*Multistate Tax Commission*

# REPORT OF HEARING OFFICER

*regarding the MTC proposal to adopt the*

# MODEL RECORDKEEPING AND RETENTION REGULATION

Submitted by:

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# REPORT OF THE HEARING OFFICER

**regarding the MTC proposal to adopt the**

# MODEL RECORDKEEPING AND RETENTION REGULATION

## I. Summary of Report.

This Report recommends adoption of the Model Recordkeeping and Retention Regulation developed by the State/Industry Task Force on EDI Audit and Legal Issues for Tax Administration (hereinafter "EDI Task Force"). The Hearing Officer recommends that the "Model Regulation" replace the MTC's existing Recordkeeping Regulation for Sales and Use Tax Purposes, Reg. VII.1. The Model Regulation is designed specifically to govern State tax recordkeeping in an electronic environment, an area currently not addressed in the MTC's regulations. The full text of the Model Regulation has been set forth at pages 14 to 21 of this Report.

Additionally, the Report recommends that the EDI Task Force's Explanation and Commentary to the Model Regulation be attached to the Model Regulation, not as an MTC recommendation, but as an appendix available for reference for those States that decide to adopt the Model Regulation and wish to include a commentary and explanation with their version.

The Report also includes a discussion of a number of issues raised by commentators during the hearing process. Although the Hearing Officer recommends adoption of the Model Regulation precisely as drafted by the EDI Task Force, because it is anticipated that States deciding to adopt the model will make some modifications, these States may wish consider during its administrative process the issues raised as part of the MTC's hearing process. All of the written comments submitted during the comment period have been attached to the Hearing Officer's Report as part of the public hearing record.

## II. Hearing Officer's Report.

### A. Uniformity Proposal Hearing Process

This uniformity proposal was developed outside of the MTC's ordinary uniformity process. Normally, MTC uniformity proposals are drafted by the State representatives comprising the Uniformity Committee. In this instance, however, the Model Recordkeeping and Retention Regulation is the work-product of a joint State/Industry task force whose purpose is to study and draft recommendations regarding State tax administration issues arising out of emerging business processes, particularly electronic data interchange (EDI) and other electronic commerce technologies. The task force drafted the Model Recordkeeping and Retention Regulation ("Model Regulation") with the expectation that the Multistate Tax Commission and Federation of Tax Administrators would endorse the document and that as many States as possible would adopt the Model Regulation.[1]

Following publication of the model provision by the EDI Task Force on Audit and Legal Issues for Tax Administration, the MTC's Uniformity Committee reviewed the Model Regulation, including the Steering Committee Report of the task force, and decided to recommend to the Executive Committee that the Model Regulation be referred directly to the MTC's public hearing process.[2] Although the Steering Committee Report includes an Explanation and Commentary to the Model Regulation, the Uniformity Committee recommended public hearing on only the text of the Model Regulation. The Executive Committee accepted the Uniformity Committee's

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[1] The FTA Executive Committee endorsed the Model Regulation during its June 1996 meeting.

[2] Although the MTC's Public Participation Policy had not been adopted formally at the time the Uniformity Committee reviewed the Model Regulation, the Committee considered the possibility of referring the proposal to the public participation process. The Committee determined that because the Model Regulation represents the joint work of both industry and State parties, it would not be inappropriate to refer the proposal directly to the public hearing process.

recommendation and referred the Model Regulation to public hearing pursuant to Article VII of the Multistate Tax Compact and MTC Bylaw 7.

A Hearing Officer was appointed and the public hearing was held Tuesday, December 10, 1996, in Washington, D.C. {Notice of Hearing attached as *Exhibit A.*} The public comment period was left open until January 10, 1997 for additional written comments from interested parties. As required under the MTC's public hearing provisions, this Report sets forth the full text of the recommended proposal and includes an explanation of the proposal and related issues.

The Executive Committee may accept, reject or modify the Hearing Officer's recommendations contained herein or the Committee may take any other action which it deems appropriate, including authorizing another hearing session. If the Executive Committee decides to refer a uniformity recommendation in this matter to the full Commission, it may authorize the conduct of a Bylaw 7 survey of the affected MTC Member States. If a majority of the surveyed Member States agree to consider the proposal for adoption, then, at its next meeting after the survey, the full Commission will vote on whether to adopt the proposal as a Multistate Tax Commission recommendation to the States. Although a uniformity proposal may be adopted by the MTC, there is no requirement that the States adopt the recommended provision. Each State decides independently whether to pursue adoption of an MTC recommended provision through that State's individual administrative or legislative process.

**B. Background and Explanation of Terms of Model Regulation**

In March 1996, the Task Force on EDI Audit and Legal Issues for Tax Administration (hereinafter "EDI Task Force") issued its first work product: a Steering Committee Report introducing the Model Recordkeeping and Retention Regulation ("Model Regulation") designed to govern State tax recordkeeping issues related to the growing utilization by businesses of new

business processes like electronic data interchange (EDI). EDI allows commercial transactions between trading partners to be conducted solely electronically, thereby eliminating paper documents like invoices, purchase orders and sales receipts and presumably creating more efficiencies in the conduct of business. However, existing State tax recordkeeping provisions do not necessarily address explicitly the requirements for retention of records in this paperless environment. It was recognized that there was a need for the development of State tax recordkeeping provisions to handle circumstances where original paper documents, relied on for conducting tax audits, no longer exist.

The EDI Task Force was established to examine and make recommendations related to audit and legal issues arising out of the use of EDI and other electronic technology. Formed in late 1994 under the leadership of the Federation of Tax Administrators (FTA), the EDI Task Force includes representatives of the Committee on State Taxation (COST), the Institute of Property Taxation (IPT), the Tax Executives Institute (TEI) and the MTC in addition to the top tax agency administrators of several States and State tax agency personnel.[3] Initially, the task force established two Work Groups, the EDI Audit Approaches working group and the Legal Requirements and Recordkeeping working group, the group assigned the task of developing a model recordkeeping regulation that would account for records created through the use of EDI technology. After completion of the model regulation, a new working group, the Electronic Business Processes Work Group was formed to address issues related to several other emerging business processes.[4]

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[3] The Hearing Officer participated as an MTC Staff member in most of the EDI Task Force deliberations on the Model Regulation.

[4] Since issuing the Model Regulation, the EDI Task Force has issued an EDI audit procedures guideline and a white paper addressing auditing procurement card transactions. The task force continues to examine other electronic business process issues such as

The EDI Task Force considered a number of sources in developing the Model Regulation including existing State recordkeeping regulations, a draft regulation under development by the California Board of Equalization, Revenue Procedure 91-59 adopted by the Internal Revenue Service to govern automated recordkeeping and accounting systems and TEI's suggested revisions to Revenue Procedure 91-59.[5] Using these sources as guidance and drawing on the expertise and experience of the State and business representatives who included auditors, lawyers, tax managers, systems and technology experts and others, the Task Force endeavored to draft an administrable recordkeeping provision to address State and business concerns regarding tax administration in an EDI environment. States were concerned about what data taxpayers would have available for tax audit purposes and businesses were concerned about what data States would require for audit. As explained in the EDI Task Force Steering Committee Report, the final product "attempts to achieve a realistic balance between the needs of tax administrators and the needs of taxpayers." "Above all, [the Model Regulation] is aimed at facilitating an efficient and effective tax administration process."

The Steering Committee Report contains an Explanation and Commentary providing a section-by-section description of the Model Regulation. Although the Uniformity and Executive Committees did not refer the Explanation and Commentary to public hearing, that section is provided in full as *Appendix I: Explanation and Commentary* to this Hearing Officer's Report, not as a recommendation, but as a useful explanation of the terms of the Model Regulation.

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development of an electronic exemption certificate, drafting a model approach to direct pay authority and drafting an issue paper on evaluated receipts settlements.

[5] Rev. Proc. 91-59, issued in 1991, spells out the basic requirements for record retention for taxpayer records maintained on an automatic data processing system. To date, Rev. Proc. 91-59 has not been revised. {A copy of Rev. Proc. 91-59 is attached as *Exhibit G.*}

### C. Hearing Proceedings

Many of the participants attending the public hearing also played a significant role in the development of the Model Regulation through the EDI Task Force. These participants stressed their desire to have the MTC adopt the Model Regulation exactly as drafted by the Task Force. The Task Force members consider it very important that any MTC recommendation mirror the Model Regulation to maintain uniformity among the Task Force, the FTA and the MTC.

The majority of the hearing participants also expressed concern that the Uniformity and Executive Committees had not referred the Explanation and Commentary portion of the Task Force report to this hearing process. These commentators requested that the Hearing Officer recommend adoption of the Explanation and Commentary together with the text of the Model Regulation.

