

Why you should maintain adequate records

Inadequate records are defined as "the lack of records, or records so incomplete that correctness of taxable income cannot be determined." Your taxable income is the amount upon which you compute your tax, after subtracting adjustments to income, exemptions, and itemized deductions. In short, anything that has a bearing on your income tax return and affects your tax liability in any way must be available for inspection when requested by the IRS. You are required to maintain records in sufficient detail to enable you to make a proper income tax return. In order to determine the correctness of the return, the IRS has authority to examine those records or any other data which may be relevant or material. The IRS is also authorized to issue a summons compelling any person it deems proper to appear with his or her books and records at a reasonable place and time and give testimony, under oath. You are required to maintain records as long as they are material to the administration of the Internal Revenue laws. Keeping proper records is to your advantage. As discussed later in Step 3, if you know what items of proof you need to substantiate your deductions, you'll be better prepared to face the IRS in the event of a challenge. Saving taxes is saving your dollars. Other considerations in proper recordkeeping include:

- Inadequate or irregular recordkeeping is a "badge of fraud" (see Chapter 7). It can immediately arouse the suspicion of the tax examiner who may be compelled to probe deeper into your finances in anticipation of discovering unreported sources of income. Such a finding could turn into a criminal investigation leading to prosecution, and possibly jail.**
- The IRS examiner could assess a negligence penalty of an additional 5 percent of the underreported tax (see Chapter 7). A Congressional Committee report indicates Congress is concerned that negligence and fraud penalties (also see Chapter 7) have not been applied by the IRS or the courts in a substantial number of instances where their application would be fully justified. The Committee report emphasizes that negligence and fraud penalties are appropriate if a taxpayer claims tax benefits that cannot be supported by the substantiation requirement of Code Section 274(d) (this is explained later).**
- Regarding any item on your tax return, the burden is on you to prove its accuracy in any audit. The burden of proof only shifts to the government in fraud cases. If you cannot meet the burden of proof for any deduction, the IRS may disallow it in its entirety, especially if supporting documentation or collateral evidence is not available.**
- Inadequate recordkeeping also puts a burden on your professional income tax preparer, who is also subject to penalties from the IRS. An Income tax return preparer may be subject to a civil liability for understating your tax liability resulting from negligence or an intentional disregard of rules and regulations. Because the IRS has been clamping down hard on preparers, you may not even be able to find one to do your tax return if your books and records are disorganized.**
- Courts have ruled that failure to keep accurate books and records may be taken into consideration in determining whether you have intended to evade or defeat payment of the tax, a criminal offense under Code Section 7201 (see Chapter 7).**
- The concept of audit-proofing requires that you keep good books and records. Step 3 in the audit-proofing process involves knowing what the IRS will be looking for. The first aspect of that step is knowing what proof is necessary to support each**

deduction and making sure what it is available should the IRS want to see it. You cannot audit-proof your tax return without keeping good books and records of income and expenses supported by documentary evidence.