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## PROBLEMS RELATING TO TAXPAYER'S OBLIGATION TO RETAIN ADEQUATE BOOKS AND RECORDS FOR FEDERAL INCOME TAX PURPOSES

HARRY GRAHAM BALTER\*

### I. INTRODUCTORY DISCUSSION

A. The "Self-assessment" System of Collecting Federal Taxes Produces Important Corrolaries: In the case of the typical taxpayer at the time he files his federal income tax return, he is put to "his honor," *i.e.*, he assesses himself for what he declares his tax obligation to be. But the right thus afforded him is balanced by the correlative duty to justify the amount he assessed himself if and when his return is later subjected to audit.

It may be best to determine the area of our discussion at the very beginning by pointing out the principal by-products of this "self-assessment" system:

1. A Statutory obligation on part of most taxpayers to maintain adequate books and records which "clearly reflect income."
2. If taxpayer's records "clearly reflect income" the accounting method he adopts normally must be used by the Commissioner.
3. But if in the Commissioner's judgement the taxpayer's accounting method does not "clearly reflect income," he has the statutory power to determine income by any method he finds to be more accurate.
4. Where the Commissioner determines additional income by

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methods other than that reflected in taxpayer's accounting method or his books and records, this determination is presumed to be correct.

5. In any later controversy which may arise between the Commissioner and the taxpayer over this determination of additional taxes, the burden of proof will be on the taxpayer to show error on the Commissioner's part.

B. Stating the Basic Problems: These principles suggest some basic problems respecting the taxpayer's books and records:

1. *Which* taxpayers are required to keep books and records?
2. *What* books and records must be kept and retained by the taxpayer in order to meet statutory requirement of adequacy?
3. What records and what accounting methods would be considered to "clearly reflect income" so as to prevent the Commissioner from resorting to other sources or methods for proving additional income?
4. For what period of time must a taxpayer retain his books and records?
5. What risks does the taxpayer run if his previously kept books and records are no longer available in whole or in part when an audit of his return is undertaken at a later date?

6. Is there any "safe period" after which records may be destroyed?

## II. ADEQUACY OF RECORDS AND ACCOUNTING METHODS

A. Which Taxpayers Are Required to Keep Books and Records:

1. The Statute: Sec. 6001 of the INT. REV. CODE of 1954 provides as follows:

"Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, . . . and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to . . . keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title."

2. The Regulations: Regulations 118, Sec. 39.54-1 (a) provides as follows:

"Every person subject to the tax except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1 . . . ."

3. Commentary: Even if a taxpayer is or claims to be in a class

exempt by Regulations from the obligation to maintain books and records, he will still have the burden of proving the correctness of items of income or deductions if challenged by the Commissioner; supporting records, therefore, are needed as a practical matter.

B. What Constitutes Adequate Books and Records and What Is Adequate Accounting Method: There are two practical purposes for requiring a taxpayer to maintain adequate books and records: (1) So that the taxpayer may adopt an accounting method based on his books and records which will reflect his true income when he prepares his income tax return, and (2) so that at a later date if the Commissioner audits the return, he in turn may determine whether the taxpayer's accounting method and the supporting records do in fact reflect the true income.

Now let us turn to the sources for this requirement:

1. The Statute: INT. REV. CODE of 1954, Sec. 446 (a) provides:

"General rule. Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) *Exceptions*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

2. The Regulations: Regulations 118, Sec. 39.41-(3) provides:

"It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so . . . .

"Section 39.41-2 (a). Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency . . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period . . . ."

3. The General Guide: A General Guide issued by the Commissioner in 1956, while not having the force of Statute or of a Regulation, is intended to indicate what the Internal Revenue Service believes would be the *minimum records* which taxpayers in various categories should keep for subsequent inspection by the Commissioner.

A few of the more common situations would be reflected by referring to some sections of this General Guide:

"5.3 *Persons engaged in the production, purchase, or sale of merchandise.* To keep a record of inventory conforming to the best accounting practice in the trade or business which clearly reflects income and is consistent from year to year.

" . . . .

"5.8 *Employers claiming deductions for contributing to an employees' trust or annuity plan or compensating an employee under a deferred-payment plan.* To keep records substantiating all data and information required to be filed with respect to each plan and the deductions claimed thereunder.

