What Records are Necessary

IRS regulations state that records required to be maintained by the IRS must be accurate, but no particular form is required. However, other IRS guidelines specify the following:

- Taxpayers whose only income is from salaries, wages, or similar compensation for personal services rendered are required by the IRS to be prepared to show how each item of income and expenses on the return was computed. Therefore, the only records you need to keep are records to support your income and deductions. See Step 3 for a listing of types of proof the IRS will allow to substantiate your deductions.
- Taxpayers who are in business or self-employed must keep primary and secondary records. Primary records are those documents upon which individual transactions of buying and selling merchandise, supplies, services, and business assets are recorded. Examples are:

invoices, vouchers, bills, receipts, tapes, detailed inventory lists, canceled checks, duplicate deposit slips, bank statements, etc. Secondary records are the permanent books, worksheets, tallies, etc., which list or summarize the primary records into classifications of income or expenses. These records into classifications of income or expenses. These records may consist of a simple book or record, a simple set of books, or a complicated set of records in which numerous analyses, consolidations, or summarizations are made to achieve the final product.

AUDIT-PROOFER'S STRATEGY RULE

For all taxpayers there are at least three aspects to proper recordkeeping that are necessary to sustain a deduction: (1) You must know the tax rules. (2) You must keep adequate records of your deductible expenses. (3) You must keep proofs (receipt, canceled checks) of your expenses.

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(1) You need to know the rules under which an expense is deductible or income is reportable.

Knowing the rules helps you to become tax-wise, thereby translating into saving tax dollars. By knowing the rules, you focus your time and energies on those things that are important, or those expenses that are tax deductible. For example, if you know that your aerobic exercise program is not deductible, you won't waste your time keeping track of the expense and the receipt.

(2) You need to record your tax deductible expense, or keep track of them in some way. This can be done by buying a tax recordkeeping book, or by setting up a simple system you design yourself. For example, if you use your checking account for all your disbursements and income, you already have a means of keeping track. All you have to do next is to mark your check register in some way to indicate deductible expenses; you could circle the check number, or underline the payee in red. Just by keeping track of your tax deductible expenditures, you will help yourself immensely in preparing your tax return.

(3) You need to maintain proof of your expense. A very simple way to maintain proof is to set up

a file box with jacket folders for the appropriate receipts and documents. A minimal attempt could be made just by keeping receipts in a shoe box. But keeping receipts and documents is just part of the job. You should also be able to locate the right receipt with the right canceled check, and provide an explanation of what the expense was for. For example, a receipt and a canceled check paid to the Girl Scouts might not be sufficient to substantiate a charitable contribution. The expense must be able to meet the rules, or the IRS may disallow it if your proof doesn't support the rules. In this example, the IRS may suspect you purchased Girl Scout cookies (not deductible in full; only the excess value over their fair market value is deductible), paid to send your daughter to a weekend camp, or made on a purchase of supplies for your Girl Scout daughter.

It's also important you know what proof is required to be kept. You will find that information in Step 3.

A good recordkeeping system will bridge all three aspects so that you'll be readily prepared to support any item on your tax return the IRS

may question.

Special Substantiation Rules Began in 1986

For 1985 the substantiation requirements of Code Section 274(d) only applied to travel while away from home, entertainment, recreation or amusement expenses, and gifts. They did not apply to local travel expenses, computers used for business purposes, and other listed property known as Section 280F property. Instead, tax deductions and credits for local travel and Section 280F property were subject to the general substantiation requirements applicable to all other business expenditures.
However, beginning in 1986, Section 280F property now falls within the Section 274(d) substantiation requirements, except for minimal personal use of business vehicles which still must be justified under Code Section 162 relating to business expenses or Code Section 212 relating to income producing expenses.
The Committee Report states "the conferees intend that the principles of these regulations fully apply to deductions and credits claimed for local travel and the use of other listed property

under Section 274(d)," but that "these principles will need to be carefully applied." This is because expenses for local travel or the use of computers commonly do not involve receipts, and may occur more frequently than expenses for overnight travel.

The IRS has issued regulations specifying how such recordkeeping is to be required, and what documentation is required for local travel (these regulations were issued on November 1, 1985). Taxpayers are not required to maintain trip-by-trip logs and records encompassing each element of the substantiation standards of Section 274(d) to justify a deduction or credit. Instead, taxpayers may substantiate their automobile business use with a journal in which each element of business use during the week is recorded at the end of the week. Also, if the business use follows a consistent pattern, detailed records are not necessary. Instead, you can maintain adequate records for portions of the taxable year that are representative of the business for the entire year and employ those percentages extrapolated for the whole year.

Congress wants to ensure that you only claim those deductions and credits to which you are entitled without being unduly burdened by unnecessarily complex recordkeeping requirements. Yet Congress also believes that you should provide SUFFICIENT information on your tax return so that the IRS can make a preliminary evaluation of the "appropriateness" of your deductions or credits claimed for the business use of an automobile. Previously, this was difficult to do unless you were audited. Congress has now directed the IRS to obtain certain information from you directly from your tax return. Starting with the 1985 tax year, on returns due April 15, 1986, the IRS began asking you to provide this information about your use of a business automobile:

- Total mileage driven during the year, divided into separate categories for business, commuting, and personal use.
- The percentages of business use and personal use.
- Whether you had the personal use of other vehicles.

- Whether you were able to use the vehicle during after-work hours.
- Whether you have adequate records or sufficient evidence to support the business use claimed on the return.

In the case of other Section 280F property subject to Section 274(d) rules, such as yachts, computers, and airplanes, the IRS will ask you the percentage of business use, and whether you have evidence to support the business use. For computers, the IRS is not required to ask you what the percentage of the year your computer was located at you home, as was originally planned by the House version.