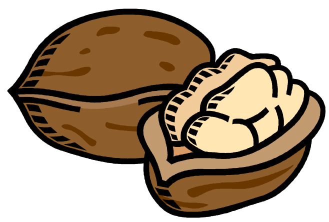
Recordkeeping in a Nutshell



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RECORDKEEPING

One of the most common questions asked of professional tax preparers is “How **long** should I keep my tax returns/ business records?” The reason for this question’s popularity is because taxpayers don’t want to store endless amounts of paper. However, taxpayers seldom ask “What **type** of records should I keep?”

As trusted advisors, it is important for tax preparers to inform clients of the specific records to retain as required by law and/or the IRS. The following is intended as an introduction to recordkeeping for small businesses. A taxpayer starting a new business should use the following IRS publications for detailed information about rules and regulations affecting businesses:

- IRS Pub. 15, *Circular E, Employer’s Tax Guide*
- IRS Pub. 334, *Tax Guide for Small Business (For individuals who use Schedule C or C-EZ)*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 538, *Accounting Periods and Methods*
- IRS Pub. 583, *Starting a Business and Keeping Records*

BASIC RECORDKEEPING REQUIREMENTS

For most small businesses, income and expenses are summarized from information recorded in the checkbook. However, before anything is written in the checkbook, there is usually a piece of paper that triggers an entry. For example, a check is written because a bill is received. The bill usually shows the date of the transaction and what was purchased; it is called a “supporting document.”

Supporting Documents to Keep

General. Supporting documents that are generally used by small businesses are:

- Check register,
- Bank statements,
- Depreciation schedules, and
- Year-end inventory calculations.

These documents may be kept either on paper or electronically.

Income Related. Supporting documents related to income are typically:

- Invoices given to customers,
- Bank deposit slips,
- Receipt books,
- Cash register tapes,
- Credit card sales slips, and
- Forms 1099-MISC and 1099-INT received by the business.

Expense Related. Supporting documents typically related to outgoing transactions or expenses are:

- Invoices from vendors,
- Cancelled checks,
- Cash register receipts,
- Account statements,
- Credit card charge slips,
- Real estate closing statements, and
- Forms 1099-MISC and 1099-INT issued by the business.

> **Caution.** Proof of payment of an amount, by itself, does not establish deductibility. Documents that show why the cost was incurred must also be kept. For example, a credit card statement may show a $500 charge at the office supply store. However, the statement does not show whether what was purchased was a Personal Digital Assistant for business use or an MP3 player for a child's birthday.

SPECIFIC RECORDKEEPING REQUIREMENTS

Specific recordkeeping rules apply to expenses related to travel, transportation, entertainment, and gifts. IRS Pub. 463, *Travel, Entertainment, Gifts, and Car Expenses,* provides useful information about these expenses. Evidence is usually considered adequate if it shows the amount, date, place, and business purpose of the expense.

The chart at the end of this section summarizes the special requirements for these expenses.

Sampling

If an adequate record is kept for part of the tax year, that record can be used to prove the amount of business or investment use for the entire year.[1] Other evidence must demonstrate that the periods for which the record is kept are representative of the use throughout the tax year.

Example 1. Sandy uses her car to visit the offices of clients, meet with suppliers, and pick up and deliver items to clients. She and her family also use the car for personal purposes. She keeps adequate records during the first week of each month that show that 75% of the use of the car is for business. Invoices and bills show that her business use continues at the same rate during the later weeks of each month. Her weekly records are representative of the use of the car each month and are sufficient evidence to support the percentage of business use for the year.

The IRS released guidance on establishing the amount of meal and entertainment expenses when the expenses are not subject to the 50% limitation.

> **Note.** Statistical sampling is addressed in Rev. Proc. 2004-29 which is covered in Chapter 13, Rulings and Cases, Business Expenses.

Car Expenses

Several uses of a car can be considered part of a single use, such as a round trip or uninterrupted business use, and documented with a single record. Minimal personal use, such as a stop for lunch on the way between two business stops, is not an interruption of business use.

1. Temp. Treas. Reg. §1.274-5T(c)(3)(ii)

Example 2. Howard makes deliveries at several different locations on a route that begins and ends at his office. He can account for these using a single record of miles driven. This is true even if he also stops to pick up his dry cleaning between two of the deliveries.

HOW LONG TO KEEP BUSINESS RECORDS

Taxpayers must keep records "as long as they may be needed for the administration of any provision of the Internal Revenue Code."[2] Some books and records of a business may be "material" for tax purposes as long as the business remains in existence. In addition, there may be nontax reasons to retain certain records for an indefinite period of time. The IRS recommends that copies of filed returns be kept indefinitely. The general time requirement can be separated into two categories:

1. **Records of Property.** Records of property, required to determine a basis to compute gain or loss upon disposition, depreciation, or amortization, must be kept until a taxable disposition is made. After the disposition, the time requirements listed below apply.

Example 3. In 1995, Phil bought a backhoe. Before it was fully depreciated, he traded it for another backhoe in 2000. Phil sold this backhoe in 2004. He must take both backhoes into account when calculating the realized gain/loss. Therefore, even though the 1995 backhoe is now fully depreciated, the supporting documents for both backhoes might be required if the 2004 return is audited.

