Good Records Can Reduce Tax Liability

Keeping Your Tax Exposure as Low as Possible Isn’t Sinister But You Do Need to Prove Expenses

By Joseph Arkin, C.P.A., M.B.A.

All taxpayers should be cognizant of the words of the late Judge Learned Hand in his opinion in Newman (35 AFTR 857), “... Over and over again the courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich and poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.”

The Internal Revenue Service does not prescribe any specific accounting records, documents, or systems. The IRS does require that all business entities—proprietorships, partnerships and corporations—maintain permanent books of account or records which can be used to identify the firm’s income, expenses, and deductions. For certain deductions there are specific requirements as to required supporting details or substantiation.

Although the IRS requires no particular form of records, your records must be accurate and reflect taxable income and allowable deductions. Records must also be kept so that they are available for inspection by IRS officers.

Unfortunately, in contrast to criminal law, the tax laws place the burden onto the taxpayer to provide proof of correct taxable income. Therefore, your records should be as accurate as possible in view of the fact that your return may be selected for audit. Otherwise, the agent may disallow any deductions which you have made.
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and cannot substantiate. Sometimes because of poor record keeping, income which could legally be deferred to other years may get included in the current year. As a result, you may have to make payments of additional taxes, plus penalties and interest.

In addition, if you do maintain adequate records, all the facts needed to properly prepare your return(s) will be available. Thus, aside from obtaining extensions, you can avoid charges for late filing. Moreover, you remove any suspicion of willful negligence and fraud for which a taxpayer can be fined or imprisoned.

Oral Warning . . .

You should be familiar with IRS procedure in the case of a taxpayer who fails to keep records reflecting true taxable income. If an IRS agent finds upon inspection that the records of a business are inadequate for the proper determination of taxable income, there is an oral warning. Thereafter there is written communication to the taxpayer advising of the inadequate records and failure to keep permanent books of account which will allow the Commissioner of Internal Revenue to determine correct tax liability. The warning includes the threat of fines and possible criminal prosecution for failure to keep records as prescribed by tax laws and regulations.

Failure to follow “adequate” recordkeeping (remember, we said earlier that the IRS does not issue fine guidelines as to how to keep a set of books) can result in the imposition of a 5% negligence penalty, and if it can be spelled out that the poor records are for the purpose of committing fraud, the offending taxpayer can be heavily fined and even go to jail.

It should be noted that the IRS does not have the final say in this matter. Whether or not records are adequate, or whether there is evidence of fraudulent intent, is a matter for the courts to decide. However, tax lawyers rank very high in the legal fee schedule, and it is wiser to keep good records than incur huge legal expenses.

What can be considered as adequate? The sole proprietor can get by with a checkbook, a cash receipts journal, a cash disbursements journal, a payroll book, and petty cash vouchers.

Check Book: All funds that pass in and out of your business should go through your business check account. It is usually best to take a weekly draw and pay personal bills from a separate check account, but if only one account is maintained, all items of a personal nature should be charged to the drawing account and not charged to business accounts. Intentional write-off of personal items can lead to a charge of fraud. Your accountant can advise you how to handle items which are part business/part personal.

Cash Receipts Journal: All receipts should be entered into a cash receipts journal, originating from cash register readings, or from collections of sales invoices. Businesses where inventory is an income-determining factor will have to report on the accrual basis and actual sales made, rather than collections will constitute the gross income of the business. The keeping of a cash receipts journal will allow for segregation of items which do not constitute gross income. Examples would be collection of sales taxes, exchange items, contributions of capital by proprietor, etc.

Cash Disbursement Journal: All checks disbursed should be entered into this journal. Columns should be established for the items which constantly repeat themselves. All other items should be entered into a general column with a notation next to the dollar amount of the type of expense. Again, if your firm is on the accrual basis, your accountant will have to
convert to that method at year-end by taking into account a list of unpaid merchandise bills and other unpaid expenses, incurred in the current year, but not yet paid.

Keeping books on a “cash” basis all during the year for the sake of simplicity (thus bypassing a purchase journal and sales journal is permitted by the IRS, if proper adjustment is made for proper reporting on the accrual basis where that method is required. Firms dealing in merchandise as opposed to strictly performing personal services, thus having inventory, will be the type which must report on the accrual basis.

Accrual is merely the terminology of recognizing income and expenses in the current year even though paid in the following year. Sales made in December are collected in January, February or March, and likewise, purchases made in December are paid after December 31st.

The check book should be reconciled with the bank statement after it has been received by the bank. The back of most bank statements show various methods of reconciling the monthly bank statement.

Petty Cash Vouchers: A pad of petty cash vouchers can be obtained at low cost from most office supply store or variety stores. All payments made in cash should be recorded on an individual slip and proof should be attached, or the person to whom the funds are paid should be asked to sign the receipt. This will assure an IRS agent that the funds were in fact, actually spent.

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More to Do...

A corporation or partnership has a little more to do in the manner of recordkeeping. Corporate form 1120 or 1120S and Partnership form 1065 both require a balance sheet. The easiest way to prepare a balance sheet is by keeping one additional book that a proprietor might keep, but needn’t, namely, a general ledger.

A partnership does not pay any income tax and the form merely informs the government of its income and expenses and net profit-together with forms K-1 showing allocations of profit or (loss) to each partner and other items to enable the partner to properly prepare a personal income tax. This is similar to Corporate form 1120S, a subchapter S corporation, where most items pass through to the stockholders. Regular corporations pay salaries to officers and the resultant profit is subject to corporation income tax.

Payroll book: It is necessary to keep a proper payroll book. This will show compliance with state (where applicable) and federal minimum wage laws. The payroll book will also be a starting point to prepare Form 941 showing withholding and social security tax liability. It will also serve as a basis of preparing state unemployment taxes, federal unemployment taxes, and disability benefits taxes, etc. Take note that sick pay is not subject to FICA, (social security.) When added and crossfooted it serves as an easy way to determine the amounts to be deposited to meet depository requirements of IRS laws.

Other records: A record of fixed assets should be maintained. This will allow for depreciation write-offs and pick-up of the very important investment credit. Have a profit sharing, pension plan, IRA program for employees? Record keeping here is essential to preserve tax deductibility of your cost.

Good record keeping makes sense. As stated in the previous paragraph you can take advantage of special depreciation write-offs if you maintain a good set of fixed asset records. The laws provide a special first year allowance of 20% if certain requirements are met. Likewise, you don’t have to stick with straight-line depreciation. You can elect (for certain assets and specified lives) to use 150% and 200% declining balance method, or the sum of the years-digit method.

The investment credit is very valuable as it is a direct reduction of tax liability, not merely an offset against taxable income. The 1978 Tax Act even brought the investment credit to certain types of real property, heretofore not permitted.

Keeping records as prescribed by specific sections of the Internal Revenue Code can permit you to report on the installment method, a method that will often save taxes. Are you receiving prepaid income? Various court cases have evolved and some prepaid items have been specifically mentioned in recent tax laws . . . watch for these, check with your accountant for possible tax savings.

Another item to watch for. A new corporation can elect any reporting period of twelve months. Thus, a new corporation organized and starting business in May, for instance, can elect to end its year at November 30th. Advantage? Additional salary can be accrued for the stockholder-officers, reduce current year’s corporation income tax, but paid in January and taxable to the recipients in a year following when taxes might already be known to be cheaper.

Other advantages of good record keeping? Ability to ascertain possible tax savings for Targeted Jobs Credit, credit for pollution control devices, credit for energy savings devices, etc.