Bloomberg
Tax

bloombergindustry.com

INSIGHT: Broken Records May Cost More Than a Song

BY JASEN D. HANSON

Lost in the shuffle of complex accounting and tax principles, hot button IRS campaigns and topical changes to the Internal Revenue Code lies the often overlooked but essential role of proper record keeping. The Internal Revenue Code requires that every taxpayer maintain books and records ''sufficient to establish the amount of gross income, deductions, credits, or other matters'' shown on a tax return. Treasury Regulation Section 1.6001-1(a). Just as a scratch on a vinyl album (or compact disk) ruins your favorite song, a missing business or tax record can undo an otherwise legitimate item on a tax return.

Poor Record keeping Impacts Every Potential Tax Issue

The record keeping requirement imbues every potential issue arising during examination, appeals, and litigation of federal tax issues. Procedural foot-faults (such as an improper Form 8283) and lack of expense substantiation remain the easiest ways for the IRS to disallow a claimed expense or deduction. For most issues, the taxpayer bears the burden of proving entitlement to that expense or deduction. That burden can be made impossible if you must rely on third parties, such as banks and vendors to produce that substantiation. Hoping someone else kept a record relevant to your cause does not constitute an adequate record keeping system.

Not only can reliance on third party record keeping pose a problem, it can prove to be costly. Proper record keeping protects you, your CPA, or other tax professional from the cumbersome task of combing through various sources of information to compile the necessary substantiation of return items. Here, an ounce of prevention is worth a pound of cure.

Inadequate books and records may also lead the IRS to perform a bank deposit analysis. Generally, that analysis treats every deposit as taxable income absent proof that a particular deposit stems from a non-taxable source (*i.e.* loans, gifts). This can be a costly endeavor not only because it represents a time consuming process, but most taxpayers fail to adequately account for non-taxable deposit sources resulting in the taxes owed on otherwise non-taxable amounts; the worst kind of result.

Finally, bad record keeping substantially increases the likelihood of subsequent and continuous examinations. Like a broken record repeating itself, the IRS is prone to picking up subsequent tax years where they identify deficiencies in record keeping practices. The ease with which the IRS can assert deficiencies based on inadequate records and the often repetitive nature of those record keeping issues provides a cost-efficient mechanism for identifying and potentially collecting additional taxes.

What Constitutes Proper Record keeping?

Proper record keeping will depend on the nature of your business and the type of expenses incurred. For example, an entity involved in producing widgets may be subject to the uniform capitalization provisions of Section 263A which require extensive cost allocation among activities, functional departments, items of property, and cost of goods sold or ending inventory. On the other hand, a service entity may incur more travel and entertainment costs, which requires additional substantiation under Section 274(d). Each set of circumstances presents its own challenges and needs.

Every taxpayer would do well to consult with a tax professional on their particular circumstances but there are four key aspects to consider:

Organize your records for success. The goal of every record keeping system should be to sufficiently substantiate the items reported in financial statements and other accounting records, as well as tax returns. It should be easy to maintain, have a logical organizational structure, and promote compliance by every employee. One bad apple can ruin the bunch.

Establish a clear document retention policy. For most items a retention policy of four to six years provides adequate coverage. However, if you incur carryover losses such as net operating losses or passive activity losses, you should consider longer retention policies for the underlying expenses that contribute to those losses.

Digitize records. In today's increasingly electronic environment, the ability to digitally store and maintain records has become increasingly popular and cost-efficient. Digital records can be easier to track, manage, and store. Not to mention that nothing fades as fast as the very receipt you need three years down the road.

Know the requirements for your specific expenses. Every business expense must be tied to a discernible, ordinary, and necessary business purpose. However, certain expenses such as travel, meals and entertainment, mileage, and employee reimbursement programs require heightened levels of contemporaneous substantiation. Here, knowledge is power.

No record keeping system is safe from IRS scrutiny. However, utilization of established third-party accounting software, strong and clear document retention policies, and consultation with tax professionals on proper record keeping requirements for your particular business can alleviate potential headaches and defense costs should the IRS come knocking on your door.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Jasen D. Hanson. Esq.is an attorney in Chamberlain Hrdlicka's Atlanta office in the Tax Controversy and Litigation Group. He can be reached at Jasen.Hanson@chamberlainlaw.com.