Written comments were submitted by the State of New York presenting its concerns that: 1) the Model Regulation does not require retention of the original transaction record transmitted as part of an EDI transaction; 2) the final version of the regulation does not contain a provision for testing a taxpayer's computer system under circumstances where EDI transaction sets have not been retained and 3) the Model Regulation does not establish consequences for the failure to provide adequate electronic records. {See *Exhibit B.*}

Stan Arnold, Commissioner of the New Hampshire Department of Revenue Administration (and also Chair of the EDI Task Force) made formal comments during the public hearing strongly urging the MTC to adopt the Model Regulation. Commissioner Arnold also submitted written comments re-stating his favorable oral testimony during the hearing. {See *Exhibit C.*}

Several industry and business-related organizations submitted comments on the Model Regulation. MCI Telecommunications Corporation

wrote in general support of the effort to create a uniform recordkeeping provision, but noted a number of objections to many of the sections of the Model Regulation. {See *Exhibit D.*} Carol Calkins, representing the American Institute of Certified Public Accountants, provided both oral and written comments in favor of the Model Regulation as a substitute for the MTC's current recordkeeping regulation. {See *Exhibit E.*} Besides suggesting several clarifying language changes, Ms. Calkins raised an issue regarding the difficult burden that the AICPA believes would be placed on small businesses required to adhere to the regulation provisions. These potential problems are detailed in a memorandum attached as an addendum to the AICPA's written comments. {See Addendum to *Exhibit E.*}

While suggesting a number of changes to the Model Regulation, the Tax Executives Institute's letter recommends that the MTC adopt the Model Regulation in place of the existing MTC recordkeeping regulation. {See *Exhibit F.*}

**D. Recommend Adoption of Model Regulation**

The Hearing Officer recommends adoption of the Model Regulation in place of the current MTC Recordkeeping Regulation for Sales and Use Tax Purposes, Reg.VII.1. Adopted eleven years ago, the MTC's existing regulation contains no provisions that explicitly acknowledge evolving business processes and the consequent changes that have and will occur in the form and manner in which records relevant to sales and use tax administration are created and retained. The MTC's regulations should address records retention and maintenance in the electronic and paperless environment. In addition, although the Model Regulation seems oriented towards addressing sales and use tax records, the provisions of the Model Regulation could apply to recordkeeping for operational taxes like the income tax. Replacing the existing MTC provision with the Model Regulation would provide a recordkeeping rule that States may consider for sales and use tax and income

and franchise tax purposes. Thus, the Hearing Officer recommends adoption of the Model Recordkeeping and Retention Regulation as the new MTC Regulation VII.1.

Moreover, it is recommended that the Model Regulation be adopted as drafted by the EDI Task Force, without change. Because it is very likely that States deciding to adopt the Model Regulation will make adjustments to suit their specific State law requirements, the basic model of the regulation should remain unchanged. As noted in the EDI Task Force Steering Committee Report, it was anticipated that the Model Regulation would be modified in accordance with each adopting States' laws, but it also was anticipated that the general requirements set forth in the document would be adopted uniformly among the States. The Hearing Officer is persuaded by the argument of the EDI Task Force participants that the text of the Model Regulation should be uniformly adopted by the Task Force, the FTA and the MTC. *The text of the Model Regulation has been set forth at pages 14 to 21 of this Report.*

Several States already have adopted the Model Regulation in substantially similar form as drafted by the EDI Task Force: Arizona issued an Administrative Release, General Tax Ruling GTR 96-1; Florida adopted Rule 12-24; Illinois promulgated regulation Section 130.805; New Jersey amended its regulations at Reg. 18:2-7.1, *et seq.* and New Mexico adopted regulation 3 NMAC 1.5.15.1, *et seq.* It must be noted that a number of the foregoing States have made modifications in adopting the Model Regulation.

Although this Report recommends adoption of the Model Regulation as drafted by the EDI Task Force, the Report will address several issues that States deciding to adopt the Model Regulation may wish to consider. These are points raised by respondents during this hearing process that the Hearing Officer believes warrant discussion as part of this Report.

*1. Explanation and Commentary as an Appendix to the Model Regulation.*

The Hearing Officer does not recommend adoption of the Explanation and Commentary section of the Task Force Report as part of the MTC regulations, but recommends the attachment of an appendix to the Model Regulation for consideration by States inclined to adopt the Explanation and Commentary as part of their regulations. During MTC Uniformity Committee deliberations on the Model Regulation, a number of State representatives indicated that their States do not or cannot adopt explanations or comments as part of their regulations. If the MTC adopts the Explanation and Commentary, not as part of the regulation, but as an Appendix to the regulation, the Explanation and Commentary is readily available for review by each state willing to consider it, it becomes a permanent part of the record for MTC purposes, yet it will not serve as a deterrent to adoption for those states that will not consider including commentary in their regulations. The Hearing Officer believes that this approach reasonably balances the interests of EDI Task Force participants in ensuring that the Explanation and Commentary is available for States' consideration with the concerns of those States that would view the inclusion of commentary as a barrier to adoption of the Model Regulation. The Hearing Officer recommends that the Explanation and Commentary set forth following introductory statement:

> The following Explanation and Commentary has not been recommended for adoption by the Multistate Tax Commission as part of the Model Recordkeeping and Retention Regulation. It is provided here for reference purposes only.

*See* Appendix I: Explanation and Commentary, attached to this Report.

*2. "Records necessary to a determination of the correct tax liability."*

Several commentators expressed concern that the first sentence of Section 3.1 of the Model Regulation may be overly broad. That sentence reads as follows:

> A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under [the State's specific statute].

Section 3.1 of the Model Regulation allows for the inclusion of a State-specific listing of the records that may be required, which should provide taxpayers with an indication of the types of records that may be included as necessary records. Additionally, the above language may be compared with that contained in Rev. Proc. 91-59. The IRS adopted a provision requiring retention of all records that may be or may become material and requiring that the records provide "the information necessary to determine the correct tax liability." *Rev. Proc.* 91-59, *Sec.* 5.01. States may choose to use the IRS term "material" instead of "necessary" however, although there appears to be little difference in the intended breadth of records required under Rev. Proc. 91-59 or the Model Regulation. Also note that the States that have adopted versions of the Model Regulation still refer to either "material" or "necessary" records, and the consensus of the State and industry representatives on the EDI Task Force settled on the language as set forth in Section 3.1. The ever-present issue of precisely which records are necessary or material for a particular State tax determination was not expected to be resolved with this Model Regulation.

Related to the concern over the breadth of records required, is the question raised by several hearing participants regarding the meaning of "correct tax liability." The argument has been made that there are differing views about what constitutes a taxpayer's "correct" tax liability. Determining taxpayers' correct liability is one of the core purposes of a tax agency and the issue of correct tax liability is at the heart of every tax dispute. Again, determining "correct" tax liability is a concept that may be found in Rev. Proc. 91-59. The concept appears to be neutral, placing no less burden on the tax agency than on taxpayers.

*3. Standard Record Format.*

Several hearing participants commented on the potential difficulties presented by the requirement under Section 4.1.2 of the Model Regulation that records be converted to a "standard record format" at the time of examination by the State. These commentators noted that establishing a "standard" format is impractical in an environment of rapid technological changes. The Model Regulation does not define "standard record format," although the Explanation and Commentary to the Model Regulation indicates that it is "expected that the determination of the precise format of the data ... will be determined in conjunction with the taxpayer."

IRS Rev. Proc. 91-59 requires the taxpayer to be able to "process" records, which shall include the ability to print a hardcopy of any record. The revenue procedure also requires conversion of pre-existing records to a format compatible with any new system a taxpayer may put in place. In its version of the Model Regulation, Illinois requires records to be "capable of being processed" which is defined as being able to retrieve, manipulate, print hard-copy, or produce other output. *Ill. Reg. Section* 130.805.b) 2) A) iii). These are examples of alternatives to the use of the term "standard record format."

Perhaps this is an area in which States can take an especially flexible approach that will take into account the circumstances of individual taxpayers. Small businesses particularly, could face significant burdens if they possess neither the resources nor the expertise to provide records in a State's standard record format. This is an area in which States may consider working together to develop and adopt a uniform "record format" to be used by all States as a means of relieving the potential burden on taxpayers to comply with different record formats in different States.

*4. Small Business Concerns.*

The AICPA's written submission regarding the Model Regulation includes an addendum raising concerns that small businesses may be overly-

burdened by the recordkeeping requirements under the Model Regulation. The comments specifically point to the possible problems for small businesses attempting to meet the requirements for providing records in and/or converting records to a standard record format and to respond to States' requests for records in a machine-sensible form. The AICPA addendum suggests flexibility in the implementation of the regulation and recommends limiting the applicability of the Model Regulation either to only companies that utilize EDI technology or to larger companies with the resources to comply with the terms of the Model Regulation.

The Model Regulation already builds in some flexibility in Section 6 addressing States' access to machine-sensible records. Section 6.1 appears to require consideration of a particular taxpayer's "facts and circumstances through consultation with the taxpayer" when States seeks access to machine-sensible records. Section 6.2 sets forth a number of ways in which access may be provided, including developing a mutual agreement between the taxpayer and the State on the means of access.

*5. Other issues raised.*

New York submitted concerns regarding the absence of several provisions in the Model Regulation. Under Section 4.2.2 of the Model Regulation, the original EDI transaction record containing the business data being transmitted between business partners need not be retained. The EDI Task Force reached a consensus, after a significant amount of discussion on the issue, that the Model Regulation should reflect that the original transaction records need not be retained because: 1) businesses indicated that transaction records either could not be retained or could be retained for only very short periods of time and 2) many State representatives participating on the EDI Task Force indicated that original transaction records were not needed for audit as long as other means of verifying information were available. Thus, the regulation does not require retention of

original EDI transaction sets "provided the audit trail, authenticity, and integrity of the retained records can be established." *See* Section 4.2.2. In addition, the Model Regulation allows for a State to review the business process used by the taxpayer to retain the EDI data in order to ensure the integrity of the electronic records. *See* Section 4.4.

The EDI Task Force also determined that the Model Regulation should not include a provision regarding System Evaluations because the subject was integral to the work of the EDI Audit Approaches work group of the EDI Task Force. A separate report published by the EDI Task Force titled, "Auditing Electronic Data," addresses in detail the issue of evaluating taxpayers' EDI and business transaction systems.

The Model Regulation also does not contain a penalty provision because the EDI Task Force expected that adopting States would modify the Model Regulation to ensure that their penalty provisions for noncompliance would be applicable.

### E. Conclusion

For the reasons set forth in this Report, the Hearing Officer recommends that the Executive Committee consider adoption of the Model Recordkeeping and Retention Regulation as drafted by the State/Industry Task Force on EDI Audit and Legal Issues for Tax Administration. The Hearing Officer also recommends including an appendix to the Model Regulation setting forth the Explanation and Commentary to the Model Regulation as an available reference for those States wishing to consider for adoption both the regulation and the commentary.

