

IRS ISSUES RULES FOR ELECTRONIC RECORD STORAGE

By Gary A. Porter, CPA

The Internal Revenue Service (IRS) recently issued Revenue Procedure 98-25. This Revenue Procedure applies to taxpayers that maintain their records on computer as “machine-sensible records”. This refers to transactions that were created electronically and have never become hard copy (paper) records.

Last year, in Revenue Procedure 97-22, the IRS outlined how hard copy, or paper records, may be maintained in an electronic storage system. So Revenue Procedure 98-25 is simply the next step in the process of the IRS’ recognition of the trend towards a paperless economy. It should be noted that Revenue Procedure 97-22 continues to apply to paper records that had been converted to an electronic storage medium. It should also be noted that taxpayers must still retain hard copy records that are required by existing law and regulations. For instance, this means that a paper copy of a tax return must exist, because only a paper copy can contain the signatures required by law.

Revenue Procedure 98-25 is effective for a machine sensible computer records for tax years beginning after December 31, 1997. Revenue Procedure 98-25 supercedes a prior Ruling that dealt with this issue, Revenue Procedure 91-59.

This Ruling is intended to apply to taxpayers with assets of \$10,000,000 or more at the end of their tax year. Those exceeding this threshold must comply with this Revenue Procedure. However, it should also be noted that there are enough exceptions on certain portions of the Ruling as to raise the question whether smaller entities must comply with this Ruling also. I believe it is better to safe than sorry, and that all taxpayers should look to this Revenue Procedure for guidance in storage of electronic

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The Ruling provides that a taxpayer’s machine sensible records must provide sufficient information to support and verify entries made on the taxpayer’s income tax returns, and to determine the correct tax liability. These records must reconcile with the taxpayer’s books, records, and tax returns, even if these are also stored in an electronic format. Also, machine sensible records are required to be retained, and must be available to the IRS upon request, and must be capable of being processed. This means that they must have the ability to be retrieved, manipulated, printed out on paper, or to produce an output on electronic media, such as a diskette.

Machine sensible records are subject to the same statute of limitations as are paper records. The Ruling also provides that, in the event an IRS audit, the taxpayer must provide the IRS with the appropriate resources, i.e. hardware, software, terminal access, computer time, personnel, etc., to enable the IRS to process the taxpayer’s machine sensible books and records. In a recent case, the



IRS Rules for Electronic Record Storage (continued)

court held that a software manufacturer must turn over underlying code to the IRS to allow the IRS to determine if the computation contained on a taxpayer's income tax return was correct. While that may be the extreme example of giving the IRS the ability to process the information, all taxpayers would be well advised to make sure that as software programs change, or are updated or abandoned, that sufficient records be maintained to allow those programs to be accessed and operated, at least during the period the statute of limitations is open.

In most instances, the statute of limitations is three years from the due date, including extensions, of filing of the income tax return. If the tax return is filed late, the statute begins three years from the date the tax return was filed.

Other statutes may apply, however. If the IRS makes a determination that there is a substantial (25%) underpayment of tax or understatement of income, then the statutes of limitation is six years, not three years that is otherwise set forth in the Internal Revenue Code. This may be critical in the community association industry, particularly for association filing Form 1120. Recent IRS audits have held that reserve assessments are not properly excluded from income as capital assessments, but are member income. This could easily create a "substantial understatement of income". In the event that fraud is suspected, there is no statute of limitations.

Electronic storage of records may be much more efficient for an association, and is becoming less expensive on almost a daily basis. The storage in an electronic media also can make records highly susceptible to accidental erasure or loss, unless adequate backup procedures exist. All associations are encouraged to make sure that they have adequate backup procedures. One of my clients who fears that magnetic media storage can be easily disrupted by accidental exposure to powerful magnetic

sources, has decided that all archival records will also be stored on a CD-ROM format. This is not susceptible to erasure from a magnetic source. For the same reason, it is also wise to keep backup tapes at least in two separate locations. Many business records storage facilities now contain specialized computer data storage facilities. While these are very expensive on a per square foot basis, the computer data storage fortunately takes up very little space. This is an alternative many associations may wish to consider for storing archival documents. Storage in an electronic media allows an association to store a vast amounts of data in a very small space very inexpensively.

Associations may wish to consider another storage media known as COLD. This stands for Computer Output to Laser Disc. This is a storage technique which allows books and records to be viewed or reproduced without use of the original program. This may become particularly important during the next few years as many associations discover that they are going to be required to abandon "legacy" software systems that cannot be upgraded for year 2000 compliance in favor of newer programs that are year 2000 compliant. They may not have the ability to run the original programs in the future.

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