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Tax

Taxpayer Record Retention Requirements

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The Internal Revenue Code requires the maintenance of adequate accounting records to properly determine taxable income each year.[1] These records must be retained as long as the taxable income of that year is subject to adjustment by tax authorities. For federal income tax purposes, accounting records should be kept until expiration of the applicable statute of limitation for the taxable year, generally at least three years after the return due date, including extensions.[2] This period is lengthened when the statute of limitations is extended by agreement with the Internal Revenue Service (IRS),[3] or when net operating losses or investment credit carrybacks cause recalculation of prior years' tax liabilities.[4] The statute is extended to six years where gross income is understated by more than 25 percent[5] while an indefinite statute applies where a false or fraudulent return is filed.[6] If a return is delinquent, the statutory period begins only after the return is filed.[7]

In light of the above rules, failure to retain records or to retain them for an insufficient period of time may result in the assessment of additional tax. Additional tax may be assessed because of the disallowance of deductions or a downward adjustment of basis used in determining gain or loss on the disposition of property. This article provides guidelines to assist businesses in deciding what records to retain, especially where the taxpayer maintains automatic data processing (ADP) systems and/or microfilm storage facilities.

Record Retention for Small Business

The Internal Revenue Code specifies neither the type of records nor any time period for retention. Generally, the Code requires taxpayers to keep such records as the IRS may from time to time prescribe.[8] The regulations merely require that records be kept accurately without otherwise prescribing the particular form or detail required. However, the regulations do require that records be maintained in a manner that will enable the IRS to ascertain whether liability for tax is in fact incurred and the amount of such liability.[9]

Regardless of what books and records are retained, the regulations require that taxable income be computed under the method of accounting used to compute income for financial statement purposes.[10] Furthermore, every taxpayer is required to maintain accounting records for the purpose of filing a correct return. Accounting records for this purpose include the taxpayer's regular books of account and other records and data as may be necessary to support the entries on the books of account and on the return.[11]

As for the time period such records must be retained, the general requirement is that records be kept "so long as the contents thereof may become material in the administration of any internal revenue law." [12] With such limited guidance, taxpayers must conservatively assume that some books and records may be "material" as long as the business remains in existence. At a minimum, the regulations state that records be maintained "for at least four years after the due date of such tax for the return period to which the records relate, or the date such tax is paid, whichever is later."[13]

In addition to the Internal Revenue Code, regulations, and certain IRS rulings, a valuable source of guidance with respect to record retention is the *Guide to Record Retention*, published by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. While this book does not have the effect of law, regulation or IRS ruling and is incomplete for tax purposes, it contains record retention advice for some 40 federal agencies including the IRS. Among its suggestions for retaining records in several relevant and frequently encountered tax areas are:

- Persons paying travel or other business expenses incurred by an employee in connection with the performance of his service should keep detailed records of ordinary and necessary travel, transportation, entertainment, and similar business expenses, including identification of amount and nature of expenditures. Supporting documents, especially in connection with large or exceptional expenditures, should be retained.

- Persons claiming allowance for depreciation should maintain regular books of accounts or permanent auxiliary records showing for each account the basis of the property, including adjustments necessary to establish the cost of each property. These records must be maintained in a manner sufficient to determine an estimate of salvage value, if necessary.

The general requirements for record retention described above can be more usefully understood by distinguishing the documentation relating to property records as opposed to records supporting items of income, deductions, and credits for the current taxable year. Generally, records to support income, deductions, and credits appearing on a return should be kept, at a minimum, until the statute of limitations for that return expires. Property records retained to establish a basis in property in order to compute gain or loss upon disposition and to establish the depreciation, amortization, or depletion that is allowed or allowable must be maintained until the ultimate disposition or retirement of the property in question and until the expiration of the statute of limitation period for the taxable year in which such disposition or retirement occurs. Thus, if property is given a basis determined by reference to other property held by that person or another person, records pertaining to the other property also must be retained to document that basis. After a disposition, or retirement, the rules for retaining records for income, deductions and credits for the current taxable year apply.