# Model Recordkeeping and Retention Regulation

## 1. PURPOSE

1.1 The purpose of this regulation is to define the requirements imposed on taxpayers for the maintenance and retention of books, records, and other sources of information under *[insert appropriate citations to state tax statutes]*. It is also the purpose of the regulation to address these requirements where all or a part of the taxpayer's records are received, created, maintained or generated through various computer, electronic and imaging processes and systems.

## 2. DEFINITIONS

2.1 For purposes of this regulation, these terms shall be defined as follows:

2.1.1 "Database Management System" means a software system that controls, relates, retrieves, and provides accessibility to data stored in a database.

2.1.2 "Electronic data interchange" or "EDI technology" means the computer-to-computer exchange of business transactions in a standardized structured electronic format.

2.1.3 "Hard copy" means any documents, records, reports or other data printed on paper.

2.1.4 "Machine-sensible record" means a collection of related information in an electronic format. Machine-sensible records do not include hard-copy records that are created or recorded on paper or stored in or by an imaging system such as microfilm, microfiche, or storage-only imaging systems.

2.1.5 "Storage-only imaging system" means a system of computer hardware and software that provides for the storage, retention and retrieval of documents originally created on paper. It does not include any system, or part of a system, that manipulates or processes any information or data contained on the document in any manner other than to reproduce the document in hard copy or as an optical image.

2.1.6 "Taxpayer" as used in this regulation means *[insert state's applicable definition of taxpayer and other persons required to maintain records necessary to determination of tax liability].*

## 3. RECORDKEEPING REQUIREMENTS-GENERAL

3.1 A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under *[insert appropriate citations to state tax statutes].* All required records must be made available on request by the *[state taxing authority*] or its authorized representatives as provided for in *[insert appropriate citations to state tax statutes].* Such records shall include, but not be necessarily limited to:

*[Insert elements of state law which require certain records to be retained (e.g., books of account, invoices, sales receipts), or specific tax elements or transactions (e.g., credits, exemptions etc.) for which particular records may be required.]*

3.2 If a taxpayer retains records required to be retained under this regulation in both machine-sensible and hard-copy formats, the taxpayer shall make the records available to the *[state taxing authority]* in machine-sensible format upon request of the *[state taxing authority].*

3.3 Nothing in this regulation shall be construed to prohibit a taxpayer from demonstrating tax compliance with traditional hard-copy documents or reproductions thereof, in whole or in part, whether or not such taxpayer also has retained or has the capability to retain records on electronic or other storage media in accordance with this regulation. However, this subsection shall not relieve the taxpayer of the obligation to comply with subsection 3.2 of this regulation.

## 4. RECORDKEEPING REQUIREMENTS-MACHINE-SENSIBLE RECORDS

4.1 General Requirements

4.1.1 Machine-sensible records used to establish tax compliance shall contain sufficient transaction-level detail information so that the details underlying the machine-sensible records can be identified and made available to the *[state taxing authority]* upon request. A taxpayer has discretion to discard duplicated records and redundant information provided its responsibilities under this regulation are met.

4.1.2 At the time of an examination, the retained records must be capable of being retrieved and converted to a standard record format.

4.1.3 Taxpayers are not required to construct machine-sensible records other than those created in the ordinary course of business. A taxpayer who does not create the electronic equivalent of a traditional paper document in the ordinary course of business is not required to construct such a record for tax purposes.

4.2 Electronic Data Interchange Requirements

4.2.1 Where a taxpayer uses electronic data interchange processes and technology, the level of record detail, in combination with other records related to the transactions, must be equivalent to that contained in an acceptable paper record. For example, the retained records should contain such information as vendor name, invoice date, product description, quantity purchased, price, amount of tax, indication of tax status, shipping detail, etc. Codes may be used to identify some or all of the data elements, provided that the taxpayer provides a method which allows the *[state taxing authority]* to interpret the coded information.

4.2.2 The taxpayer may capture the information necessary to satisfy section 4.2.1 at any level within the accounting system and need not retain the original EDI transaction records provided the audit trail, authenticity, and integrity of the retained records can be established. For example, a taxpayer using electronic data interchange technology receives electronic invoices from its suppliers. The taxpayer decides to retain the invoice data from completed and verified EDI transactions in its accounts payable system rather than to retain the EDI transactions themselves. Since neither the EDI transaction nor the accounts payable

system captures information from the invoice pertaining to product description and vendor name (i.e., they contain only codes for that information), the taxpayer also retains other records, such as its vendor master file and product code description lists and makes them available to the *[state taxing authority]*. In this example, the taxpayer need not retain its EDI transaction for tax purposes.

4.3 Electronic Data Processing Systems Requirements

4.3.1 The requirements for an electronic data processing accounting system should be similar to that of a manual accounting system, in that an adequately designed accounting system should incorporate methods and records that will satisfy the requirements of this regulation.

4.4 Business Process Information

4.4.1 Upon the request of the *[state taxing authority]*, the taxpayer shall provide a description of the business process that created the retained records. Such description shall include the relationship between the records and the tax documents prepared by the taxpayer and the measures employed to ensure the integrity of the records.

4.4.2 The taxpayer shall be capable of demonstrating

(a) the functions being performed as they relate to the flow of data through the system;

(b) the internal controls used to ensure accurate and reliable processing; and

(c) the internal controls used to prevent unauthorized addition, alteration, or deletion of retained records.

4.4.3 The following specific documentation is required for machine- sensible records retained pursuant to this regulation:

(a) record formats or layouts;

(b) field definitions (including the meaning of all codes used to represent information);

(c) file descriptions (e.g., data set name); and

(d) detailed charts of accounts and account descriptions.

## 5. RECORDS MAINTENANCE REQUIREMENTS

5.1 The *[state taxing authority]* recommends but does not require that taxpayers refer to the National Archives and Record Administration's (NARA) standards for guidance on the maintenance and storage of electronic records, such as the labeling of records, the location and security of the storage environment, the creation of back-up copies, and the use of periodic testing to confirm the continued integrity of the records. [The NARA standards may be found at 36 Code of Federal Regulations, Part 1234, July 1, 1995, edition.]

5.2 The taxpayer's computer hardware or software shall accommodate the extraction and conversion of retained machine- sensible records.

## 6. ACCESS TO MACHINE-SENSIBLE RECORDS

6.1 The manner in which the [*state taxing authority* ] is provided access to machine-sensible records as required in subsection 3.2 of this regulation may be satisfied through a variety of means that shall take into account a taxpayer's facts and circumstances through consultation with the taxpayer.

6.2 Such access will be provided in one or more of the following manners:

6.2.1 The taxpayer may arrange to provide the [*state taxing authority*] with the hardware, software and personnel resources to access the machine-sensible records.

6.2.2 The taxpayer may arrange for a third party to provide the hardware, software and personnel resources necessary to access the machine-sensible records.

6.2.3 The taxpayer may convert the machine-sensible records to a standard record format specified by the [*state taxing*

*authority*], including copies of files, on a magnetic medium that is agreed to by the [*state taxing authority*].

6.2.4 The taxpayer and the [*state taxing authority*] may agree on other means of providing access to the machine-sensible records.

## 7. TAXPAYER RESPONSIBILITY AND DISCRETIONARY AUTHORITY

7.1 In conjunction with meeting the requirements of section 4, a taxpayer may create files solely for the use of the *[state taxing authority].* For example, if a data base management system is used, it is consistent with this regulation for the taxpayer to create and retain a file that contains the transaction-level detail from the data base management system and that meets the requirements of section 4. The taxpayer should document the process that created the separate file to show the relationship between that file and the original records.

7.2 A taxpayer may contract with a third party to provide custodial or management services of the records. Such a contract shall not relieve the taxpayer of its responsibilities under this regulation.

## 8. ALTERNATIVE STORAGE MEDIA

8.1 For purposes of storage and retention, taxpayers may convert hard-copy documents received or produced in the normal course of business and required to be retained under this regulation to microfilm, microfiche or other storage-only imaging systems and may discard the original hard-copy documents, provided the conditions of this section are met. Documents which may be stored on these media include, but are not limited to general books of account, journals, voucher registers, general and subsidiary ledgers, and supporting records of details, such as sales invoices, purchase invoices, exemption certificates, and credit memoranda.

8.2 Microfilm, microfiche and other storage-only imaging systems shall meet the following requirements:

8.2.1 Documentation establishing the procedures for converting the hard-copy documents to microfilm, microfiche or other storage-only imaging system must be maintained and made available on request. Such documentation shall, at a minimum, contain a sufficient description to allow an original document to be followed through the conversion system as well as internal procedures established for inspection and quality assurance.

8.2.2 Procedures must be established for the effective identification, processing, storage, and preservation of the stored documents and for making them available for the period they are required to be retained under section 10.

8.2.3 Upon request by the *[state taxing authority]*, a taxpayer must provide facilities and equipment for reading, locating, and reproducing any documents maintained on microfilm, microfiche or other storage-only imaging system.

8.2.4 When displayed on such equipment or reproduced on paper, the documents must exhibit a high degree of legibility and readability. For this purpose, legibility is defined as the quality of a letter or numeral that enables the observer to identify it positively and quickly to the exclusion of all other letters or numerals. Readability is defined as the quality of a group of letters or numerals being recognizable as words or complete numbers.

8.2.5 All data stored on microfilm, microfiche or other storage-only imaging systems must be maintained and arranged in a manner that permits the location of any particular record.

8.2.6 There is no substantial evidence that the microfilm, microfiche or other storage-only imaging system lacks authenticity or integrity.

## 9. EFFECT ON HARD-COPY RECORDKEEPING REQUIREMENTS

9.1 Except as otherwise provided in this section, the provisions of this regulation do not relieve taxpayers of the responsibility to retain hard-copy records that are created or received in the ordinary course of business as required by existing law and regulations. Hard-copy records may be

retained on a recordkeeping medium as provided in section 8 of this regulation.