" . . . .

"5.11 *Persons subject to income tax, except persons whose gross income consists solely of compensation for personal services rendered or arises solely from growing and selling products of the soil.* To keep permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, and other matters required to be shown in any income tax return . . . .

" . . . .

"5.13 *Persons who participate in a transfer to a corporation by the transferor.* To keep records in substantial form showing information to facilitate the determination of gain or loss from a subsequent disposition of stock or securities and other property, if any, received in the exchange.

" . . . .

"5.15 *Qualified electing shareholders receiving distributions in complete liquidation of domestic corporations other than collapsible corporations.* To keep records in substantial form showing all facts pertinent to the recognition and treatment of the gain realized upon shares of stock owned at the time of the adoption of the plan of liquidation.

" . . . .

"5.17 *Persons who participate in a tax-free exchange in connection with a corporate reorganization.* To keep records in substantial form showing the cost or other basis of the transferred property and the amount of stock securities and other property or money received (including any liabilities assumed upon the exchange, or any liabilities to which any of the properties received were subject), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

" . . . .

"5.20 *Executors or other legal representatives of decedents, fiduciaries of trusts under wills, life tenants and other persons to whom a uniform basis with respect to property transmitted at death is applicable.* To make and maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made."<sup>1</sup>

C. What Tests Are To Be Applied To Determine Whether Tax-

<sup>1</sup> Sec. X 5 GUIDE TO RECORD RETENTION REQUIREMENTS, 21 F.R. 6431; 565 CCH par. 6696 (August 28, 1956).

payer's Accounting Method and Records On Which It Is Based Do In Fact "Clearly Reflect Income:"

1. General Rules: Some of the basic principles which we learn from an examination of the requirements of the Statute, the Regulations and the General Guide as outlined above are the following:

(a) The taxpayer is free to adopt almost any method of accounting he chooses, as long as the method meets certain requirements, namely: (1) It must clearly reflect his income on a 12-month period; (2) It must be based on adequate records; (3) It must have been consistently used without distorting annual income; and (4) Its use cannot cause excessive administrative inconvenience or result in undue loss of revenue. (Such a situation would border closely on tax evasion).<sup>2</sup>

(b) To "clearly reflect income" means that the income must be reflected with as much accuracy as standard methods of accounting permit.<sup>3</sup>

(c) Since it is impossible to define these terms in general language, it has become necessary to apply them in the light of the particular case, the particular business involved, the particular methods employed in that business, and with reference to the specific items of income or deduction involved.<sup>4</sup>

(d) If taxpayer's method of accounting does in fact clearly reflect income, both he and the Commissioner will be bound by it.<sup>5</sup>

(e) It is significant for the taxpayer to show that his books of account or method of accounting reflect the same type of accounting employed by the vast majority of those in the same type of business or profession.<sup>6</sup>

(f) The Commissioner is not prevented from disapproving the taxpayer's method of accounting as not clearly reflecting income merely because it has been regularly used for many years.<sup>7</sup>

2. More Specific Rules: With these general principles in mind, it may be valuable now to discuss more specific applications:

(a) The fact that taxpayer's books, records and accounting method meet requirements of other federal or state agencies does not bind Commissioner who may independently determine whether they "clearly reflect income."<sup>8</sup>

<sup>2</sup> *Harden v. Commissioner*, 223 F.2d 418 (10th Cir. 1955); Note 54 COL. L. REV. 1267 (1954).

<sup>3</sup> *Caldwell v. Commissioner*, 202 F.2d 112 (2d Cir. 1953).

<sup>4</sup> *Bradstreet Company of Maine v. Commissioner*, 65 F.2d 943 (1st Cir. 1933); *Boynton v. Pedrick*, 136 F. Supp. 888 (S.D.N.Y. 1954); *V.T.H. Bien*, 20 T.C. 49 (1953); 54-2 U.S.T.C. par. 966; *Pacific Grape Products Co.*, 219 F.2d 862 (9th Cir. 1955); 1 MERTENS, INCOME TAXATION §12.05 (1956).

<sup>5</sup> *Daley v. U.S.*, 243 F.2d 466 (9th Cir. 1957).

<sup>6</sup> *V.T.H. Bien*, 20 T.C.49 (1953).