2. **Records of Income, Deductions and Credits.** At a minimum, records of income, deductions, and credits appearing on a tax return should be kept until the statute of limitations expires on the tax return. Generally, tax must be assessed within three years of the date the return is filed or two years after payment, whichever is later.[3] A claim for refund or credit must be filed within three years after the date the return is filed or two years after payment was made, whichever is later.[4]

If the taxpayer...	Then the period is...
1. Owes additional tax and 2, 3, and 4 do not apply	3 years
2. Does not report income that he should and it is more than 25% of the gross income shown on the return	6 years
3. Files a fraudulent return	No limit
4. Does not file a return	No limit
5. Files a claim for credit or refund after filing the return	Later of 3 years or 2 years after tax was paid
6. Files a claim for a loss from worthless securities	7 years
7. Has employment records	4 years after the tax becomes due or is paid.

Note. Returns filed before the due date are treated as filed on the due date.

There are specific recordkeeping requirements if accounting records are kept using an automatic data processing system.[5] These requirements generally apply to multi-million dollar businesses and are not covered in this section.

2. 26 CFR 1.6001-1

3. 26 CFR 301.6501(a)-1

4. 26 CFR 301.6511(a)-1

5. Rev. Proc. 98-25

Fraud. While fraud carries an unlimited time period for an IRS audit, the IRS often has a difficult time proving fraud. The determination of whether fraud exists is a difficult problem for the courts. It is best explained in a court case which lists several indications of fraud or "badges of fraud."[6] They include:

1. Understatement of income,
2. Inadequate books and records,
3. Failure to file tax returns,
4. Implausible or inconsistent explanations of behavior,
5. Concealment of assets,
6. Failure to cooperate with tax authorities,
7. Filing false Forms W-4,
8. Failure to make estimated tax payments,
9. Dealing in cash,
10. Engaging in illegal activity, and
11. Attempting to conceal illegal activity.

Employment Taxes. If a business has employees, employment tax records must be kept for at least four years after the date the tax becomes due or is paid, whichever is later. For more information about recordkeeping for employment taxes, see IRS Pub. 15, *Circular E, Employer's Tax Guide*.

DOCUMENTATION TO PROVE EXPENSES

Expenses should be listed in an account ledger or log, this can include reports kept on the computer. In addition, documentation showing the date, place, amount, and the "essential character" of the expense should be kept to support the ledger entries. Receipts, bills, and cancelled checks usually contain the required information for most types of expenses. For the expenses listed in the following table, additional support is required.

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6. *Gold Bar, Inc. DBA All American Trucking Co v. Commr.,* TC Memo 2000-211, 80 TCM 33, July 10, 2000

SPECIFIC RECORDS AND INFORMATION REQUIRED TO SUPPORT CERTAIN EXPENSES

Type of Expense	Figuring the Amount	Time	Place or Description	Business Purpose and Business Relationship
TRANSPORTATION				
Vehicle	Use the standard mileage rate (published by the IRS annually) multiplied by the business miles, or actual expenses multiplied by the percent of business use. With either method, a record should be kept of the date the vehicle was first used for business, the mileage for each business use, and the total miles for the year. To use actual expenses, keep track of the costs of the vehicle, operating expenses and improvements.	Date of the expense. For car expenses, the date of the use of the car.	The business destination	**Purpose:** Business purpose for the expense **Relationship:** N/A
Other transportation	Cost of each separate expense	Date	Destination	**Purpose:** Business purpose of the expense
TRAVEL	Cost of each separate expense for travel, lodging, and meals Incidental expenses may be totaled in reasonable categories such as taxis, daily meals, telephone, etc. Special rules apply on cruise ships.	Dates of departure and return for each trip and number of days spent on business	Destination or area of travel (name of city, town, or other designation)	**Purpose:** Business purpose for the expense or the business benefit gained or expected to be gained **Relationship:** N/A
ENTERTAINMENT	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc. may be totaled on a daily basis. Only 50% of entertainment expenses are deductible.	Date of entertainment	Name and address or location of place of entertainment Type of entertainment if not otherwise apparent	**Purpose:** Business purpose for the expense or the business benefit gained or expected to be gained For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion, the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.

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SPECIFIC RECORDS AND INFORMATION REQUIRED TO SUPPORT CERTAIN EXPENSES (continued)

Type of Expense	Figuring the Amount	Time	Place or Description	Business Purpose and Business Relationship
GIFTS	Cost of the gift The maximum amount of deductible gifts is generally $25 per person per year.	Date of the gift	Description of the gift	**Relationship:** Occupations or other information, such as names, titles, or other designations about the recipients that shows their business relationship to the business
MEALS	The cost of the meal if it was for entertainment purposes	Date		See **Entertainment** above. In addition, records must show that an employee or owner was present during the entertaining meal.
	If the meal expense was incurred while traveling out of town, use either the actual cost of the meals or figure the costs using the published meal and incidental rates by city multiplied by the number of days at each location. The rates can be found on the Internet at www.policyworks.gov/perdiem or in IRS Pub. 1542, *Per Diem Rates (For travel within the continental United States).*	Dates of travel		See **Travel** above.
LISTED PROPERTY Cell phones Computers and peripherals Cameras Other property generally used for entertainment, recreation, or amusement	A log must be kept which shows the amount of business use and personal use. Expenses related to the property must be prorated based on the percentage of business use. A log is not required if the property is exclusively used on the business premises or as part of the business purpose.	Dates used		Business purpose for the expense

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It should be recognized that tax law includes many issues yet unresolved. Any errors, omissions or misinterpretations are those of the publisher. Corrections are posted on the University of Illinois Tax School website at: www.ace.uiuc.edu/taxschool.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is printed with the understanding that the publisher is not engaged in rendering legal, accounting or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.[7]

7. From a declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of the Publisher.

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