9.2 If hard-copy records are not produced or received in the ordinary course of transacting business (e.g., when the taxpayer uses electronic data interchange technology), such hard-copy records need not be created.

9.3 Hard-copy records generated at the time of a transaction using a credit or debit card must be retained unless all the details necessary to determine correct tax liability relating to the transaction are subsequently received and retained by the taxpayer in accordance with this regulation. Such details include those listed in subsection 4.2.1.

9.4 Computer printouts that are created for validation, control, or other temporary purposes need not be retained.

9.5 Nothing in this section shall prevent the *[state taxing authority]* from requesting hard-copy printouts in lieu of retained machine-sensible records at the time of examination.

## 10. RECORDS RETENTION - TIME PERIOD

10.1 All records required to be retained under this regulation shall be preserved pursuant to *[insert adopting state's applicable statutory citation]* unless the *[state taxing authority]* has provided in writing that the records are no longer required.

# Appendix I: Explanation and Commentary

***The following Explanation and Commentary has not been recommended for adoption by the Multistate Tax Commission as part of the Model Recordkeeping and Retention Regulation. It is provided here for reference purposes only.***

## Model Recordkeeping And Retention Regulation
### EXPLANATION AND COMMENTARY

**Section 1. Purpose**

The purpose is stated as defining the record retention and maintenance requirements imposed under state tax statutes and further to address those requirements as they apply to records created, maintained or received through various computer, electronic and imaging processes and systems.

**Section 2. Definitions**

The following terms are defined: data base management system, electronic data interchange, hard-copy record, machine-sensible record, storage-only imaging systems, and taxpayer.

**Section 3. Recordkeeping Requirements - General**

This section establishes the general recordkeeping requirements imposed on all taxpayers without regard to whether they use paper, computer or electronic processes, systems or technology. The obligation is stated as a requirement to maintain those records necessary to determine the correct tax liability of the taxpayer.

*Subsection 3.1* contains the basic requirement to retain all records necessary to the correct determination of tax liability and to make such records available to the state taxing authority. It also allows each state to list specific types of records (e.g., books of account, invoices, sales receipts) or specific tax elements or transactions (e.g., credits, exemptions etc.) for which particular records may be required. Differing specific requirements can be provided for different types of taxes, e.g., motor fuel, sales tax, etc.

*Subsection 3.2* provides that where a taxpayer maintains records in both machine-sensible (i.e., electronic) and hard-copy form as part of the normal business process, such taxpayer shall provide the records to the state taxing authority in machine-sensible form upon request. The subsection is intended to insure that the state taxing authority has access to appropriate machine-sensible records for examination purposes should it so desire. State taxing authorities may also request that the appropriate records be provided for examination purposes in hard-copy form. See also subsection 9.5.

*Subsection 3.3* further provides that the regulation does not preclude the taxpayer from demonstrating tax compliance with traditional hard-copy documents even if the taxpayer has maintained machine-sensible records. The subsection does not relieve the taxpayer of the obligation to provide machine-sensible records if required under subsection 3.2. It is intended instead to allow a taxpayer to demonstrate tax compliance with information in hard-copy records if such are needed to supplement or clarify information in the machine-sensible records or if it is otherwise determined that use of hard-copy records is the best means of determining the correct tax liability.

**Section 4. Recordkeeping Requirements - Machine-Sensible Records**

This section defines the requirements imposed on taxpayers when relevant records are generated or maintained through electronic means. It contains several subsections:

*Subsection 4.1* outlines the general requirements related to the retention of machine- sensible records. *Subsection 4.1.1* requires that machine-sensible records must contain sufficient transaction-level information to allow the records relating to an individual transaction to be identified and

made available to the state taxing authority on request. It is understood that for certain taxpayers with large volumes of sales transactions, source detail on individual *sales transactions* may not be available for prior years. Summary reports containing transaction-level detail and documentation on the preparation of the reports from individual transactions should, however, be available under the regulation. Moreover, taxpayers indicate that on a prospective basis, testing of the system and examination of source detail for a finite period could be done.[1] It is expected that individual transaction- level detail *on purchase transactions* will be available for examination for use tax purposes.

The subsection also authorizes the taxpayer, in his/her discretion, to discard duplicated or redundant records and information. For example, departmental records stored in departmental data files that are duplicated in a central system could be discarded provided that all required information in the departmental records (including the department identification) is contained in the central system and the requirements of the regulation are met. Similarly, daily or weekly data files could be discarded provided that appropriate monthly, quarterly or annual data files with the ability to access appropriate transaction- level records are available.

*Subsection 4.1.2* further provides that machine-sensible records must be capable of being retrieved from the computer system and converted to a standard record format that will facilitate use of the records during an examination. This requirement is intended to facilitate the use of computer-assisted audit techniques in examining large volumes of transactions. It is expected that the determination of the precise format of the data and the nature of the access to the electronic records will be determined in conjunction with the taxpayer. [See related items in Section 6.]

*Subsection 4.1.3* provides that taxpayers will not be required to create the electronic equivalent of a traditional paper document unless that type of electronic record is created in the normal course of business. For example, taxpayers receiving invoices using electronic data interchange may not create or retain an electronic invoice file. Instead, they may take the data elements, required to be retained pursuant to Section 3.1, from the EDI record and transfer it directly to the accounts payable and other systems without retention of individual invoice data. Under the regulation, the taxpayer could not be required to produce an electronic invoice provided that transaction-level details on the purchase were available. They must, however, be able to provide complete information to determine that the correct tax liability for the transaction was paid.

*Subsection 4.2* outlines the requirements for records received through electronic data interchange. *Subsection 4.2.1* provides that for taxpayers using EDI, the level of detail retained from an EDI transaction, in combination with other records related to the transaction, must be equivalent to that required in paper records. For example, the data elements retained would include information on the vendor, commodity purchased, tax paid, etc. Codes may be used to identify some or all of the data elements in the EDI transaction provided the state taxing authority is provided access to any code lists or other information necessary to interpret the transaction. It also provides that if the requirements of the regulation are met, the taxpayer need not retain the original EDI transaction data.

*Subsection 4.2.2* provides that the information necessary to satisfy subsection 4.2.1 can be captured at any point in the accounting system, [e.g., invoice-related information can be captured in the accounts payable and other systems, rather than being retained separately] provided that the taxpayer can demonstrate the audit trail, authenticity and integrity of the processes through which the EDI transaction is parceled to the various other systems and that the required data is retained. If the taxpayer is capable of meeting these conditions, the original EDI transaction file

need not be retained for examination by the taxing authority.

*Subsection 4.3* establishes that electronic data processing accounting systems employed by taxpayers should incorporate methods and records that will satisfy the requirements of the regulation.

*Subsection 4.4* provides that the taxpayer, at the request of the state taxing authority, is required to provide a description or documentation of the various business processes involved with the creation, retention and maintenance of the records being examined and the internal controls associated with those systems. *Subsection 4.4.1* provides that the documentation is to include a description of the relationship between the records substantiating tax liability and the tax returns filed by the taxpayer as well as the measures used to ensure the integrity of the records. *Subsection 4.4.2* establishes that the taxpayer must be capable of demonstrating the functions and processes being performed and the flow of data through the various systems as well as the internal controls used to assure reliable and authentic records and to prevent unauthorized alteration of the records. *Subsection 4.4.3* establishes specific documentation requirements for retained machine-sensible records, including record formats, field definitions, code definitions and charts of accounts and associated descriptions.

**Section 5. Machine-Sensible Records Maintenance Requirements**

This section provides general guidance on the maintenance of the electronic records which are required to be kept or retained. *Subsection 5.1* recommends that taxpayers refer to standards of the National Archives and Records Administration for guidance on the subject. *Subsection 5.2* further provides that the taxpayer's computer hardware and software shall accommodate the extraction and conversion of retained records. The intent of subsection 5.2 is to establish that even as a taxpayer's computer hardware and software change over time, the taxpayer has an obligation to be able to access retained machine-sensible records and provide them to the state taxing authority in a standard record format at the time of an examination.

**Section 6. Access to Machine-Sensible Records**

*Subsection 6.1* provides that the manner in which a state taxing authority is to be provided access to machine-sensible records as required in subsection 3.2 is to be developed in consultation with the taxpayer and reflect the facts and circumstances of each taxpayer. *Subsection 6.2* outlines a variety of alternatives for providing such access including through use of the taxpayer's computer facilities and personnel, use of a third-party, conversion to a format and medium agreed to by the state taxing authority for processing either on-site or off-site with computer resources of the state taxing authority, or such other means as may be determined by the state and the taxpayer. The premise underlying this section is that decisions regarding access to electronic records should be capable of being mutually reached between the state and the taxpayer. These decisions should reflect the needs and preferences of both parties and facilitate the efficient conduct of an examination. In cases where there is an irreconcilable dispute between the taxpayer and the state taxing authority as to the manner in which access is to be provided, state law will control the outcome.

**Section 7. Taxpayer Responsibility and Discretionary Authority**

*Subsection 7.1* provides that in meeting its obligations under the regulation, a taxpayer may create special files for use by the tax authority. This procedure would be used, for example, if a taxpayer chose to create an extract of the transaction-level details in its records for the state taxing authority to use in a computer-assisted audit, instead of allowing the taxing authority to access the records directly. In such a case, the taxing authority would specify the records and data elements it wished to have extracted. *Subsection 7.2* provides that a taxpayer may use a third party to provide record management services. In such cases, a

taxpayer retains the obligation to meet the requirements of the regulation.

**Section 8. Alternative Storage Medium**

*Subsection 8.1* provides generally that as an alternative to the retention of paper documents and records, taxpayers may convert such records to microfilm, microfiche and other alternative "storage-only imaging systems." By definition (Section 2), a storage-only imaging system is one that is not designed to and does not include the ability to manipulate or process information in the imaged record other than to print a hard copy of such record. If the requirements of section 8 are met, the taxpayer is not required to retain hard-copy documents converted to alternative storage media for tax purposes.