Because of the lack of comprehensive guidelines, specific rules regarding what documents to keep and what to discard are unavailable. To provide some assistance, Table 1 offers guidelines for record retention procedures for a small business. While the chart is not based on law, it reflects the experience of the authors and other practitioners and conforms to the general IRS requirements for record retention.

Table 1
Record Retention Guidelines
P = Permanent

Correspondence	Years
General	2
License, Traffic and Purchase	6
Production	8
Legal and Tax	P

Insurance	Years
Policies (All Types — Expired)	4
Accident Reports	6
Fire Inspection Reports	6
Group Disability Records	8
Safety Reports	8
Claims (After Settlement)	10

Personnel	Years
Contracts (Expired)	6
Daily Time Reports	6
Disability & Sick Benefits Records	6
Personnel Files (Terminated)	6
Withholding Tax Statements	6

Accounting	Years
Bank Statements and Deposit Slips	3
Payroll (Time Cards)	3
Payroll (Individual Time Reports and Earnings Records)	8
Dividend Checks (Canceled)	6
Checks (Payroll and General)	8
Expense Reports	6
Subsidiary Ledgers (Including A/P and A/R Ledgers)	6
Monthly Trial Balances	6
Vouchers for Payments to Vendors, Employees, Etc.	8
Audit Reports	P
General Ledgers and Journals	P

Corporate Records	Years
Mortgages, Notes & Leases (Expired)	8
Bylaws, Charter, & Minute Books	P
Cash Books	P
Contracts and Agreements	P
Patents, Copyrights & Trademark Registrations	P
Deeds and Easements	P
Capital Stock & Bond Records (Including Stock Certificates and Transfer Lists)	P
Documentation for Purchase of Assets	P
Labor Contracts	P
Proxies	P
Retirement & Pension Records	P
Tax Returns & Workpapers	P
Financial Statements	P

Purchasing & Sales	Years
Purchase Orders	3
Requisitions	3
Sales Contracts & Sales Invoices	3

Receiving & Shipping	Years
Export Declarations, Freight Bills, Manifests, Shipping and Receiving Reports, Waybills and Bills of Lading	4

Travel and Entertainment	Years
Account Books	6
Diaries	6
Statements Identifying Time, Place and Amount of Each Expenditure	6

Automatic Data Processing (ADP) Systems and Microfilm/Microfiche

Although the IRS has not provided specific guidelines on general record retention for taxpayers, the growth of ADP systems and microfilm accounting records has led the IRS to issue very specific guidelines on how taxpayers must maintain such accounting systems in the event of an IRS audit. As in the case of a manual accounting system, documentation of the ADP portion of an accounting system and those files that feed into the accounting system must be retained and be accessible so long as their contents may be material in the administration of any tax law. Moreover, retention of records or files produced on an ADP system does not eliminate the responsibility for retaining underlying hardcopy documents. In Rev. Proc. 86-19,[14] the IRS has set out rules for ADP systems utilized by taxpayers (or controlled groups of corporations) with assets of at least $10,000,000 (Table 2).

In addition to an ADP system, use of microfilm/microfiche is often desirable in view of storage costs associated with retaining detailed records such as canceled checks, invoices, vouchers, etc. In general, taxpayers are responsible for the effective identification, processing, storage, and preservation of microfilm, having it readily available for as long as the contents may become material in the administration of any tax law. In Rev. Proc. 81-46,[15] the IRS has established specific requirements for the retention of records on microfilm (Table 3).

