

Tax Action Memo®

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Helping Business Clients Establish Reasonable Record Retention Policies

<p>Type of Clients: Businesses.</p> <p>Situation: Your business client asks about rules for retaining income tax records.</p> <p>Deadline: N/A.</p>	<p>Tax Action Required: Review this article and provide clients with the attached letter describing record retention guidelines. Meet with clients as appropriate.</p>
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Background

Businesses maintain tax records primarily to document amounts reported on their tax returns in the event of an IRS audit. Because of the severe time constraints under which most businesses operate, the maintenance of tax records is a low priority for the average business. But, if the IRS audits the business's return, the value of well-maintained tax return documentation will be immeasurable. So, with this in mind, we thought it would be helpful to review the tax record retention requirements and discuss some of the related issues. We also have included a client letter that you can make available to your clients.

How Long Must Records Be Kept?

Every taxpayer is required by IRC Sec. 6001 to maintain adequate tax records and to make those records available to the IRS upon request. The Section 6001 regulations also require a taxpayer to keep the records so long as they may be material to the administration of the tax laws. In that regard, the IRS stated in Rev. Proc. 98-25, "at a minimum, this materiality continues until the expiration of the period of limitations for assessment, including extensions, for the tax year." Unfortunately, the IRS has issued no binding guidance specifically stating how long the records must be kept.

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

The statute of limitations period for income tax returns is generally three years. However, it's six years if there is a substantial understatement of gross income (i.e., the return understates income by more than 25%). The statute never runs if a fraudulent return is filed or if no return is filed. Furthermore, special statutes of limitations apply to certain types of deduction items. For example, IRC Sec. 6511(d)(1) provides a seven-year statute of limitations period with respect to deductions taxpayers claim for bad debts and worthless securities.

When advising clients about record retention periods, a good rule of thumb is to add a year to the statute of limitations period. Using this approach, taxpayers should keep most of their income tax records a minimum



of four years, but it may be more prudent to retain them for seven years. However, be sure to consider applicable state tax statutes since they may include unique record retention requirements.

Regardless of the federal or state tax assessment periods, taxpayers should retain certain records for longer periods, and in some cases, indefinitely. Records substantiating the cost basis in property that may be sold (such as fixed assets or investments) should be retained based on the record retention period for the year the property is sold. Depreciation records for a fixed asset should be kept based on the record retention period for the last year depreciation expense on the asset is claimed. Tax returns, results of an audit by a tax authority, general ledgers, and financial statements should normally be kept indefinitely.

Appendix 2 provides recommended document retention periods based on federal assessment periods. It will need to be adjusted for any unique state requirements. Also, it may be necessary to retain some records longer because of nontax reasons. For example, insurance policies, leases, real estate closing statements, and employee payroll records might need to be kept longer than needed for IRS purposes. Taxpayers should consult with their attorneys about how long to retain legal documents.

Document Destruction Policies

Businesses should have written procedures detailing their document destruction policies to avoid losing any important data and as protection against sanctions imposed by the Tax Court. The Tax Court has punished taxpayers that destroyed records when the destruction was not in the ordinary course of business and was done before the records were required for audit or litigation purposes. The Tax Court has also asserted that tax records not destroyed in the ordinary course of business were destroyed because they contained incriminating information that was harmful to the party that disposed of them. The document destruction policy must comply with federal, state, and local assessment and record retention periods.

Requirements for Maintaining Computer Records

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

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

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

Observation: If the computer record retention rules apply, the taxpayer is not relieved of the obligation to comply by keeping hard copy records of the same information. The increasing use of computers by most businesses may cause at least one of the previously mentioned conditions to apply, which means most businesses (not just those with at least \$10 million of assets) will be subject to the computer record retention rules.

The rules of Rev. Proc. 98-25 can be summarized as follows:

1. Computerized records must provide sufficient information to support and verify entries made on the taxpayer's returns and to determine the correct tax liability. The taxpayer's computer records will meet this requirement only if the records reconcile with the taxpayer's books and the taxpayer's return. The reconciliation must provide an audit trail between the account totals in the computer records and the account totals in the taxpayer's books and on the taxpayer's return.

