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Recordkeeping Requirements and the Consequences of Lost, Destroyed or Stolen Records

Taxpayers must substantiate the accuracy of their returns with appropriate books and records.

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In filing tax returns or other documents with the IRS, taxpayers are under a duty to keep and maintain books and records that will substantiate the accuracy of their filed documents. Tax law includes both general and specific recordkeeping responsibilities. A failure to adhere to these can result in the loss of favorable tax treatment, the disallowance of deductions, tax deficiencies and, often, penalties. When records are lost, destroyed in a casualty or stolen, some relief is possible, but only after satisfying tough burden-of-proof and reconstruction requirements.

Books and Records

Regs. Sec. 1.6001-1 requires that all persons filing income tax returns must keep books of account or records (including inventories) to sufficiently establish gross income, deductions, credits and other matters shown on the return and making them available for inspection by the IRS. The regulation also requires retaining records that may be material to the administration of the tax. Other regulations under Sec. 6001 list similar requirements for estate tax, gift tax, payroll taxes, excise taxes and information returns.

According to Regs. Sec. 1.441-1(b)(7), books should consist of records that clearly and adequately reflect income on an annual basis. To that end, Sec. 446 specifies using the cash receipts and disbursement method of accounting, the accrual method, or some combination of methods approved by the Service, as long as it clearly reflects income. Inventory requires use of the accrual method for purchases and sales, although there are some small business exceptions. A hybrid method can use elements of both methods, provided it clearly reflects income and is used consistently from year to year. Special transactional accounting methods are also available, such as the installment and completed-contract methods. Whatever the method, it must clearly reflect income and accurately represent the taxpayer's income, expenses and credits.

While wage-earners have to keep accurate records, they do not have to keep formal accounting books, under Regs. Sec. 1.6001-1(b). Whether or not required to keep books, all taxpayers must be able to substantiate the accuracy of their returns.

Recordkeeping Requirements

Sec. 274 imparts strict recordkeeping requirements for specific expenditures. When applicable, it requires taxpayers to have expense records; otherwise, they cannot take the deduction, even if otherwise eligible.

Taxpayers meet the Sec. 274 substantiation requirement when they maintain adequate records. The term "adequate records" has two components — a diary, log of expenses or similar record — corroborated by documentary evidence, which generally includes receipts for all items over $75 and for lodging. They can be described as follows:

1. *Amount.* This is the amount of each separate expense, such as transportation, lodging or meals. However, the daily cost of meals and incidentals can be compiled into general categories, such as meals, taxi fares and laundry. Entertainment is treated similarly; the daily cost of taxi fares and telephone calls is aggregated. The amount spent on gifts or listed property (including acquisition costs and capital improvements) must be documented.
2. *Time.* This is the exact dates the traveler is away from home; the number of days spent on business while away from home and the dates of entertainment, gifts and acquisition of listed property.
3. *Place/Destination.* This is the specific cities, towns or places the traveler visited while on business away from home, and includes the name, address, and/or location of entertainment or place of business discussion.
4. *Description of item.* This is a description of the specific gift given.
5. *Business purpose.* This is the business reason for traveling or the type of benefit the individual expects to result from traveling or the use of listed property. It includes the business reason

and the nature of the business discussion, as well as the business reason or anticipated benefit for entertainment and gifts.
6. *Business use.* This is the amount of business or investment use, such as miles driven for automobiles or minutes of conversation for cell phones. This component supports the allocation of business and nonbusiness use of an item of property.
7. *Business relationship.* This is the identification of the people entertained or the recipients of gifts and their occupations, to establish a business relationship.

For an automobile or other listed property, the business verses personal-use components of usage may be substantiated by use of a sample taken over a representative portion of the year.
An employee who makes an adequate accounting to his or her employer will not be asked to substantiate those expenses again, except in the following cases:

- An employee whose business expenses exceed the total amount of reimbursement and who claims expenses on his or her return.
- An employee who is a greater-than-10 percent owner of the employer.

General Expense Substantiation Principles

When analyzing inadequate-record cases, the courts have set forth these general legal principles:

1. The Service's determinations are presumed to be correct;
2. The taxpayer bears the burden of proving the determination erroneous; and
3. Deductions are a matter of legislative grace; taxpayers bear the burden of proving they are entitled to any deduction claimed, including the burden to substantiate.