Conclusion

Every business must keep records that facilitate the filing of numerous required reports and that provide evidence in support of its actions in various business situations. This is especially true in the area of income tax returns, the validity of which are heavily dependent upon proper retention of records. As a general rule, taxpayers should retain any record supporting a position on a tax return for at least six years. In most cases, this will cover the federal income tax statute of limitations and the statutes of various state and local taxing authorities. However, where records substantiate the cost basis of an asset, such records should be retained at least until the expiration of the statute of limitations of the tax return for the year in which the asset is disposed of or retired. Ω

REFERENCES

1. With respect to what documents must be retained for income tax purposes, Sec. 6001 provides:
   Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such

TABLE 2
Retention of ADP System Records

- Documentation of the scope of the ADP operations must indicate the functions being performed by the ADP equipment, the procedures employed in each function, and the controls used to insure accurate and reliable processing. There must be documentation for each computer file indicating the record formats used, system and program flowcharts, label descriptions, source program listings of programs that created the files retained, and detailed charts of accounts for each period.
- The system must be designed to insure that details underlying the summary accounting (invoices, vouchers, etc.) are easily identifiable and available to the IRS upon request.
- All machine-sensible records (punched cards, magnetic tapes, disks) used in the system must be retained by the taxpayer in a retrievable format for the applicable retention period.
- All retained records must be clearly labeled and stored in a secure environment, e.g., any machine-sensible record retained should be labeled with a retention date and a statement that the record is for IRS use. Back-up machine-sensible files should be stored at an off-site location.
- Periodic checks should be made on all files being retained for IRS use. Files that are subsequently lost, destroyed, damaged, or found to be incomplete or materially inaccurate must be reported to the IRS. Such files must be recreated within a reasonable period of time.
- The use of a Data Base Management Systems necessitates, in addition to the above, that sequential files are processible by conventional means and, at a minimum, that the following documentation exists: Data Base Description, Record layout of each segment with respect to fields in each segment, Systems Control Language, Program Specification Block, and Program Communication Block.
- The utilization of an outside service bureau or time-sharing service does not eliminate any of the above responsibilities.

TABLE 3
Retention of Microfilm Records

- There must be written procedures governing the establishment of a microfilm system and designating the individuals who are responsible for maintaining and operating the microfilm system with appropriate authorization by the Board of Directors, general partner(s), or owner.
- The microfilm system must be complete and must be used consistently in the regularly conducted activity of the business.
- There must be established processing procedures, with appropriate documentation, so the original document can be followed through the micrographic system.
- There must be internal procedures for inspection and quality assurance.
- There must be a record of where, when, by whom, and on what equipment the microfilm was produced.
- When displayed on a reader or reproduced on paper, the material must exhibit a high degree of legibility and readability.
- A detailed index of all microfilmed data must be maintained and arranged in a manner that permits the immediate location of any particular record.
- All microfilming and processing duplication, quality control, storage, identification, and inspection must meet industry standards.
- In case of IRS audit, the taxpayer must make available upon request a reader/printer in good working order at the examination site for reading, locating, and reproducing any record maintained on microfilm.

records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulation, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title. The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a). Thus, the power of the IRS to require records, statements, and returns, etc., is virtually unlimited.

2. Sec. 6501.
3. See I.R.S. Form 872 & Section 6501(c)(4).
4. Sec. 6501(h), (j), (k).
5. Sec. 6501(e)(1).
6. Sec. 6501(c)(1).
7. Sec. 6501(c)(3).
8. Sec. 6001.
9. Treas. Regs. 1.6001-1(a). The regulations require taxpayers to keep copies of any form, return, schedule, statement, refund claim or other document filed with the IRS Treas. Regs. 1.6001-1(b), (c). Specific guidance on documentation required with respect to each employee upon whom income tax is withheld is set out at Treas. Regs. 31.6001-5.
10. Treas. Regs. 1.446-1(a)(1).
11. Treas. Regs. 1.446-1(a)(4).
12. Treas. Regs. 1.6001-1(e).
13. Treas. Regs. 31.6001-1(e)(2).
14. 1986-1 C.B. 558.
15. 1981-2 C.B. 621, clarified by Rev. Proc. 83-6, 1983-1 C.B. 582.

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