit within which a legal action must be commenced by filing a summons and complaint or the aggrieved party (the plaintiff) loses his/her right to sue the alleged or perceived offenders (the defendants) for redress. There are numerous statutes of limitation that govern various types of legal actions, but the *default statute*, if the situation is not specifically addressed elsewhere, generally *establishes a three year period from the last provision of services if the consumer was a client, i.e., the broker's principal*. Thus, typically, once three years has elapsed from the last activity in a transaction, the seller/lessor or buyer/tenant will be barred from commencing a legal action against his/her former agent for most causes. *However, if the alleged wrong involves matters that constitute* ***unfair and deceptive trade practices****, then the applicable statute of limitations under the unfair and deceptive trade practices act is* ***four years*** *from the accrual of the cause of action*. Statutes pertaining to unfair and deceptive trade practices are found in Chapter 75 of the North Carolina General Statutes and in private actions, i.e., those brought

by consumers rather than the Attorney General, allow an award of treble damages (three times the amount of the consumer's actual damages) as well as an award of attorney fees.

The foregoing generally applies between agents and their principals. However, *where the broker* was not the consumer's agent, but instead *represented the other side, then the* ***statute of limitation clock*** *may not* ***start to tick*** *upon the cessation of activity in the transaction, but from the* ***discovery of the wrong or when it reasonably should have been discovered***.

For example, several years ago there was a case where the listing company/agent stated in the MLS information that the residential property was serviced by city water and sewer. Buyers, represented by an agent from a company other than the listing company, purchased the property. Two years after the transaction had closed, the buyers discovered that the property in fact was on a septic system. They requested that the real estate company atone for its misrepresentation by paying to have the property connected to city sewer service which was readily available. After negotiating with the company for numerous months to no avail, the buyers filed a lawsuit against the individual agent and the real estate company and the broker-in-charge approximately 3.5 years after the transaction closed. The defendant real estate company moved to dismiss on the grounds that the statute of limitations had expired, but the Court held that the statute did not begin to run until the buyers discovered the problem and thus they had timely commenced their legal action.

The point of this discussion is to alert brokers-in-charge and owners of companies that they are not necessarily absolved from all civil liability the moment three years has passed from the conclusion of the transaction and that they may wish to consider this potential liability when determining their record retention policies. Even when the consumer is the broker's client/principal, the consumer may have a four year window from the last provision of services in which to commence a legal action if the cause of action falls under the unfair and deceptive trade practices laws. Where the consumer is not the broker's principal, but a "customer," s/he may have up to three to four years *from the discovery of the problem* (or when it reasonably should have been discovered) within which to commence a lawsuit.

Answers to Record Retention Questions in Practical Application Section

Case 1: *When did the buyer agent's three year record retention period begin?* October 1, 2007, the day after the parties entered into the written termination of contract agreement and the buyer abandoned her property search. *End?* October 1, 2010.

Did the listing company's record retention period begin at the same time as the buyer agent's? No. *Did the listing company's record retention period begin in April/May 2008?* No; the period still had not commenced on the failed transaction because the listing company still had the disputed earnest money deposit in its trust account.

When did the listing company's three year record retention period begin? End? The period began December 18, 2009, the day after the broker deposited the disputed earnest money deposit with the Clerk of Court, and it ends/ended December 18, 2012.

If both the seller and buyer had been represented by the same company acting as a dual agent, would that have altered any of the foregoing record retention periods? Yes; the period would not have commenced for either transaction file until the earnest money deposit was disbursed from the company's trust account.

Case 2: *Does the broker's record retention period begin as to all the transactions on August 2, 2015 following the termination of the agency agreement?* No.

When does the broker's record retention period begin for each of the 21 transactions s/he handled on behalf of the buyer-investor? The broker's record retention period for each transaction would begin the day after the transaction terminated *unless* the broker was holding any monies related to the specific transaction in his trust account, in which case it would begin upon the disbursement of all trust monies to the appropriate parties.

What if the buyer has a pending contract to purchase on August 1, 2015, the buyer agent is holding the earnest money deposit, but the parties reach an impasse and ultimately enter into an Agreement to Terminate Contract Without Release of Earnest Money Deposit on August 24, 2015. When does the broker's record retention obligation begin and end in this case? The period would not **begin** for this final transaction until such time as the broker disburses the earnest money from his trust account, whether pursuant to the parties' written agreement or payment to the Clerk of Court pursuant to G.S. 93A-12.

Case 3: *Has the broker's record retention period commenced on any of these transactions?* Yes.

If so, when did it commence and end for Tenant A? It would have commenced the day after the broker disbursed the tenant security deposit to the appropriate parties, which should have occurred no later than October 1, 2005 (assuming that any payment due the tenant was not returned).

Tenant B? As with Tenant A, the three year period would have commenced within days of disbursing the tenant security deposit to the appropriate parties, which should have occurred no later than June 27, 2007 (assuming that any payment due the tenant was not returned).

Tenant C? See discussion in the materials, pp. 11-12.