Lost Records

When a taxpayer claims that his or her records are lost, Temp. Regs. Sec. 1.274-5T(c)(5) provides some relief, in limited circumstances. "Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as by fire, flood, earthquake, or other casualty, the taxpayer shall have the right to substantiate a deduction by reasonable reconstruction of his expenditures or use." Courts enforcing this regulation impose three requirements:

1. Show by credible evidence that he or she maintained adequate records;
2. Show that the loss of the records was due to circumstances beyond his or her control; and
3. Reconstruct the records.

Record Reconstruction

When a taxpayer is eligible to reconstruct his or her expenses, IRS Pub. 4268, *Indian Tribal Government Employment Tax Guide*, suggests the following:

1. Determine exactly what has been lost.
2. Determine if it is the only copy of an item.
3. For those items that are the only copy, rank the relative importance of the lost items, starting with those of highest importance.
4. Make a list of the items that warrant the time and expense of reconstruction.
5. Determine if there is a state, Federal or other agency from which to request a copy of a lost report.
6. For items of public record, contact the local courthouse for a copy.
7. For bank records, contact the bank. It can be expensive to get copies of canceled checks, but they are available.

Reconstruction must coincide with the facts and be based on more than vague generalizations.

Charitable Contributions

The records taxpayers are required to keep to substantiate charitable contributions vary with the type of contribution (cash or noncash) and the amount. For cash contributions of less than $250, taxpayers must retain either a cancelled check or a receipt, such as a letter that shows the name of the organization, the date and the amount of the contribution. When taxpayers make charitable

contributions of $250 or more, Sec. 170(f)(8) specifies that to claim a deduction, taxpayers must receive a contemporaneous written acknowledgment from the donor organization that states:

1. The amount of cash and a description of any noncash property received;
2. Whether the donee organization provided any goods or services in exchange for the contribution; and
3. A description and good-faith estimate of any goods or services provided to the donor.

Shifting the Burden of Proof

Sec. 7491 provides a diligent taxpayer with an opportunity to shift the burden of proof to the IRS in a records case by doing the following:

1. Complying with the requirements to substantiate an item; and
2. Maintaining all required records and cooperating with reasonable Service requests for witnesses, information, documents, meetings and interviews.

In the case of a partnership, corporation or trust, net worth cannot exceed $7 million.

Penalties

A review of the cases involving inadequate records shows that the IRS has imposed the accuracy-related penalty for negligence many times. It appears to be imposed in all Sec. 274 cases and a majority of non-Sec. 274 cases. The penalty is 20 percent of the understatement as computed by the Service. Under Sec. 6662(c), “negligence” includes any failure to make a reasonable attempt to comply with the provisions of the title. Also, Regs. Sec. 1.6662-3(a) states that it includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. To contest the application of the penalty under Sec. 6664(c), the taxpayer must either prove that its recordkeeping was adequate or successfully argue that its failure to do so was due to reasonable cause and that it acted in good faith. Courts will consider the taxpayer’s experience, knowledge and education, and efforts to comply with the law, including reliance on the advice of professionals.

Record Retention

The general rule governing how long to keep tax records is a minimum of three years from the later of the due date of the return or the date filed, while the statute of limitations (SOL) on assessment is still running. However, if gross income is understated on a return by more than 25 percent, the SOL extends to six years under Sec. 6501(e), in which case, retaining records for six years is helpful. Under Sec. 6501(c), there is no SOL if a return is not filed or is fraudulent. Further, records showing the basis of business and investment assets should be kept for at least three years after the return was filed on which the sale of the asset was reported. Similarly, IRA and pension-related records should be kept for a minimum of three years after all the funds have been withdrawn from the accounts and reported on a return. Vacation homes, charitable deduction carryovers, businesses that may be construed as hobbies or net operating losses necessitate retaining records for extended periods.

Conclusion

Although most tax professionals are well aware of the need to keep records and document expenses, many may not be aware of the situations in which approximations are permitted under Cohan. Further, it is useful to review the specific documentation required for travel, entertainment, gifts and listed property, including home office expenses, gambling and charitable deductions, to ensure that clients can claim all the tax benefits to which they are entitled. Careful recordkeeping and reconstruction of lost records can help avoid costly litigation and tax penalties.