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Recordkeeping

Why should I keep tax records?

There are time limits for certain records and those will be discussed later, but there are some general reasons for creating a good recordkeeping system.

Identify Sources of Income: This can seem silly since most taxpayers don't want to prove additional income for the IRS to simply tax. However, certain income sources might be non-taxable, and you should always separate business income from non-business income. How sources of income are presented on your tax returns can have a large impact of your tax consequence.

Keep in mind that the IRS has the right to review bank deposits during an audit. For example, if you lent money to your son to buy his first car, and you're depositing the payments the IRS will consider this income unless you keep good records proving the money is actually loan payments to you and not income.

Keep Track of Expenses: The IRS does not necessarily announce an amount of unclaimed tax deductions, but many tax professionals agree that deductible expenses are commonly missed for the basic lack of memory. You buy something in March, and a year later you forget and you lose the deduction. Who did you talk to on the phone last Wednesday, and what did you have for lunch? Hard to recall, even with ginseng and crossword puzzle exercises. Developing a good recordkeeping system will help with tax amnesia.

Property Basis: This is absolutely critical, and the one most overlooked reasons for maintaining good records. As a tax preparation firm, we spend a ton of time trying to minimize your tax consequence. It's our job, and you expect us to do it well. But if taxpayers don't keep track of what they paid for something (basis) such as stocks, business asset or real estate the accuracy of the tax return often suffers.

The most challenging property is stocks- the IRS and the SEC now require brokerage firms to maintain cost or purchase history information, and report this to you on your tax forms. They also require that this information transfers with the stock if you move securities to another brokerage firm. Having said that, we've seen mistakes with this information so we still encourage taxpayers to maintain his or her own record of what stocks they purchased, the price and the date.

The classic example is a person who buys stock through an employee stock purchase program, holds onto it for twenty years, retires, moves the stock into another account, and then sells it. Without historical cost or purchase information, the gains and subsequent taxes is impossible to accurately compute. In the past we've reconstructed cost information through Yahoo! Finance which works most of the time, but good recordkeeping can prevent this exercise

Homes and other real estate such as rental properties can also prove problematic. Sure, you have the HUD or closing statement from the purchase, and you'll get another one for the sale. But improvements to the property such as a new roof, appliances, furnace, additions, etc. will all add to your property basis (cost) and can reduce your tax consequence. Sure, you get a big exemption for the sale of your primary residence, but how long is that going to last for? Congress might eliminate that at any time. And rental properties and other real estate investments don't enjoy this exemption.

Tax Return Preparation: All the above reasons boil down to tax preparation. Keeping good records will ensure that your tax returns are comprehensive and accurate, and you won't waste a bunch of time piecing together information. Of course, we like it too.

Audits: If your tax returns are examined by the IRS, much of your success will hinge on your recordkeeping skills. Keep in mind that if you comply with the IRS and provide all the requested documentation, the burden of proof is on the IRS. Conversely, if you are missing information or you refuse to provide your records, the IRS and Tax Court will assume the information does not support your tax return as filed, and you will receive a tax bill.

Do I need receipts for my expenses?

Receipts and recordkeeping are common concerns. It is your responsibility to prove your expense- in the absence of proof, the IRS and the Tax Court will allow some estimation but it is weighed heavily against the taxpayer.

Here's the skinny: you need **a record** showing the business nature and you need **documentary evidence** showing that you paid the amount, who you paid it to, and the date.

A record is:

1. Logbook
2. Account Book
3. Diary
4. Or something similar (iPhone app, electronic journal, etc.)

Documentary evidence is:

1. Receipts
2. Canceled Checks
3. Bills, Invoices
4. Credit Card Statements
5. Bank Statements (for electronic funds transfer)

What does all this mean? If you have a receipt, you should jot down what the purchase was for. If you have a credit card statement, you should circle the amount, and make a note what the purchase was for. If you make payments in cash, you should get a dated and **signed** receipt showing the amount and the reason for the payment. Essentially your documentary evidence must show the amount, date, place and the record must show the nature of the expense.

Myth Buster: Simply keeping track of your expenditures in your iPhone or a spreadsheet will not be enough. This would only be the record part of the two-part requirement. If you spend $150 on office supplies, you can keep an electronic record of the purchase but you also need a receipt, credit card statement, etc.

