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RETENTION REQUIREMENTS FOR TAX RECORDS

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Overview

- General Requirements
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  - Procedure
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General Requirements

- Taxpayer must keep "such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information." Treas. Reg. § 1.6001-1(a)
- Taxpayer must keep those records "so long as the contents thereof may become material in the administration of any internal revenue law." Treas. Reg. § 1.6001-1(e)
  - Scope of records required may go beyond traditional "accounting records," contracts, and transactional documents.

General Requirements (cont'd)

- Consequences if adequate records are not maintained:
  - Generally the taxpayer has the burden of proof, and to shift the burden must not only present credible evidence but also comply with record retention requirements. See, e.g., I.R.C. § 7491
  - The IRS may impose the accuracy-related penalty for negligence. Treas. Reg. § 1.6662-3(b)(1)
  - In extreme circumstances, the IRS may issue an Inadequate Records Notice, requiring the taxpayer to report corrective action within 6 months and possibly leading to follow-up examinations and penalties. Treas. Reg. § 1.6001-1(d); I.R.M. 4.10.8.16
  - Willful failure to maintain tax records also is a misdemeanor, subject to a fine of not more than $100,000. I.R.C. § 7203

Recommendations

- Procedure
- Returns and Subsequent Adjustments
- Supporting Records
- Closed Year Doctrine
- Special Cases

Procedure

- The complex statutes of limitation, combined with the frequency of extensions and administrative/judicial reviews, preclude a simple determination that "after X years" records may be destroyed.
- The records custodian often does not have all the information relevant to the determination.
- Records for a given tax year should not be discarded without an **affirmative determination** as to that tax year by a centralized corporate authority.

Returns and Subsequent Adjustments

- Taxpayers should retain indefinitely copies of
  - All tax returns, and
  - Any subsequent adjustments to tax liability, interest, or penalties.
- Taxpayers should retain proof of payment of tax liabilities until the statute of limitations for collection, by levy or judicial proceedings, has expired.

Supporting Records

- As a general rule, supporting records must be maintained until the tax year is "closed."
  - The limitations periods for assessment, refund claims, and initiation of judicial proceedings have expired.
  - Any administrative or judicial proceedings have been finally resolved, including exhaustion of appeals.
- Which limitations period for assessment?
  - General – 3 years. too short
  - Substantial omission of income – 6 years. ←
  - Fraud or failure to file a return – indefinitely. too long

Supporting Records (cont'd)

- Special limitations periods for particular records
  - Refund claims
    - Bad debts or worthless securities – 7 years. I.R.C. § 6511(d)(1)
    - Foreign tax credits – 10 years. I.R.C. § 6511(d)(3)
  - Assessments, listed transactions – no earlier than one year after disclosure to the IRS. I.R.C. § 6501(c)(10)
  - Once the overall statutes of limitations have expired, segregate and retain only records related to those specific items or transactions with an extended limitations period.

Closed Year Doctrine

- NOL, capital loss or credit carrybacks – I.R.C. §§ 6501(h)-(j), 6511(d)(2)-(4)
  - IRS may assess as long as the limitations period is open for either the loss/credit year or the year to which the loss/credit is carried.
  - Retain supporting documentation for the loss/credit year at least until the limitations period closes for that year.
  - **But** if the limitations period is still open for **any** year to which the loss/credit was carried back, retain supporting documentation for a longer period, as for carryforwards.

Closed Year Doctrine (cont'd)

- Carryforwards
  - For capital loss or credit carryforwards, retain records attributable to the loss/credit (but not other supporting records for the loss/credit year) until the limitations period expires for all year(s) to which the loss/credit may be carried.
  - For NOL carryforwards, it may not be practical to retain records until all years to which the NOL may be carried (up to 20 years after the loss year) have closed. If the IRS audited the loss year and the statute of limitations on assessment has expired, **consider** relying on the general IRS policy of not re-opening an audited year. Cf. Treas. Reg. § 601.105(j) (describing circumstances under which the IRS will reopen a case closed after examination)

Closed Year Doctrine (cont'd)

- Assets
  - Retain all records relating to assets, including but not limited to records relating to basis, until disposition of records has been authorized for all tax years during which the taxpayer owned the asset, including the year of disposition.
  - If assets are given an exchange basis (determined by reference to other property) – see, e.g., I.R.C. §§ 362, 1031(d), 1032(b) – retain records for the property transferred in the exchange as long as the records for the property received in the exchange.

Special Cases

- Partnerships
- Deferred Gain or Loss
- Earnings and Profits
- Interest

Partnerships

- Adjustments to partnership items may be timely, even if the I.R.C. § 6229 period has expired, if the statute of limitations for **any** of the partners is still open.
  - IRS can assess only those partners whose years are still open, but the partners are dependent on the partnership to retain the relevant supporting documentation.
  - Potential trap if the partnership destroys records after the I.R.C. § 6229 period has expired, and the IRS then starts an audit based on an open limitations period for a partner.
  - Probability is low, but potential consequences are severe.