<sup>7</sup> *Ibid.*

<sup>8</sup> *Old Colony Railroad Company v. Commissioner*, 284 U.S. 552 (1931); *Pennsyl-*

(b) The fact that records are complete on their face and appear to be honest and truthful does not prevent Commissioner from determining that they do not in fact conform to an accounting system clearly reflecting income.<sup>9</sup>

(c) Requirement that if taxpayer does not keep books he must use calendar year and not fiscal year basis is not satisfied by keeping of informal and fragmentary records.<sup>10</sup>

(d) Where taxpayer purports to use accrual basis of accounting, his books must be adequate to clearly reflect income by that method and the test will not be satisfied if the fragmentary records he keeps more clearly reflect income on the cash basis.<sup>11</sup>

(e) But mere fact that records are simple and fragmentary does not justify Commissioner ignoring them if under special circumstances the records in fact clearly reflect income.<sup>12</sup>

(f) Where Regulations require him to keep inventories, he will be audited on the accrual basis whether or not he has kept inventories and whether or not he has kept books on the cash basis.<sup>13</sup>

(g) If the taxpayer has kept no books of account the Commissioner will audit his return on the cash basis.<sup>14</sup>

D. If Commissioner Determines That Taxpayer Has No Regular Accounting Method or That His Books and Records Do Not "Clearly Reflect Income," He May Resort to Any Accounting Method or to Any Indirect Methods of Proof Which in His Judgment Will "Clearly Reflect Income." The key to our entire problem is the power which vests in the Commissioner to ignore the taxpayer's books and records where he decides that they do not "clearly reflect income," and to resort to any accounting method or to any indirect method of proving a higher income than that reflected in the taxpayer's books.

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vania Electric Company v. Commissioner, 135 F. Supp. 416 (Ct. Cl. 1955); Gulf Power Co., 10 T.C. 852 (1948); National Airlines Inc., 9 T.C. 159 (1947); Seas Shipping Company Inc., 1 T.C. 30 (1942); 1954-1 CUM. BULL. 288.

<sup>9</sup> Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953); Boynton v. Pedrick, 136 F. Supp. 888 (S.D.N.Y. 1954); Sam Mesi, 25 T.C. 513 (1955); V.T.H. Bien, 20 T.C. 49 (1953).

<sup>10</sup> Louis M. Brooks, 6 T.C. 504 (1946); (Slips of paper kept on file and informal ledger not enough; general ledger is not a book of original entry); Malcolm G. Brooks, 5 CCH Tax Ct. Mem. 181 (1946); Max H. Stryker, 36 B.T.A. 326 (1937).

<sup>11</sup> Matter of Pinkus Newman, 94 F.2d 108 (6th Cir. 1938).

<sup>12</sup> Becheli v. Hofferbert, 111 F. Supp. 631 (D. Md. 1953); Frank Shinkonis, 10 CCH Tax. Ct. Mem. 503 (1951); Arthur Ward, 7 CCH Tax. Ct. Mem. 505 (1948) (Taxpayer-owner of liquor store retained simple records; Revenue Agent ignored these records and substituted unit mark-up permitted by State. *Held*: This was arbitrary under special circumstances; evident taxpayer did not make that much profit).

<sup>13</sup> Herberger v. Commissioner, 195 F.2d 293 (9th Cir. 1952); Boynton v. Pedrick, 136 F. Supp. 888 (S.D.N.Y. 1954); Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953).

<sup>14</sup> Greengard v. Commissioner, 29 F.2d 502 (7th Cir. 1928) *affirming*, 8 B.T.A. 734 (1927); Fredrico Stallforth, 6 T.C. 140 (1946).

These are some of the manifestations of the Commissioner's power in this respect:

1. He may switch the taxpayer's accounting method from the accrual or the hybrid basis to the cash basis or vice versa.

2. He may switch from the fiscal to the calendar year basis, or vice versa.

3. He may apply the *Cohan* rule of approximation where deductions are not adequately substantiated or he may disallow the deductions entirely.<sup>15</sup>

4. Among the more common indirect methods of proving income which he may use are the following: (a) Net worth increase;<sup>16</sup> (b) Cash expenditures;<sup>17</sup> (c) Bank deposits;<sup>18</sup> (d) Unit mark-up; (e) Net profit percentage; (f) Raw materials usage.<sup>19</sup>

E. Contesting the Commissioner's Action: The Commissioner's action in rejecting the taxpayer's books and methods and resorting to some alternative method of determining the true income, of course, is subject to court review.