Also, documentary evidence is not required for items under $75, even if they collectively exceed $75. However, a record in most cases will be required by the IRS in the event your tax return is examined.

Please understand that keeping all receipts is still the best procedure for minimizing tax complications regardless of the $75 caveat. Credibility is critical if you are required to present your proof to the IRS- make life easy, and be organized.

We will not need copies of your records or documentary evidence to prepare your tax return. This is only in the event your tax return is examined by the IRS (in 2011, only 1% of tax returns were audited, and most of those were done through the mail).

In looking ahead, our advice to taxpayers who need to track expenses associated with his or her job, or small business owners and rental property owners, is to use a **separate credit card** for those purchases. We understand that using separate credit cards might create some hassles, but ensuring that all your expenses are properly documented and more importantly deducted on your tax returns should outweigh the inconvenience.

Continue reading **How should I maintain my records?** for more detailed information on how to keep records.

How should I maintain my tax records?

There are several acceptable IRS techniques for maintaining your records. Each has its advantages, and you might find success in using a mixture depending on your needs and your attention to detail.

Separate Credit Card: If you use a separate credit card for your tax related purchases such as business expenses, rental property repairs and unreimbursed employee business expenses (job-related) then you can simply jot down on the credit card statement the nature of the expense. In most cases such as OfficeMax you can toss the receipt away since the merchant and the business nature is fairly obvious. However, and this is a big however, if you went to WalMart you might still want to keep the receipt- WalMart sells office supplies but they also sell diapers, which unfortunately is not a tax deduction.

Financial Software: Quicken and Money do a great job of tracking your expenses, but it is a garbage in garbage out system. A bit of patience is required to ensure that your software is giving you the information you need. Keep in mind that only tracking of your expenditures will not be enough. This would only be the ‘record’ part of the two-part requirement (see **Do I need receipts for my expenses?**). For example, if you spent $150 on office supplies, you can keep an electronic record of the purchase in Quicken but you will also need to keep a receipt, credit card statement, etc.

Envelopes: This is old fashioned, but still works well. Many taxpayers will label a handful of envelopes and toss receipts in each envelope depending on the purchase. For example, you could have goodwill, church, office supplies, meals, etc. as your labels. Shoeboxes work too, but they are really old fashioned- then again, they might give you a good excuse to buy some more shoes.

All kidding aside, as you stuff your envelopes you should jot down the business purpose. This is especially true for meals and entertainment where the substantiation (business purpose) requirements from the IRS demand the person's name, what was discussed and if any portion was personal or pleasure.

Scanner: This is the best invention ever. Well, not really, but who wants paper or envelopes or shoe boxes? A receipt or invoice is still the best way of proving your tax deduction, by far. In reading several Tax Court opinions and summaries, it is amazing how a receipt can say a thousand words. So, each time you make a purchase, a contribution or receive a medical bill, jot down the business connection if necessary, and then scan it, and then forget it.

As a side note, many receipt printers in department stores such as Home Depot, WalMart, etc. use heat to print the receipt. Unless you put your receipts in the freezer the characters will fade over time. Ever leave your receipt on the seat of your car during the summer?

PDF Printer: This allows you to print anything to a PDF file. For example, if you wanted to save an electronic copy of a web page that is dynamic (such as your banking dashboard or home page) you cannot just save the web page contents to your computer. But if you print the web page and choose your PDF printer, the information on your computer screen will now be saved as a PDF. Most operating systems already have a PDF printer installed, but if not you can download one from **www.cutepdf.com**.

Backups: If you end up using an electronic archive you absolutely need to invest into Google docs, Carbonite or similar online backup service. It doesn't do you any good if your computer crashes and all your tax information is gone. Scan your information to a folder, and have that folder selected as continuously backed-up. Whatever you use make sure it is a secure server, and that the provider performs their own backups.

Discipline: So much of your recordkeeping success will depend on your discipline. It is hard to be vigilant all the time, every day, but using the envelopes method with a monthly scan-fest over a cup of coffee is our strong suggestion.

What are the requirements for mileage records?

Mileage is one of the most often deducted expense, and therefore it is one of the most scrutinized records. First, you need to prove you own the vehicle(s). Next, you need to keep track of your beginning and ending odometer readings. It is a good idea to make copies of service invoices such as Jiffy Lube since these companies record odometer readings. Lastly, you need to keep track of the date, the business miles driven and the business connection.