2. Computerized records must contain sufficient transaction-level detail that the information and the source documents underlying the computerized records can be identified.
3. All computerized records must be made available to the IRS upon request and must be capable of being processed. In addition, the taxpayer must provide the IRS with the resources (e.g., hardware and software, terminal access, computer time, or personnel) to enable it to process the computerized records. Upon request, the IRS must be provided documentation of the business processes that (1) create, modify, and maintain the records; (2) support and verify entries made on the taxpayer's return and determine the correct tax liability; and (3) evidence of the authenticity and integrity of the taxpayer's records.
4. Taxpayers using the computer-to-computer exchange of information (Electronic Data Interchange or EDI) must retain the records that alone, or in combination with any other records, contain all the information that the IRS requires of hardcopy books and records. For example, a taxpayer using EDI technology to receive electronic invoices from suppliers may not have product descriptions on the EDI transactions. To have complete records, the taxpayer would have to supplement its EDI records with product code description lists.
5. The taxpayer must promptly notify the IRS if any computerized records are lost, stolen, destroyed, otherwise no longer capable of being processed, or found to be incomplete or materially inaccurate.

The IRS can modify or waive any part of the computerized record retention requirements to which a taxpayer is subject by way of a record retention limitation agreement with the taxpayer.

Failure to comply with the record retention requirements for computerized systems can potentially result in the imposition of the Section 6662 accuracy-related penalty. If the failure is caused by an intentional disregard of the rules under IRC Sec. 7203, the penalty can be a fine of up to \$100,000 or imprisonment for not more than one year (or both) along with the costs of prosecution (Rev. Proc. 98-25).

Electronic Storage Systems

The IRS has also issued guidance on using electronic storage systems to satisfy recordkeeping requirements (Rev. Proc. 97-22). An electronic storage system is used to prepare, record, transfer, index, store, preserve, retrieve, and reproduce books and records by either electronically imaging hard copy documents to an electronic storage medium, or transferring computerized books and records to an electronic storage medium that allows them to be viewed or reproduced without using the original program.

Observation: Rev. Proc. 97-22 applies to income tax records of taxpayers who must maintain books of account or records, as required by Reg. 1.6001-1(a). This includes all taxpayers, other than farmers and wage earners, who are specifically exempt from the requirement to maintain books. Presumably, this means that taxpayers operating a business, other than farmers, must maintain a bookkeeping system and, as such, can take advantage of the electronic storage system rules in Rev. Proc. 97-22. Whether individuals with salary or wage income can store records electronically, as described in the revenue procedure, is unclear. But, from a practical standpoint, it seems reasonable to conclude that they can.

In general, the IRS says that an electronic storage system must—

1. ensure an accurate and complete transfer of the hard copy or computerized books and records to an electronic storage medium;
2. index, store, preserve, retrieve, and reproduce the electronically stored books and records;
3. include reasonable controls to ensure the integrity, accuracy, and reliability of the electronic storage system and to prevent and detect the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of the electronically stored books and records;

4. include an inspection and quality assurance program evidenced by regular evaluations of the electronic storage system, including periodic checks of electronically stored books and records;
5. include a retrieval system that has an indexing system;
6. exhibit a high degree of legibility and readability when displayed on a video display terminal and when reproduced in hard copy; and
7. provide support for the taxpayer's books and records. For example, the information maintained in an electronic storage system and the taxpayer's books and records must be cross-referenced to provide an audit trail between the general ledger and the source documents.

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

At the time of an IRS examination, or for tests of a business's electronic storage system that the IRS may periodically initiate, the business must retrieve and reproduce (including hard copies, if requested) electronically stored books and records and provide the IRS with the resources (e.g., appropriate hardware and software, personnel, or documentation) necessary to locate, retrieve, read, and reproduce (including hard copies) any electronically stored books and records.

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

Once a taxpayer has verified that the storage system complies with and will continue to comply with the Rev. Proc. 97-22 requirements, the taxpayer may destroy the original hard copies and delete the original computerized records (other than certain machine-sensible records that must be retained). But since a state may have its own guidelines for storing and processing records in an electronic format, businesses should review applicable state law when using electronic storage systems.

Conclusion

There are various factors to consider when determining how long to keep and how best to maintain income tax records. Foremost is the IRS requirement that they be retained as long as they may be material to the IRS administration of the tax laws; however, nontax reasons often require that some records be kept longer. Practitioners can provide a valuable service to their clients by periodically reminding them of the tax recordkeeping requirements and informing them on how certain electronic storage systems can be used to comply. Appendix 1 contains a sample client letter retaining business records.