The following are some useful guides for understanding the scope and meaning of judicial review:

1. The burden of proof is on the taxpayer to show that *his* accounting method rather than the alternative method chosen by the Commissioner more accurately reflects income. In this regard the Commissioner's action is further aided by judicial recognition that he must be given broad administrative discretion.<sup>20</sup>

2. The adequacy of the taxpayer's records and accounting method is a question of fact and not of law, and is subject to judicial review of the entire record.<sup>21</sup>

3. The court will test the Commissioner's action in the light of the realities of the situation, neither according to book entries a presumption of correctness nor ignoring the realities of a transaction

<sup>15</sup> *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

<sup>16</sup> *Samuel G. Malouf*, 15 CCH Tax Ct. Mem. 571 (1956); *David Meade Peebles*, 15 CCH Tax Ct. Mem. 801 (1956); *Epstein v. U.S.*, 246 F.2d 563 (6th Cir. 1957); *Schwarzkooff v. Commissioner*, 246 F.2d 731 (3rd Cir. 1957). *Cf.* *West v. Henslee*, 575 CCH par. 9932 (D. Tenn. 1957).

<sup>17</sup> A "cash expenditures" case normally is present as an important phase of a "net worth increase" case, rather than as an independent method of proof.

<sup>18</sup> *Dell v. Glenn*, 231 F.2d 186 (6th Cir. 1956); *Lesly Cohen*, CCH Tax Ct. Mem. 172 (1957); *Sam Saffren*, CCH Tax Ct. Mem. 184 (1957); *Morris Miller*, 14 CCH Tax Ct. Mem. 398 (1955); *Herman J. Romer*, 28 T.C. No. 145 (1957).

<sup>19</sup> *D & H Bagel Bakery Inc.*, 15 CCH Tax Ct. Mem. 334 (1956).

<sup>20</sup> *V.T.H. Bien*, 20 T.C. 49 (1953); *Burnet v. Houston*, 238 U.S. 223 (1930); *Welch v. Helvering*, 290 U.S. 111 (1933); *United States v. Tillinghast*, 69 F.2d 718 (1st Cir. 1934); *Harry Gleis*, 24 T.C. 941 (1956); *Morris Lipsitz*, 21 T.C. 917 (1954); *aff'd*, 220 F.2d 871 (4th Cir. 1955).

See *Balter, Rules of Evidence Applicable in Proceedings Before the Tax Court of the U.S.: Burden of Proof and Presumptions*, Seventh Annual Marquette University Institute on Taxation (1956).

<sup>21</sup> *Sam Mesi*, 25 T.C. 513 (1955); *Jack Showell*, 23 T.C. 495 (1954).

merely because a taxpayer has failed to record it or has improperly recorded it in his books.<sup>22</sup>

4. But in resorting to methods of proving income other than that adopted by the taxpayer, especially where indirect methods of proof are utilized, the Commissioner's action will be disapproved to whatever extent it reflects a disregard of realities or an unreasonable and arbitrary attitude.<sup>23</sup>

5. But the fact that the Tax Court modifies some of the Commissioner's adjustments does not mean that the accounting method which he used must be rejected as arbitrary.<sup>24</sup>

### III. PERIOD FOR RETENTION OF BOOKS AND RECORDS

A. Stating the Problems: Assume taxpayer at one time had an adequate accounting method supported by adequate records, but when subsequent audit is made (first or successive), taxpayer no longer has adequate records, either having lost or destroyed them.