*Subsection 8.2* outlines the specific requirements that such records storage and conversion systems must meet. They include the availability of documentation of the system (§8.2.1), procedures for identifying, processing and storing the imaged documents (§8.2.2), access to facilities for reading, locating and reproducing the stored documents (§8.2.3), standards for readability and legibility of the stored records (§8.2.4), an ability to trace individual documents and records (§8.2.5), and ability to assure the integrity of the records (§8.2.6).

**Section 9. Effect on Hard-copy Recordkeeping Requirements**

This section generally outlines that unless otherwise provided, the regulation does not relieve the taxpayer of retaining hard-copy records received or produced in the normal course of business. *Subsection 9.1* provides that the hard-copy records and documents that have been converted to an alternative storage medium in accord with Section 8 need no longer be retained for tax purposes. *Subsection 9.2* provides that if hard-copy records are not created or produced in the normal course of business, such hard-copy records need not be created. *Subsection 9.3* provides that hard-copy records generated at the time a transaction is entered into using debit cards or credit cards (i.e., sales receipts) must be retained unless all the details necessary to determine correct tax liability regarding the transaction are later received and retained by the taxpayer. The information required would include the vendor, item purchased, tax paid, shipping details, etc. It should not be assumed by taxpayers that the periodic billing statements associated with a credit or debit card will normally provide the required information. *Subsection 9.4* establishes that computer printouts produced for control or validation purposes need not be retained. *Subsection 9.5* allows the state tax authority to require production of hard-copy records in lieu of machine-sensible records during an examination.

**Section 10. Record Retention Periods**

This section provides that required records shall be retained for the period required under state law unless the state taxing authority provides in writing that they are no longer necessary.

# List of Exhibits

**Exhibit A** Notice of Public Hearing regarding The Model Recordkeeping and Retention Regulation.

**Exhibit B** Letter from William Herman, New York State Department of Taxation and Finance, dated December 4, 1996.

**Exhibit C** Letter from Stanley R. Arnold, State of New Hampshire Department of Revenue Administration, dated December 6, 1996.

**Exhibit D** Letter from Daniel T. Piekarczyk, MCI Telecommunications Corporation, dated December 10, 1996.

**Exhibit E** Letter from Michael E. Mares, American Institute of Certified Public Accountants, dated December 10, 1996.

**Exhibit F** Letter from James R. Murray, Tax Executives Institute, Inc., dated January 10, 1997.

**Exhibit G** Revenue Procedure 91-59.

**Exhibit A** Notice of Public Hearing regarding The Model Recordkeeping and Retention Regulation.

*Multistate Tax Commission*

# NOTICE OF PUBLIC HEARING

**regarding**

## THE MODEL RECORDKEEPING AND RETENTION REGULATION

The Multistate Tax Commission will conduct a public hearing regarding the Model Recordkeeping and Retention Regulation for the purpose of receiving comments from the public on whether the MTC should adopt this model regulation as a uniformity recommendation to the States. This hearing session will be held at the following location on the date and at the time specified:

**DECEMBER 10, 1996, 2:30 P.M.**
Hall of the States Building
444 North Capitol Street, N.W., Suite 331
Washington, D.C. 20001-1538

The Model Recordkeeping and Retention Regulation represents the work product of the Task Force on EDI (electronic data interchange) Audit and Legal Issues for Tax Administration, led by the Federation of Tax Administrators (FTA). The joint task force included representatives of the FTA, the Committee on State Taxation (COST), the Institute of Property Taxation (IPT), Tax Executives Institute (TEI) and the Multistate Tax Commission (MTC). The mission of the task force was to provide guidance to taxpayers and to States on addressing issues posed by EDI and other electronic business processes in the administration of State taxes. In partial fulfillment of its mission, the task force developed a model regulation governing particularly the retention of electronically generated and retained records for State tax administrative purposes. The Steering Committee of the task force approved the final version of the Model Recordkeeping and Retention Regulation in November 1995, and subsequently issued a report that included the text of the model regulation and an Explanation and Commentary to the regulation.

Public comment is sought on whether the MTC should adopt as a uniformity recommendation to the States the text of the Model Recordkeeping and Retention Regulation as drafted. Comment also is sought on whether the model regulation should be incorporated into or substituted for the MTC's existing Recordkeeping Regulation for Sales and Use Tax Purposes, MTC Reg.VII., adopted in July 1986. To obtain a copy of the Model Recordkeeping and Retention Regulation or of the MTC's current recordkeeping regulation, please call Ms. Teresa Ruffin at (202) 624-8699. Please submit all other questions, comments or correspondence regarding this hearing matter to:

René Y. Blocker, Hearing Officer
Multistate Tax Commission
444 North Capitol Street, N.W., Suite 425
Washington, D.C. 20001-1538
Phone: 202.624.8699 Fax: 202.624.8819 e-mail: rblocker@mtc.gov

All interested parties are invited to participate in this public hearing. Those who wish to make oral presentations are requested to notify the Hearing Officer in writing at least two (2) working days prior to the hearing date. Interested parties may request the opportunity to participate in the hearing via telephone. Written comments are acceptable and encouraged. Please provide written submissions at any time prior to the hearing date or at such later date as may be announced for the closing of the public hearing period.

**Exhibit B** Letter from William Herman, New York State Department of Taxation and Finance, dated December 4, 1996.

New York State Department of
**Taxation and Finance**
Compliance and Audit Systems Division
Fiscal Systems Management Bureau
Field Audit Support Section
W. A. Harriman Campus, Bldg. 9 Rm. 308, Albany, NY 12227
(518) 457-3403 FAX: (518) 485-1777

December 4, 1996

René Y. Blocker, Hearing Officer
Multistate Tax Commission
444 North Capitol Street, N.W., Suite 425
Washington, D.C. 20001-1538

Dear Ms. Blocker:

New York has reviewed the Model Recordkeeping and Retention Regulation which is being proposed by the Multistate Tax Commission. We have developed a list of concerns enumerated below.

1. Section 4.2.2 states that " the taxpayer need not retain its EDI transaction for tax purposes". We feel that if the original transaction set is destroyed and not available for audit, a critical part of the audit trail has been lost. We would like to have the original transaction set available so that we can authenticate the data and verify where it came from.

2. In a previous draft there was a section on System Evaluation which is no longer included in the final document. If the taxpayer is not required to retain the original EDI transaction, it could be necessary to at least do some form of system testing which would satisfy an auditor with regard to the taxpayer's internal controls. This could prove vital so that an auditor can rely on the electronic records they are auditing.

3. The regulation makes no mention of the consequences associated with not having the electronic records or having incomplete electronic records. This issue will most likely need to be left up to each individual taxing jurisdiction to impose some type of penalty. Having dealt with taxpayers' electronic records on audit for 17 years, New York has a significant amount of experience with this issue. One of the biggest obstacles we encounter over and over again is where a taxpayer has not maintained the electronic data that can be used for audit.

If further clarification is required, please contact Andy Blumbergs or me at (518)457-3403. We appreciate this opportunity to comment.

Sincerely,

William Herman

William Herman
Bureau Director

**Exhibit C** Letter from Stanley R. Arnold, State of New Hampshire Department of Revenue Administration, dated December 6, 1996.

State of New Hampshire
Department of Revenue Administration
51 South Spring Street, P.O. Box 457
Concord, N.H. 03302-0457

Stanley R. Arnold
Commissioner

Barbara T. Reid
Assistant Commissioner



December 6, 1996

René Y. Blocker, Hearing Officer
Multistate Tax Commission
444 North Capitol Street, N.W., Suite 425
Washington, DC 20001-1538

Re: Model Recordkeeping and Retention Regulation

Dear Ms. Blocker:

I strongly urge the MTC to adopt the Model Recordkeeping and Retention Regulation as a uniformity recommendation to the States. I would also recommend that the model regulation be incorporated into or substituted for the MTC"s existing Recordkeeping Regulations. Rule making is a difficult task for any Revenue agency because taxpayers say they dislike rules, but then ask for guidance on every transaction that may have a tax impact on them. The challenge in adopting a regulation is to achieve a balance between providing the taxpayer sufficient information for effective compliance without appearing to be overly intrusive and/or burdensome. This regulation meets that challenge.

It has been my pleasure and honor to chair the EDI Task force since its inception in 1994. The task force had broad representation from FTA, MTC, COST, TEI and IPT. MTC member states provided key technical and professional personnel on the Legal Requirements and Recordkeeping Work Group co-chaired by Majorie Welch, Oklahoma Tax Commission. It was this group that developed the regulation.

The recordkeeping regulation appeared to be one of the easier tasks facing the EDI Audit and Legal Issues Task Force at its formation. After all, we had IRS Rev. Proc. 91-59, suggested revisions to 91-59 developed by the Tax Executives Institute (TEI), and a draft regulation prepared by the California Board of Equalization. Initial hopes of a quick resolution soon became a concern, whether or not agreement could be reached on a model regulation. In general, the business community representatives believed the regulation had unnecessary provisions while the states wanted to ensure they were not inadvertently compromising current law.

A December 1994 working group meeting in Fort Worth, Texas crystallized the challenge facing the task force. After the meeting, everyone took a step back, took a deep breath and recommitted to the idea that a solution could be found, but it was going to take hard work. The process became very similar to the State/Industry Financial Working Group. Education became the key to progress.

Tel. (603) 271-2191
TDD Access: Relay NH 1-800-735-2964

During 1995, task force members educated each other on what "EDI" was and was not. The task force initially tried to keep the focus on "EDI" issues alone. Time was to show us that we didn't really understand what we meant by "EDI." Once the education process was completed, the task force realized that we were making the issue more complicated than it needed to be. The group came to recognize that electronic records may be different than traditional hardcopy records, but the need for taxpayers to be able to demonstrate proper tax compliance remained the same as before.