References:

IRC Secs. 6001, 6501, 6511(d)(1), and 7203.
 Reg. 1.6001-1(a).
 Rev. Procs. 97-22, 1997-1 CB 652, and 98-25, 1998-1 CB 689.
 IRS Pub. 552, Recordkeeping for Individuals.

Subscriber Note: This Tax Action Memo was adapted from PPC's Guide to Dealing with the IRS. Information on this publication can be found at ppc.thomson.com or by calling 800-323-8724.

Appendix 1

Sample Client Letter on Retaining Business Records

Dear Client:

Retaining and storing your income tax records is an important final step of your tax filing responsibility. This letter is a refresher on the rules for keeping your tax records, along with some information on storage options.

When determining how long to keep most of your income tax records, we look at the time frame over which the IRS can audit a return and assess a tax deficiency or you can file an amended return. For most taxpayers, this period is three years from the original due date of the return or the date the return is filed, if later. For example, if you filed your 2008 Form 1040 on or before April 15, 2009, the IRS has until April 15, 2012, to audit the return and assess a deficiency. However, if a return includes a substantial understatement of income, which is defined as omitting income exceeding 25% of the gross amount reported on the return, the statute of limitations period is extended to six years.

A good rule of thumb for keeping tax records is to add a year to the IRS statute of limitations period. Using this approach, you should keep your income tax records for a minimum of four years, but it may be more prudent to retain them for seven years, which is what the IRS informally recommends. State tax rules must also be considered, but holding records long enough for IRS purposes will normally suffice for federal and state tax purposes, assuming the federal and state returns were filed at the same time.

Certain tax records, however, should be kept much longer than described above and some, indefinitely. Records substantiating the cost basis of property that could eventually be sold, such as investment property and business fixed assets, should be retained based on the record retention period for the year in which the property is sold. Tax returns, IRS and state audit reports, business ledgers, and financial statements are examples of the types of records you should normally retain indefinitely.

Keep in mind that there may be non-tax reasons to keep certain tax records beyond the time needed for tax purposes. This might include documents such as insurance policies, leases, real estate closing statements, employment records, and other legal documents. Your attorney can provide additional guidance.

It's also important to know that the IRS permits taxpayers to store certain tax documents electronically. Although the rules are aimed primarily at businesses and sole proprietors, they presumably apply to other individuals as well. The rules permit taxpayers to convert paper documents to electronic images and maintain only the electronic files. The paper documents can then be destroyed. Certain requirements must be met to take advantage of an electronic storage system. So, contact us if you want more details.

We hope this brief overview helps you understand the income tax record retention rules. If you have any questions regarding your specific situation or you would like to discuss these rules in more detail, please give me a call.

Best regards,

Recommended Document Retention Time Periods¹

Type of Record	Retention Period
Copies of tax returns as filed	7 years after liquidation of entity
Tax and legal correspondence	7 years after liquidation of entity
Audit reports	7 years after liquidation of entity
General ledger and journals	7 years after liquidation of entity
Financial statements	7 years after liquidation of entity
Contracts and leases	7 years after liquidation of entity
Real estate records	7 years after liquidation of entity
Corporate stock records and minutes	7 years after liquidation of entity
Bank statements and deposit slips	6 years
Sales records and journals	6 years
Other records relating to revenue	6 years
Employee expense reports	6 years
Travel and entertainment expenses records	6 years
Canceled checks	3 years ²
Paid vendor invoices	3 years ²
Employee payroll expense records	3 years ²
Inventory records	3 years ^{2,3}
Depreciation schedules	tax life of asset plus 3 years
Other capital asset records	tax life of asset plus 3 years
Other records relating to expenses	3 years ²
Partnership agreement and amendments	permanently
Operating agreement and amendments (LLC)	permanently

¹ This table contains recommended document retention periods based on federal requirements. Any unique retention requirements resulting from state tax statutes will need to be included. Also, it may be necessary to retain some records longer because of nontax reasons. For example, insurance policies, leases, real estate closing statements, and employee payroll records might need to be kept longer than needed for IRS purposes. Taxpayers should consult with their attorneys about how long to retain legal documents.

² From the later of the tax return due date or filing date. (All records related to a return should be kept for at least six years if there is any concern the IRS could show a significant understatement of gross income on the return.)

³ Longer if you use LIFO.