Pertinent problems suggested by this situation are:

1. Are Commissioner's powers any different than if records originally available were adequate?

2. What is period of time during which taxpayer is required to retain records?

3. Does good faith destruction or loss of records by taxpayers affect Commissioner's powers?

4. What is the situation where taxpayer can produce some records—primary or secondary—but not complete records?

5. Does fact that taxpayer is engaged in illegal business impose greater duty to retain records?

6. What penalties and sanctions may taxpayer incur for not having records available at time of audit?

B. The Regulations and the General Guide: There is nothing in the INTERNAL REVENUE CODE specifically dealing with the retention period for books and records. However, the Regulations and the General Guide refer to the problem:

1. The Regulations: Regulations 118, Sec. 39.54-1 (a) provides:

“. . . The books or records required by this paragraph shall be kept at all times available for inspection by internal

<sup>22</sup> *Doyle v. Mitchell Bros Co.*, 247 U.S. 179 (1918); *Commissioner v. North Jersey Title Insurance Co.*, 79 F.2d 492 (3rd Cir. 1935); *Deer Island Logging Co.*, 14 B.T.A. 1027 (1929); 1 MERTENS, *INCOME TAXATION* §5.09 (1956).

<sup>23</sup> *In re Max Sheinman*, 14 F.2d 323 (E.D. Pa. 1926); *Rubino v. Commissioner*, 226 F.2d 291 (6th Cir. 1955); *O. E. Stephens*, 15 CCH Tax Ct. Mem. 1471 (1956); *Sam Mesi*, 25 T.C. 513 (1955); *Jerome A. Giles*, 14 CCH Tax Ct. Mem. 742 (1955); *Jack Showell*, 23 T.C. 195 (1954); *Leonard Cephus Hall*, 12 CCH Tax Ct. Mem. 1067 (1953); *Arthur Ward*, 7 CCH Tax Ct. Mem. 505 (1948); *Frank Shinkonis*, 10 CCH Tax Ct. Mem. 503 (1951); (unit markup rejected).

<sup>24</sup> *Harry Gleis*, 24 T.C. 941 (1956).

revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law."

2. The General Guide: In some few instances no specified retention period is indicated; in a few other cases there is indicated a specified period of time; but in the great majority of situations the same language is used as in the Regulations, namely "So long as the contents thereof may become material in the administration of any Internal Revenue Law."

C. The phrase "So long as the contents thereof may become material in the administration of any Internal Revenue Law" must relate to the applicable statute of limitations for assessment: It would seem clear on the basis of this phrase that the minimum retention period must be for as long as the statute of limitations for further assessment is open as to the particular taxpayer.

But when it comes to determining how long the applicable statute of limitations may be for the particular taxpayer, we are in an area of great complexity.<sup>25</sup> However, it would be useful to indicate the more common aspects of the problem:

1. Special Situations: We shall speak only of the more common situations involving periods of assessment for income taxes. We should point out, however, that there are numerous specific periods of time for particular types of taxpayers and particular types of taxes indicated throughout the INTERNAL REVENUE CODE.

2. Normal Statute of Limitations for Assessments: The normal period of limitations for assessment of additional taxes is three years. This would then be the irreducible minimum period for retention of records.<sup>26</sup> Where an additional assessment is proposed by the Commissioner within what he claims to be three years after the due date of the return, the burden of proof would be on the taxpayer to show that the normal period has in fact already expired.

3. Statute of Limitations Where Burden of Proof Is On The Commissioner to Show That Longer Than Normal Period of Limitation Applies: (a) *25% understatement of gross income*: Where there is shown to be an understatement of gross income of 25% or more, the statute of limitations for additional assessment in six years.<sup>27</sup> (b) *No return filed*: Where no valid return was filed, there is no statute of limitation barring assessments.<sup>28</sup> (c) *Fraudulent return filed*: Where

<sup>25</sup> For more detailed discussion of relation of statute of limitations to retention period, see Altman, *How Long Should Records Be Kept?* 29 TAXES 875 (1951).

<sup>26</sup> INT. REV. CODE OF 1954, §6501 (a).

<sup>27</sup> *Id.* §6501 (c) (1) (A).

<sup>28</sup> *Id.* §6501 (c) (3).

the return filed by the taxpayer is found to be fraudulent, there is no statute of limitations for additional assessments.<sup>29</sup>

4. Extension of Limitation Period by Waiver: It is common practice for Revenue Agents to seek and obtain one or more waivers of the normal statute of limitations. It is important that the record be checked before it is determined that the statute of limitations has in fact run against further assessments. It is unfortunate that as a practical matter, the constant obtaining of extensions has minimized the protection presumed to be afforded the taxpayer by the statute of limitations.