There are several basic principles embodied in the regulation which were crucial to acceptance by FTA and MTC participants. The key principle is the access by the state to those taxpayer records necessary to verify proper compliance with the state's tax laws. The states were also interested in a second principle; when records are prepared and maintained in machine sensible form, the states have the right to those machine sensible records.

The model regulation also provides the taxpayer with considerable flexibility in meeting its record keeping requirement. For example, taxpayers are not required to prepare electronic records if they are not prepared in the normal course of business. Taxpayers are not required to maintain the original EDI transactions if they can demonstrate the integrity of electronic records and the records have sufficient detail to verify tax liability. Finally, this is a model regulation that allows for modification by the individual states needing to meet peculiar requirements of their state laws, such as retention periods.

This was a tough process and each point - even each word - was scrutinized and debated. Whether or not different words or different provisions could have been used, the results evolved from the group dynamics. The business community and the regulators necessarily approached this issue from different perspectives. What we have is a regulation that both sides are comfortable with.

I again encourage the MTC to recommend this regulation. We should not let this opportunity go by. There was a lot of work and effort put into what is a very good product. It is now very important to "spread the word" and have as many states as possible consider the model for adoption. MTC will play a key role in spreading the word because of its commitment to uniformity. The member states look to the MTC organization for guidance in uniformity matters and this model regulation is a good step in the direction of uniformity.

Sincerely,

Stanley R. Arnold,
Commissioner

**Exhibit D** Letter from Daniel T. Piekarczyk, MCI Telecommunications Corporation, dated December 10, 1996.

MCI Telecommunications
Corporation
1133 19th Street, NW
Washington, DC 20036
202 872 1600



December 10, 1996

Ms. Rene Blocker
Multistate Tax Commission
Suite 425
444 North Capitol Street
Washington, DC 20001

Re: Comments on Model Recordkeeping and Retention Regulation

Dear Ms. Blocker:

MCI Communications Corporation respectfully offers the following comments regarding the proposed "Model Recordkeeping and Retention Regulation". In general, we compliment the MTC on proposing a model recordkeeping regulation for the states. Because maintaining adequate records is a requirement of all state taxing jurisdictions, having uniformity in recordkeeping would be particularly advantageous to both multi-state taxpayers and the states.

While the proposed model regulation is a step in the right direction, there are a number of provisions in the draft that are defective and need to be changed. These particular provisions are overly burdensome to taxpayers and of minimal benefit to state taxing authorities, exceed general statutory authority or involve proposals that will impede the efficient functioning of the audit process. Our suggestions are as follows:

§2.1.1 We recommend adding the following language to the proposed definition to further clarify what a "Database Management System" is NOT.

" . . . It does not include any system, or part of a system, that manipulates or processes data in any manner other than to control, relate, retrieve, or provide accessibility to data stored in the database."

§3.1. This provision requires taxpayers "to maintain all records that are necessary to the determination of the correct tax liability . . ." The problems with this provision are first, the requirement of maintaining ALL records and

second, the necessity of maintaining records required to determine the CORRECT tax liability. The difficulty here is that, a taxpayer's correct tax liability is often open to dispute. Tax law generally and state tax rules in particular have many gray areas. Therefore, requiring retention of all records necessary to determine what is the correct tax liability can mean a firm must keep every record generated because it may have some impact on calculating the "correct" tax liability.

This is overly broad and inefficient. In an era when the focus is to foster tax systems that are administratively efficient and effective in operations, this type of approach is a step backwards. Rather, we suggest that the state include a materiality element to the standard. This would ensure that only the important records be retained and not every conceivable document. This is the approach taken at the Federal level and it generally works well. (See Rev. Proc. 91-59, 1991-2 C.B. 841.)

As such, we recommend changing the language to read as follows.

"A taxpayer shall maintain such records as are material to the administration of [applicable state tax statutes]."

§4.1.2. This provision requires records to be convertible to some sort of standard record format. This is a terrible idea. Any justification for requiring that all electronic records be converted into an undefined standard record format is far outweighed by the cost of such a proposal. The pace of technological change in the electronic storage area is nothing less than breathless. Requiring some sort of standard record format may in fact retard technological innovation and simplification in the maintenance of records. In other words, it may result in audits being more difficult to conduct rather than less difficult.

Moreover, we question the basis for imposing such a requirement on taxpayers. We are aware of no general provision of law that otherwise directs taxpayers to reformat their records for the convenience of the taxing jurisdiction. As there is no such rule at the Federal level, we do not understand the need for such an onerous requirement at the state level.

Therefore, we recommend the language of this provision be changed as follows.

"At the time of an examination, the retained records must be capable of being retrieved on request."

§4.1.3. We are not sure what is meant by the term "construct". However, in general terms, we do not believe it is the taxpayer's responsibility to "construct" any records. Unless otherwise agreed to between the taxpayer and the state taxing authority, the taxpayer's responsibility is limited to making available for review and examination, required records created in the ordinary course of business. Expanding this duty goes beyond anything currently required by the Internal Revenue Code or the states generally. The taxpayer's responsibility to provide records ends at the time the records are made available to the taxing jurisdiction for its review.

Therefore, we recommend the language of this provision be changed as follows.

"A taxpayer who does not create the electronic equivalent of a traditional paper document in the ordinary course of business is not required to create such a record for tax purposes."

§4.2.1. While this provision nominally describes EDI requirements, it suffers from being overly broad and unnecessarily intrusive. Specifically, we suggest in the first sentence that the words "processes and" before the word technology be deleted. The term defined is either "Electronic data interchange" or "EDI technology". There is no definition for electronic data interchange processes. In addition, we suggest in the second sentence that the word description as it relates to the products purchases be deleted. Retaining the product name should be sufficient information for taxing jurisdiction personnel to accomplish their work. Maintaining other information including a full product description is burdensome and unnecessary. Also in this same sentence, we further request that the words "indication of tax status" be deleted. There is no mention of why this information needs to be retained or what benefit accrues to the state from developing such information.

§4.2.2. Consistent with our comments to §4.2.1, we recommend that in the fourth sentence the word "description" be deleted.

§4.4.1. This provision requires taxpayers to provide a description of the business process that created records required to be retained. This inquiry is unnecessarily intrusive and without substantive justification. It smacks of a fishing expedition into the taxpayer's business operations. The important inquiry for the state is not in obtaining a dissertation on how each facet of the business works. Rather, the state's focus should be on the measures employed to ensure the accuracy and integrity of the records. Garnering additional information is unnecessary and inefficient. It wastes the time of both the taxpayer and the taxing jurisdiction's personnel.

Therefore, we recommend the language of this provision be changed as follows.

"Upon request of the [state taxing authority] the taxpayer shall describe the measures employed to ensure the accuracy, reliability and integrity of the records."

§4.4.2. Our comments for this provision echo those made to section 4.4.1. The issue for the states is not the functions being performed vis-à-vis the flow of data. Rather, it is the measures used to safeguard the integrity of the data.

Therefore, we recommend the language of this provision be deleted.

§4.4.3(d). We recommend deleting the word "detailed". The term adds nothing of substance to the subsection and, in fact, because "detailed" is not defined, adds an element of confusion to the requirement.

§5.1.2. Consistent with our comments to section 4.1.2, we recommend deletion of the requirement that equipment and software be capable of accommodating the conversion of machine sensible records to any standard record format.

§6.1. The regulation should specify that the manner of access provided to the records shall be at the discretion of the taxpayer in consultation with the state rather than the opposite. This change is necessary because this process will require, at a minimum, the taxpayer making available access to its electronic storage systems. At a maximum, the taxpayer may have to devote significant personnel, hardware and other related assistance to permit the

state to complete its audit. In order to ensure that this occurs in the most expeditious and efficient manner possible, it is only reasonable that the taxpayer be in a position to determine how this information is made available. As long as the state has access to the information, they have what they need to do their audit. Taxpayers should not be required to stop their business to generate audit information merely to meet the convenience to the state taxing authority.

Therefore, we recommend the language of this provision be changed as follows.

" . . . access to machine sensible records as required in subsection 3.2 of this regulation may be satisfied through a variety of means at the discretion of the taxpayer in consultation with the state taxing authority."

As a result of the suggested changes to §6.1, §6.2 is superfluous and should be deleted.

§8.2.1. The second sentence in this subsection is both confusing and unnecessary. It adds nothing to an understanding of the documentation requirement contained in the first sentence of the subsection. Accordingly, we recommend deleting the second sentence.

§8.2.3. Although this provision is similar to Reg. VII.1.(2)c of the Recordkeeping Reg. for Sales and Use Tax Purposes, taxpayers should only be REQUIRED to provide the facilities and equipment for reading the documents on microfilm, etc. The taxpayer should not be REQUIRED to provide the facilities and equipment for reproducing the documents. This is a responsibility of the state taxing authority. It is unreasonable to burden taxpayers with a job that belongs to the state taxing authority. Moreover, this may be a particular burden to smaller taxpayers that do not have substantial monetary and physical resources.

§8.2.4. It is too burdensome that the taxpayer be required to display or reproduce documents that display a "high degree" of legibility or that the observer be able to positively identify the number or letter "quickly." The fact of the matter is that often original documentation received by taxpayers may not be of a high degree of legibility. Moreover, record retention statutes do not speak in terms of high degree of legibility or quick identification of

information. Rather, the taxpayer's duty is to merely substantiate the applicable transactions. With this as the backdrop, the proposed statute unreasonably imposes requirements that the existing statutes do not contain.

Therefore, we recommend the language of this provision be changed as follows.

"When displayed on such equipment or reproduced on paper, the documents should be legible and readable. For this purpose, legible is defined as the quality of a letter or numeral that enables the observer to identify it positively to the exclusion of other letters or numerals. Readable is defined as the quality of the . . . "

§9.3. Consistent with our comments for §3.1, we suggest the following language.