Partnerships (cont'd)

- Partnerships should establish a clear procedure to ensure that they don't dispose of supporting documentation too early. Alternatives:
  - Survey all partners before destroying documents for any tax year, to determine whether partners' limitations periods are open.
    - Did partner's extension include partnership items? I.R.C. § 6229(b)(3); *Ginsburg v. Comm'r*, 127 T.C. 75 (2006); *Foam Recycling Assoc. v. Comm'r*, 82 A.F.T.R.2d 6307 (2d Cir. 1998)
  - Request that the partners affirmatively notify the partnership when the limitations period for the partner's year expires.

Deferred Gain or Loss

- Retain records related to the income, gain or loss that is deferred as long as either tax year is open: the tax year in which the transaction occurred, or the tax year in which the income, gain, or loss is finally recognized.
- Retain records relating to transactions for which a third party (including a member of the affiliated group) defers income, gain, or loss, if the taxpayer has an interest in such third party.

Earnings and Profits

- Various provisions of the Code reference not only current E&P but also accumulated E&P. Neither book surplus nor taxable income since inception is exactly equivalent to E&P.
- Retain indefinitely records needed to reconstruct accumulated E&P. For example, tax returns and subsequent adjustments, plus transactions for which the effect on E&P differs from the effect on taxable income, plus distributions to shareholders.
- *Union Pacific R.R. v. United States*, 524 F.2d 1343 (Ct. Cl. 1975) shows an extreme example.
  - The tax year at issue was 1942.
  - The IRS reconstructed accumulated E&P dating back to the formation of the taxpayer in 1898.

Interest

- Different and longer statutes of limitation apply, and for purposes of netting, sometimes information concerning a specific tax year is needed even after the statute of limitations has closed for that year.
- IRS interest determinations are as subject to controversy, and as prone to error, as tax liability determinations. It is important to retain records sufficient to contest those determinations.
- Taxpayers should retain records relevant to interest determinations for a given year until all interest statutes of limitation have expired **and** there is no possibility of netting balances for that year against balances for open years.

Interest (cont'd)

- Limited scope of records required.
  - Tax return plus subsequent adjustments.
  - Information that determines the interest effect date of any changes in tax liability, payments, refunds, or transfers between tax years.
  - Interest received from or paid to the government and supporting computations.
  - Whether underpayments or overpayments for specific periods have been used for netting purposes under I.R.C. § 6621(d).

Tax Records Other Than Paper

- Specific requirements for:
  - Micrographic (Microfilm or Microfiche) Storage – Rev. Proc. 81-46, 1981-2 C.B. 621
  - Electronic Storage Systems – Rev. Proc. 97-22, 1997-1 C.B. 652
  - Automated Data Processing (ADP) Systems – Rev. Proc. 98-25, 1998-1 C.B. 689
    - Includes electronic storage systems as well.

Micrographic Storage

- Records must be authentic, accessible, and readable.
- The taxpayer must establish and comply with written procedures, to ensure consistent record-keeping.
- The taxpayer is responsible for effective identification, processing, storage, and preservation, and must make equipment available for the IRS to read, locate, and reproduce any of the records.

Electronic Storage Systems

- Requirements:
  - Reasonable controls that ensure the integrity, accuracy, and reliability of the system.
  - Reasonable controls that prevent and detect unauthorized creation, addition, alteration, deletion, or deterioration.
  - An inspection and quality assurance program, including periodic checks.
  - A retrieval system that includes an indexing system, functionally comparable to a reasonable hardcopy filing system.
    - Important to consider not only minimum IRS requirements but also the concerns of internal users.
  - The ability to reproduce legible and readable hard copies.

Electronic Storage Systems (cont'd)

- Records are subject to the same requirement that they be maintained so long as their contents may become material in the administration of any internal revenue law.
- Rev. Proc. 97-22 explicitly permits the destruction of hardcopy records and computer records if the taxpayer:
  - Tests the system to confirm that the hardcopy or computerized books and records are reproduced properly, and
  - Institutes procedures to ensure continued compliance with the requirements of the Rev. Proc.
- But Rev. Proc. 97-22 does **not** permit the destruction of machine-sensible computer records.

ADP Systems

- Use of an ADP system does not relieve the obligation to retain hardcopy records, unless such records are adequately preserved in an electronic storage system.
- Rev. Proc. 98-25 requirements apply if:
  - Taxpayer has assets of $10 million or more, or
  - The system uses machine-sensible records and the taxpayer does not maintain paper records, or
  - Machine-sensible records were used for computations that cannot be verified without the use of a computer.

ADP Systems (cont'd)

- The taxpayer must demonstrate a sufficient audit trail between the records and the total amount of tax liability claimed. The Rev. Proc. sets forth detailed documentation and testing requirements.
- Taxpayer is responsible for ensuring compliance with record-keeping requirements and Rev. Proc. 98-25 even if another entity performs the actual processing.
- The taxpayer can request a Record Retention Limitation Agreement, for formal IRS approval to destroy the records.

Conclusion

- An effective record retention program must balance several needs:
  - Retain important records and eliminate irrelevant records.
  - Minimize storage costs.
  - Allow quick retrieval.
  - Apply the standards consistently.
- Careful analysis of requirements and implementation of a systematic program is increasingly important in today's environment of proliferating electronic and paper records.