5. Request for Early Audit: The INTERNAL REVENUE CODE provides an opportunity for some taxpayers (usually involving executors of estates or corporations in the liquidating process) to request an immediate audit. Under these circumstances the normal statute of limitations is reduced to eighteen months.

6. Amending the Original Return: Amending the valid original return before the applicable statute of limitations has run does not toll the limitation period; it runs from the date when the original return was due and not from the date of the filing of the amended return.<sup>30</sup>

D. What Are Consequences to Taxpayer of Premature Destruction or Loss of Books and Records?

1. Powers of the Commissioner:

(a) Agent Indicates "Non-Cooperation": Perhaps the most important effect of the taxpayer being unable to produce his books and records during the required retention period would be the likelihood of the Revenue Agent indicating in his report that the taxpayer has not "cooperated," and using this observation as a justification for "throwing the book" at the taxpayer. Here are some of the weapons which the Commissioner may use:

(b) Asserting Penalties: The Commissioner may assert and recommend various civil and criminal penalties and sanctions: (1) The 5% penalty for negligence or disregard of the Commissioner's Rules and Regulations.<sup>31</sup> (2) The 50% penalty for having filed a fraudulent return. This penalty is more likely to be asserted by the Commissioner where he is satisfied that there has been deliberate destruction of pre-

<sup>29</sup> *Id.* §6501 (c) (2). See Balter, *Rules of Evidence Applicable in Proceedings Before the Tax Court of the U.S.: Burden of Proof and Presumptions*, Seventh Annual Marquette University Institute on Taxation (1956).

<sup>30</sup> *Zellerbach Paper Company v. Helvering*, 293 U.S. 172 (1934).

<sup>31</sup> INT. REV. CODE OF 1954, §6653 (a); Ralph Romine, 25 T.C. 859 (1956); Samuel G. Malouf, 15 CCH Tax Ct. Mem. 571 (1956); David Meade Peebles, 15 CCH Tax Ct. Mem. 821 (1956); Morris Wexler, 14 CCH Tax Ct. Mem. 447 (1955); Estate of Albert D. Phillips, 14 CCH Tax Ct. Mem. 516 (1955); Sam Saf-fen, CCH Tax Ct. Mem. 184 (1957); 10 MERTENS, INCOME TAXATION §§55.25 &55.28 (1948).

existing records, which to his mind would indicate fraudulent intent.<sup>32</sup>

(3) *Criminal Sanctions*: Either a misdemeanor charge<sup>33</sup> or a felony charge<sup>34</sup> are possible recommendations which may flow from the failure of the taxpayer to make available adequate books and records for examination by the Agent.

(c) The Agent may use every available means of determining the highest additional tax and then throw the burden on the taxpayer to upset the prima facie correctness of the proposed assessment.<sup>35</sup>

(d) The destruction of pre-existing books and records may in itself help to relieve the Commissioner of the burden of proof which he would otherwise have where he is seeking to apply a longer than the normal statute of limitations. For example, in the absence of books and records the agent will be justified in using indirect methods of proving unreported income which may then indicate an understatement of gross income of 25% or more, thus permitting the six-year statute of limitations to be operative. Or if fraudulent intent can be established from the destruction of books and records and the other usual indicia of fraud, then no statute of limitations would apply.

(e) Effect of Previous Audit of Books on Right to Re-Examine: We must keep in mind certain basic rules respecting the Commissioner's right to re-audit the taxpayers returns and re-examine his books and records even though a previous audit had been made. A knowledge of these rules is important where adequate books and records may have been present on the first audit but are no longer present on a re-audit. Here are the governing principles: (1) The fact that a Form 870 agreement was reached between the Commissioner and the taxpayer presents no bar to a subsequent audit while the statute of limitations is still open, since this type of an agreement, not being a formal closing agreement, is not binding on either party.<sup>36</sup> (2) Where normal limitation period has run subsequent examination will be permitted upon Agent's allegation that he has basis for suspecting presence of fraud without the necessity of actually showing fraud.<sup>37</sup> (3) Nor does previ-

<sup>32</sup> INT. REV. CODE OF 1954, §6653(b); *Hall v. U.S.*, —F. Supp.—, 57-1 U.S.T.C. par. 9329 (D. Ga. 1956); *Goldberg v. Commissioner*, 239 F.2d 316 (5th Cir. 1956); *John Federika*, 14 CCH Tax Ct. Mem. 652 (1955); *A. J. Mandt*, 14 CCH Tax Ct. Mem. 909 (1955); *Randolph Murdough*, 14 CCH Tax Ct. Mem. 974 (1955); *Morris Miller*, 14 CCH Tax Ct. Mem. 398 (1955); *Estate of Fred Arbogast*, 7 CCH Tax Ct. Mem. 211 (1948).