"Hard-copy records generated at the time of a transaction using a credit or debit card must be retained unless the details material to the administration of [applicable state tax statutes] that relate to the transaction are subsequently received and retained by the taxpayer."

Thank you for the opportunity to provide these comments. If you have any other questions or comments, please let me know.

Sincerely,

Daniel T. Piekarczyk
Senior Attorney
MCI Communications Corporation

**Exhibit E** Letter from Michael E. Mares, American Institute of Certified Public Accountants, dated December 10, 1996.

AICPA

December 10, 1996

Ms. René Y. Blocker
Hearing Officer
Multistate Tax Commission
444 North Capitol Street, N.W.
Suite 425
Washington, D.C. 20001-1538

Re: *Model Recordkeeping and Retention Regulation*

Dear Ms. Blocker:

Enclosed are the comments of the American Institute of Certified Public Accountants (AICPA) on the Multistate Tax Commission's proposed *Model Recordkeeping and Retention Regulation*. These comments were developed by members of the State and Local Taxation Committee and approved by the Tax Executive Committee.

As our October 30, 1996 letter indicated, Carol Calkins is planning to testify on our behalf at the hearing on this project scheduled for today, December 10, at 2:30 p.m.

We welcome the opportunity to discuss these comments with the MTC staff informally or at the hearing scheduled for December 10, 1996. Please contact one of the following individuals if you would like to discuss the comments or the proposed regulation: Carol M. Calkins at (214) 754-7955; Debbie Manos-McHenry, Chair of the State and Local Taxation Committee at (216) 689-7836; or Eileen Sherr, AICPA Technical Manager at (202) 434-9256.

Sincerely,

Michael E. Mares
Chair
Tax Executive Committee

Enclosure

cc: Dan Bucks, Executive Director of the MTC

American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW, Washington, DC 20004-1081 (202) 737-6600 • fax (202) 638-4512

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# Comments Regarding Multistate Tax Commission Proposed Model Recordkeeping and Retention Regulation

Prepared By:


State & Local Taxation Committee - Model Recordkeeping Working Group

Carol M. Calkins, Model Recordkeeping Working Group, Chair
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Approved By:

State and Local Taxation Committee

and

Tax Executive Committee

Submitted to the Multistate Tax Commission

December 10, 1996


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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Comments Regarding Multistate Tax Commission
Proposed Model Recordkeeping and Retention Regulation

December 10, 1996

## GENERAL COMMENTS

In March 1996, the Task Force on EDI Audit and Legal Issues for Tax Administration (consisting of representatives from the Committee On State Taxation, Federation of Tax Administrators, Institute of Property Taxation, Multistate Tax Commission, and Tax Executives Institute) (the "Task Force") released a model state administrative regulation governing taxpayer retention of books and records, particularly electronically generated and retained books and records, for tax administration purposes. The proposed model regulation is designed as a starting point when defining the record retention and maintenance requirements imposed under State statutes in order to facilitate an efficient and effective tax administration process. As these comments make clear, it appears that the Task Force has largely accomplished its mission. While we note the need for certain transitional rules and States' investment in the requisite information technologies, we strongly recommend that the Multistate Tax Commission ("MTC") adopt the text of the Model Recordkeeping and Retention Regulation as drafted with our minor clarifications as a uniformity recommendation to the States. We also recommend that the MTC substitute the model regulation for its existing Recordkeeping Regulation for Sales and Use Tax Purposes, MTC Reg. VII., adopted in July 1986 (the "Former Regulation").

## SPECIFIC COMMENTS

**In General.** The model regulation appears to fairly balance the competing interests of taxpayers and tax administrators, while emphasizing the need for efficient and effective tax administration systems. It also recognizes the responsibility placed on taxpayers to maintain adequate books and records supporting the taxable status of transactions, while providing flexibility in the means necessary to achieve that objective.

**Section 3.1.** Section 3.1 provides that "[a] taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under [the appropriate state statute]." The basic requirement for retaining all records *necessary* to the correct determination of tax liability is substantially similar to the Former Regulations retention requirement. More importantly, the model regulation continues the State specific limitation found in the Former Regulation. We believe a State specific limitation is necessary to restrict the right of a State to request records not related to State specific transactions. Without this restriction, a State could substantially increase the administrative burden placed on a taxpayer by requiring records unrelated to transactions occurring within its borders.

Section 3.1 also provides that "[a]ll required records must be made available on request by the [state taxing authority] . . ." Many States now impose time limitations on the submission of requested documents. In Illinois, for example, taxpayers may be given 60 days in which to submit requested documents under penalty of later losing the right to introduce such documents into evidence. We believe it would be helpful if the model regulation formally recognized the relationship between the evolving nature of EDI and present technical difficulties associated with submission of required records. Therefore, it would be beneficial if the model regulation included a transition rule encouraging States to allow taxpayers a period of time in which to bring their electronic systems into compliance without the risk of substantial penalty.

Section 4.1. The general requirements related to the retention of "machine-sensible" records is described in section 4.1. In section 4.1.1, "[m]achine-sensible records used to establish tax compliance," are required to "contain sufficient transaction-level detail information so that the details underlying the machine-sensible records can be identified and made available to the [state taxing authority] upon request." The types of "transaction-level detail information" contemplated by the provision are illustrated in section 4.2.1, which provides that, "the retained records should contain such information as vendor name, invoice date, product description, quantity purchased, price, amount of tax, indication of tax status, shipping detail, etc."

Under the Former Regulation, records were required to show (1) gross receipts, (2) all allowable deductions, and (3) the total purchase price. In addition, such records included the normal books of account ordinarily maintained by the average prudent businessman engaged in such business, together with all bills, receipts, invoices, etc. We understand that section 4.1.1 of the model regulation, as amplified by section 4.2.1, does not modify the former standard. In other words, the fact that electronic data interchange may allow for the retention of greater information than traditional methods, does not appear to increase the scope of information presently required to be retained. Therefore, the "transaction-level detail information" may include information such as that set out in section 4.2.1, but need not include all such information. To be sure, the transaction-level detail information required under the model regulation remains consistent with the Former Regulation.

Section 4.1.2. Section 3.3 provides that taxpayers are not relieved of the obligation to make records available in a "machine-sensible" format merely because traditional hard-copy documents or reproductions thereof are available. One of the requirements for machine-sensible records is that, "[a]t the time of an examination, the retained records must be capable of being retrieved and converted to a standard record format."

With rapid changes in information technology, taxpayers may not have a practical means of converting electronic records to a "standard" format, particularly when each State is apparently free to adopt the electronic standard of its choice. As a result, we believe it is a wise decision to continue the Former Regulations allowance of alternative recordkeeping methods. Section 6.2.4 provides that "[t]he taxpayer and the [state taxing authority] may agree on other means of providing access to the machine-sensible records."

However, it is our hope that section 6.2.4 and similar provisions (e.g., section 9.5) will not serve as an impediment to the adoption of new information technologies by the States. As drafted, the model regulation clearly recognizes the emerging importance of electronic data interchange and similar electronic transfer and communication methods. Pressure should be placed on the States, however, to ensure that they invest in the requisite technologies because failure to do so could hamper the creation of an efficient and effective tax administration process.

## CONCLUSION

We commend the efforts of the Task Force for recognizing the inherent complexities associated with electronic data interchange and recordkeeping, and for providing a foundation around which future tax compliance can be based. While we note the need for certain transitional rules and States' investment in the requisite information technologies, we strongly recommend adoption of the model regulation. We also strongly recommend that the MTC substitute the model regulation for the Former Regulation.

Lastly, we encourage the Task Force to continue meeting on a regular basis to respond to the emerging challenges created by changes in information technology. The cooperation shown by the Task Force is itself a model that should be used as a basis for resolving the myriad challenges facing both States and businesses as we approach the 21st Century.

# memo

- ADDENDUM -

**Date:** 11/17/96

**To:** Carol Calkins via Eileen Sherr

**From:** Tom Herbert, State and Local Taxation Committee

**RE:** Model Recordkeeping and Retention Regulation

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## Introduction

I've read the Model Recordkeeping and Retention Regulations, introduction, explanation and commentary with much interest. Although these proposed regulations are well thought through and appear to be the result of much work on the part of the Steering Committee, I feel that these regulations as presently written will create a substantial burden on America's small businesses.

These regulations cover not only companies that are using EDI technology but also apply to any company that is using any type of computerized accounting system. These days this includes just about all businesses from the largest to the smallest businesses that may be using a basic system such as Intuit's *Quickbooks*. As presently written, these regulations would apply to all of these businesses equally regardless of size. The smallest computerized business would be required to maintain the same formats of records as the largest.

In the introduction under the Basic Framework section is discussed the need to have the regulations cover EDI transactions and also all records generated by a computerized system because they are so intertwined. I agree with this where a company is using EDI technology. However, the regulations also apply to all companies using computerized accounting even if they are not using EDI technology. This creates a substantial burden on small business and those CPAs that provide services to these small clients.

In the Specific Elements section of the introduction is discussed the requirement that the taxpayer must provide machine readable records if requested by the taxing authority even though all of the records are available in traditional paper documents. In addition, the taxpayer is required to have the capabilities to convert their machine- sensible records to a "standard" record format for use by the taxing authority. These two requirements are at the heart of the problem for small business.

## Specific Regulation Section Comments

Section 3.2 of the regulations requires a company that has records in both machine-sensible and hard copy formats to provide machine-sensible records, if requested by the taxing authority. Most small businesses that use a computerized accounting system print out hard copy of all books and records and work only from these records. In essence, the computer simply automates the transactions and postings but the hard copies are what are used for all purposes. Machine-sensible records are maintained in computer storage or backups but are never used unless printed out. As discussed in the commentary, I understand that for large companies the taxing authorities would like to be able to

efficiently use machine-sensible data for audit purposes. However, to allow a taxing authority to require this in all cases, even the small ones, would be an unnecessary burden on a small business.