We strongly suggest using an app for your smartphone that can track all this with GPS technology. Many of these apps will then email you a CSV file detailing all your miles. Very nice!

Are there specific records I need to keep?

Yes. The IRS lists several items in Publication 552 which include alimony, casualty losses, charitable donations, child care, education, gambling, home office deductions, IRAs, job-related expenses, medical, mortgage interest, moving expenses, pensions and annuities, sales tax on vehicles and tips.

Each item has specific requirements. For example, casualty losses and thefts require that you can demonstrate that you owned the property, that you were the named insured of the property, and that the loss occurred during the tax year of the deduction. With just that in mind, you need to keep insurance information such as a declarations page and the police report. Geez!

You can download the IRS Publication 552 from our KnowledgeBase at **www.watsoncpagroup.com/kb**

How long do I have to keep records?

Ah, the question of the century.

Receipts, Proof of Payments: These should be kept for 3 years after the filing of your tax return. This coincides with the IRS's statute of limitations for examination. However, if you file a fraudulent tax return or do not file a tax return at all, there is not a period of limitations. In other words, if the IRS considers your super-old tax return fraudulent the period of limitations is tossed out, and you need to prove your income and deductions.

Property: The cost of homes, business assets, rental properties, stocks, bonds and mutual funds should be keep for three years after the tax consequence was reported on your tax returns. So, you sell your primary residence in 2012, you should maintain the purchase records, the improvement records and the sales records through 2016 (2012 tax return is due 2013, plus 3 years, 2016).

In all reality, records should be kept as long as humanly possible. Other stakeholders in your life such as insurance companies, creditors and local governments might need this information for nontax purposes. Buy a good scanner. Sign up for Carbonite. Brew some coffee. And have some peace of mind.

How does proper recordkeeping affect my audit results?

For incomes up to $200,000 your audit risk is 1%. From $200,000 to $1 million, it jumps up to 4%, and over $1 million the audit rate is around 12%.

For those taxpayers in the 1% audit risk bracket, 77% of the audits performed are done by mail. This means the IRS sends you a letter asking for documentation. Hot topics right now include education expenses, charitable contributions and medical expenses.

Here are some things to keep in mind when responding to an audit:

Be Prompt: While the IRS gives you generally 30 days to respond to initial notices, if you wait to the very last minute to send in your documentation there is a good chance that correspondence will get crossed in the mail. Make this is a priority.

Send 100%: When you mail or fax information to the IRS, ensure that you have completely responded to the entire letter or notice. **Do not** send some information today while you gather up other information later. If you send two partial responses to the IRS, the chances of the same processor getting both pieces of your tax puzzle are very low. Request an extension for your response. Be patient, yet punctual, and send everything required at once. Fax or mail, pick one. If mailing documents, use a certified mail service.

Send Copies: Never ever send originals. The IRS might lose your documentation, and they certainly won't mail it back.

Don't Overshare: Only send what is asked for. Don't overshare with the IRS but at the same time don't send a riddle. If you make the processing agent's job a little bit easier, they might make your life a little bit easier. When they ask for your favorite color, don't respond with pizza.

Fax: When you fax your information, write your name, social security number and tax year on the bottom of each page.

Interestingly the IRS has the burden of proving certain facts in court if you kept adequate records to show your tax liability, cooperated with the IRS and met certain other conditions. Having said that, many Tax Court summaries and opinions start with the words "*As we have observed in countless opinions, deductions are a matter of legislative grace, and the taxpayer bears the burden of proof to establish entitlement to any claimed deduction.*" Sounds like the Tax Court is really on your side, wink wink.

We can't be completely sarcastic- Rule 142(a)(1) Section 7491 shifts the burden of proof to the IRS with respect to a given factual issue where a taxpayer-

1. introduces credible evidence with respect to that issue

2. meets all applicable substantiation requirements

3. complies with all record-keeping requirements

4. cooperates with any reasonable requests for information

You can learn more about audits at **www.watsoncpagroup.com/Audits.pdf** or visit our KnowledgeBase at **www.watsoncpagroup/kb**

Please call or email us anytime with your questions and concerns. Thank you in advance, and we look forward to working with you!

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