<sup>33</sup> INT. REV. CODE OF 1954, §7203.

<sup>34</sup> *Id.* §7201.

<sup>35</sup> *John Federika*, 14 CCH Tax Ct. Mem. 652 (1955); *Morgan Ice Company, Inc.*, 9 CCH Tax Ct. Mem. 170 (1950).

<sup>36</sup> *In re Wood*, 123 F. Supp. 297 (S.D. Ky. 1954); *Torras v. Stradley*, 103 F. Supp. 737 (N.D. Ga. 1951); *In re Paramount Jewelry Co. Inc.*, 80 F. Supp. 375 (S.D.N.Y. 1948); *Boren v. Tucker*, 239 F.2d 767 (9th Cir. 1956).

<sup>37</sup> *Matter of Carroll*, 149 F. Supp. 634 (1957); *United States v. People's Deposit Bank and Trust Co. of Paris, Ky.*, 112 F. Supp. 720 (C.D. Ky. 1953), *aff'd per curiam*, 212 F.2d 86 (6th Cir. 1954); *Corbin Deposit Bank of Corbin*, 244 F.2d 177 (6th Cir. 1957).

ous audit prevent Agent from access to accountant's work papers or taxpayer's records in accountant's possession.<sup>38</sup>

(f) Where taxpayer is engaged in an unlawful business, his duty to retain adequate records for requisite period is stronger although not to point of confiscation.<sup>39</sup>

2. What Can Taxpayer Do To Extricate Himself From This Situation:

(a) Produce testimony or other evidence that taxpayer originally kept complete records which were accurate and honest.<sup>40</sup>

(b) Prove that same type of records now available though inadequate were used in previous years and Revenue Agents made no objection to inadequacy.<sup>41</sup>

(c) Produce *some* available records—primary or secondary—even if not complete.<sup>42</sup>

(d) Produce convincing records as to some issues or some of the years in question even though have no adequate records as to other issues or other years.<sup>43</sup>

(e) Prove key transactions by secondary evidence—documentary or oral.<sup>44</sup>

(f) Where deductions are involved, produce evidence that some expenditures were made or losses occurred so that *Cohan* rule may be applied as to amount.<sup>45</sup>

(g) Present evidence of good faith in prematurely destroying or losing records, which may take the form of: (1) Advice of others; (2) Non-tax consideration; and (3) May avoid inference of fraud or that records concealed unfavorable information.<sup>46</sup>

<sup>38</sup> *Schulman v. Dunlap*, 105 F. Supp. 104 (S.D.N.Y. 1952); *Balter, The Accountant's Responsibility for Working Papers, Books and Records*, 32 TAXES 415 (1954).

<sup>39</sup> *Morris Wexler*, 14 CCH Tax Ct. Mem. 447 (1955); *H.T. Rainwater*, 23 T.C. 450 (1954); *Springer v. Truman*, 8 CCH Tax Ct. Mem. 108 (1949).

<sup>40</sup> *Jerome A. Giles*, 14 CCH Tax Ct. Mem. 742 (1955); *H. T. Rainwater*, *supra* note 39; *H. H. McCoy*, 5 CCH Tax Ct. Mem. 101 (1946); *Cf. Gamm v. Commissioner*, 39 F.2d 73 (5th Cir. 1930).

<sup>41</sup> *Randolph Murdough*, 14 CCH Tax Ct. Mem. 974 (1955); *Estate of Albert D. Phillips*, 14 CCH Tax Ct. Mem. 516 (1955); (Such failure to object, however, would not be construed to be acquiescence by the Commissioner); *Cf. Paulosky Estate*, 6 CCH Tax Ct. Mem. 1176 (1947).

<sup>42</sup> *Jerome A. Giles*, 14 CCH Tax Ct. Mem. 742 (1955); *Aaron Samelson, Executor*, 10 B.T.A. 860 (1928); *Ettenson Winnig Dry Goods Co.*, 3 B.T.A. 897 (1926); *Cf. Torrey v. Commissioner*, 84 F.2d 659 (6th Cir. 1936). See *Balter, Rules of Evidence Applicable in Proceedings Before the Tax Court of the United States: Burden of Proof and Presumptions*, Seventh Annual Marquette University Institute on Taxation (1956).

<sup>43</sup> *Ettenson Winnig Dry Goods Co.*, *supra* note 42.

<sup>44</sup> *Aaron Samelson, Executor*, 10 B.T.A. 860 (1929); *Ettenson Winnig Dry Goods Co.*, 3 B.T.A. 897 (1926); 9 MERTENS, INCOME TAXATION §50.76 & 50.78 (1943).

<sup>45</sup> *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930); *John Federika*, 14 CCH Tax Ct. Mem. 652 (1955); *Jack Showell*, 23 T.C. 495 (1954).

<sup>46</sup> *Cf. Harry Ralph Leacock*, 6 CCH Tax Mem. 1282 (1947); *H. T. Rainwater*, 23 T.C. 450 (1954).

(h) Show that Commissioner's determination is unfair, arbitrary, and unreasonable on basis of realities of the situation or such evidence as was available to Commissioner.<sup>47</sup>

#### IV. BY WAY OF SUMMARY

A. Rules for Determining "Safe" Retention Period: On the basis of what we have learned to this point, what then must be considered a "safe" retention period so that if he is unable to produce pre-existing books and records on an audit subsequent to his retention period, the taxpayer would with reasonable certainty avoid the difficulties to which we have already referred?

We suggest the following guides:

1. The retention period must be at least as long as the period of the statute of limitations which would apply to the particular taxpayer under the facts as he knows them to exist—which, as a practical matter, he would be presumed to have known.

2. For a longer period than indicated by the normally applicable statute of limitations if the taxpayer himself is involved in a special situation where the tax impact of the transactions would indicate that the supporting records should be made available for beyond the normal statutory period.<sup>48</sup>

By way of illustrating where this guide may be applicable, we should mention: (a) Basis situations, such as March 1, 1913 valuation, capital gains, non-taxable transactions. (b) Installment sales. (c) Allocations between tax years. (d) Carry-forward credits. (e) Loss corporations. (f) Worthless debt charge-offs.

3. Any transactions between the taxpayer and "related" or "controlled" taxpayers within the meaning of the Internal Revenue Code.<sup>49</sup>

4. Retention of records of related taxpayers or related taxable entities other than the taxpayer who is himself subject to the primary audit. This guide may be especially applicable in the case of: (a) multiple entities; (b) reorganizations, liquidations, and other devisive maneuvers.

5. If filing a claim for refund or subsequent litigation is contemplated, whether initiated by the taxpayer or the Commissioner, then the retention period should be for so long as reference to records may be needed.

#### B. The Problem of Adequate Storage Space:

It is understandable that inadequate storage space may constitute a recurring incentive to destroy old books and records. To some extent this pressure may be alleviated through the aid of the most modern

<sup>47</sup> Grace O. Dean, 14 CCH Tax Ct. Mem. 959 (1955); Jerome A. Giles, 14 CCH Tax Ct. Mem. 742 (1955).

<sup>48</sup> TAX IDEAS pars. 7014 & 7008.2(8).

<sup>49</sup> *Id.* par. 7008, 2(8).

bookkeeping and record-keeping equipment. It should also be remembered that the Commissioner permits the microfilming of supporting records.<sup>50</sup>

And finally, the harassed taxpayer may derive some comfort from the fact that the Government itself also has its record storage problems. Original tax returns normally are destroyed after six years, although no doubt they have been microfilmed. And only recently the Defense Department has placed a Rear Admiral in charge of a new "Office of De-Classification" to reduce the backlog of an estimated billion or more "secret documents" which have been accumulating since Civil War days.<sup>51</sup>

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<sup>50</sup> I. T. 3866, 57-2 CUM. BULL. 68 (1957).

<sup>51</sup> Los Angeles Times, Sept. 3, 1957.