Section 3.3 reinforces the requirements of Section 3.2 for the taxpayer to provide machine-sensible records, if they are available, when requested by the taxing authority even if compliance can be shown through hard copy records.

Section 4.1.2 requires retained records to be converted to a standard record format. Once again this should not be a problem for a large company but is a severe problem for a small business. The term "standard record format" is not defined in the regulations. Different taxing authorities could use different "standard record formats" further compounding the problems for a small business.

Section 5.2 requires a taxpayer's computer hardware & software to be able to "convert" machine-sensible records. Many computer accounting packages used by small businesses are quite capable of maintaining accurate accounting records but do not contain programs to convert records to other formats.

Section 6.2.1 requires the taxpayer to provide hardware, software and personnel to access machine-sensible records. Here again the small business that has both hard copy and machine-sensible record formats may be required during an examination to provide substantial resources that it cannot afford even if it has adequate hard copy records for examination.

Section 9.5 allows a taxing authority to request hard copy printouts even when machine-sensible records are available. I guess this section and section 3.2 is the best of both worlds. If the taxpayer has hard copy records the taxing authority can request machine-sensible. If the taxpayer has machine-sensible records the taxing authority can request hard copy records. It all seems to be up to the taxing authority with little or no recourse for the taxpayer.

**Recommendations**

Most of the above problems could be corrected by limiting the applicability of these regulations to only those companies that utilize EDI technology. Those companies that are large enough to benefit from the efficiencies and conquer the complexities of EDI technology should be able to adequately comply with these regulations. Smaller businesses that use computer accounting systems to help generate hard copy records but are not currently capable of using EDI technology should not be required to devote the substantial additional resources to comply with these regulations at such a small potential benefit to the taxing authorities.

If limiting the regulation to companies using EDI technology is not feasible , consideration should be given to including a de minimus factor, such as exempting all businesses with less than $5 or $10 million of annual sales.

Section 6 of the explanation and commentary seems to allow some flexibility for the taxpayer and taxing authority to negotiate those records that will be necessary to properly conduct the examination. If possible this type of flexibility should be included in the regulations itself. Unfortunately, if these regulations are adopted by a taxing authority, the accompanying explanation and commentary may not follow along with the regulations. Some type of flexibility is necessary in the regulations since many taxing authorities take a firm line in dealing with what appears in regulations. Without this flexibility, an examination could get hung up in details of the format of the recordkeeping rather than the substantive issues of the exam.

Thank you for the opportunity to comment on these proposed regulations. If you have any questions or would like additional clarification on any point please feel free to give me a call.

**Exhibit F** Letter from James R. Murray, Tax Executives Institute, Inc., dated January 10, 1997.

# Tax Executives Institute, Inc.

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January 10, 1997

Ms. René Y. Blocker
Hearing Officer
Multistate Tax Commission
444 North Capitol St., Suite 425
Washington, D.C. 20001-1538

*Re: Model Recordkeeping and Retention Regulation*

Dear Ms. Blocker:

Tax Executives Institute (TEI) is pleased to provide support for its members who have participated in the Federation of Tax Administrator's Task Force on Electronic Data Interchange (EDI) Audit and Legal Issues (hereinafter the "Task Force"). The Task Force's working groups and steering committees, consisting of business tax professionals and state tax administrators, have been seeking common ground and approaches to adapt existing state tax rules to emerging issues, particularly in the application of electronic data interchange to business transactions. Among the Task Force's first accomplishments is the Model Recordkeeping and Retention Regulation, which was the subject of the December 10, 1996, hearing by the Multistate Tax Commission. Tax Executives Institute is pleased to provide the following comments concerning the Regulation.

## *Background*

Tax Executives Institute is a professional association of nearly 5,000 accountants, lawyers, and other tax executives who are responsible for managing the tax affairs of their companies. TEI members must contend daily with the interpretation, application, and enforcement of business tax laws. We represent a cross-section of the business community across North America and are dedicated to the development and effective implementation of sound tax policy. We are similarly committed to the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and

government alike. TEI believes that the diversity, training, and experience of its members enable it to bring a unique and balanced perspective to the policy and administrative issues raised by the Model Recordkeeping and Retention Regulation.

***General***

In March 1996, the Steering Committee of the Task Force on EDI Audit and Legal Issues (consisting of representatives from the Committee on State Taxation, Federation of Tax Administrators, Institute of Property Taxation, Multistate Tax Commission, and Tax Executives Institute), released a two-part report: Appendix A sets forth a model state regulation to govern the retention of taxpayer records, particularly those generated or retained electronically; Appendix B contains an explanation and commentary on the regulation. Because EDI records are so intertwined with other information systems and cannot be addressed in isolation from general recordkeeping requirements, the scope of the Regulation is broader than EDI transaction records. As a result, adoption of the Regulation will permit state tax administrators and the Multistate Tax Commission (MTC) to update state recordkeeping regulations to address electronic recordkeeping requirements generally while providing taxpayers with guidance on evolving technologies affecting business transactions and recordkeeping.

In general, the Regulation attempts to balance the divergent and competing needs of taxpayers and state tax administrators. Under the Regulation, the responsibility for maintaining books and records to support reported tax liabilities is placed on taxpayers, affording them flexibility to manage the manner in which the records are created or retained. In some areas, the Regulation manifests the desire of state administrators to maintain access to "all" records — whether paper ("hard-copy" in the parlance of the Regulation) or machine-sensible — relevant to verifying taxpayers' reported transactions and tax liabilities. In other areas, the Regulation reflects the desire to avoid imposing new or unnecessary burdens on taxpayers.

In many cases, the working groups and Steering Committee of the Task Force agreed readily on the objective of certain provisions (*e.g.*, fair and cost-efficient examinations of the taxpayer's records) but reached an impasse on the language to achieve conflicting goals. In such cases, differing views were reconciled by deleting proposed provisions, inserting illustrative examples in the Regulation, adding counterbalancing provisions elsewhere in the Regulation, or inserting explanations in the commentary. As a result, the Model Regulation and commentary should be viewed, and judged, as an entire package. Appendix B of the Task Force report, which sets forth explanations for some of the Task Force's deliberations — including important compromises, concessions, and agreements on how the diverse needs and concerns of state tax administrators and taxpayers were to be reconciled — is an integral part of the report and the Regulation. Hence, we are concerned that the MTC is seemingly only considering the adoption of Appendix A (or modifications to Appendix A) without considering the context provided by Appendix B of the

Steering Committee's Report. We recommend that the MTC adopt the Regulation and the commentary as an entire package.

On the whole, TEI supports the MTC's objective of providing a Model Recordkeeping Regulation, which if adopted by a substantial majority of the States, will advance a longstanding goal of the Institute — administrative and procedural uniformity among the States. Hence, TEI recommends that the MTC substitute the Model Regulation for its existing Recordkeeping Regulation. Adoption of the Model Regulation by the MTC will provide an important imprimatur and will likely increase the number of States that adopt the Regulation. Notwithstanding our support for the MTC's adoption of the Regulation, we have several comments and recommendations that we believe will improve the Regulation.

*Specific Comments*

1. The MTC should consider rephrasing the requirement contained in section 3.1 that "a taxpayer shall maintain 'all' records that are 'necessary' to the determination of the 'correct' tax liability under . . . " as "a taxpayer shall maintain books and records sufficient to establish its tax liability under . . ." The determination of the "correct" liability is a complex process involving the interpretation of numerous provisions of law, an understanding of the facts of a transaction, as well as many computations on the return as filed by the taxpayer, carryovers from different tax years, adjustments proposed by the State or amended returns filed by the taxpayer, appeals of proposed adjustments, and, ultimately, either litigation or a settlement that represents a compromise view of the "correct" tax liability. At any point in the process, the taxpayer and the State may well have different, though good faith, views of the "correct" amount of tax liability. Hence, at a minimum, we recommend deleting the word "correct" from section 3.1.

As important, the requirement in section 3.1 to maintain "all" records "necessary" is overbroad. Indeed, a state auditor may misinterpret the requirement to keep "all" records "necessary" as a requirement to keep "any" or "every" record. A broad requirement to keep "all" records — untethered by a relevance standard or untempered by a recognition of the burden imposed on taxpayers by recordkeeping rules generally — would undermine provisions of the Model Regulation that afford taxpayers discretion to manage their records and fulfill their recordkeeping obligations in the most prudent and efficient manner. (*See, e.g.*, section 4.1.1, second sentence, providing in respect of machine-sensible records that "a taxpayer has discretion to discard duplicated records and redundant information provided its responsibilities under the Regulation are met.). Hence, we recommend that the MTC consider either deleting the word "all" from section 3.1 or adding the word "material" immediately after the word "all."

Finally, the amount of documentary evidence "necessary" to support a taxpayer's reported tax liability should be based, as has traditionally been the case, on a civil law standard of a preponderance of evidence. TEI's recommended language incorporates the preponderance of

evidence standard by stating that taxpayers are required to provide "sufficient" evidence (*i.e.*, there is "enough" evidence) to support their reported tax liability without imposing a higher evidentiary standard that taxpayers must also disprove that the correct tax liability is higher (or lower) than reported. The recommended change will not undermine the taxpayer's fundamental obligation to provide records to substantiate and verify its reported tax liability.

2. Section 4.1.2 requires a taxpayer to convert *all* machine-sensible records to a "standard record" format without defining what that standard record format is or should be. We believe the provision was conceived originally to permit the retrieval of "standard record formats" in EDI transactions where the trading partners generally must follow standards prescribed by the American National Standards Institute (ANSI) for EDI transactions. As the scope of the Regulation expanded to address *all* recordkeeping requirements, however, the provision was retained on the justification that States should be permitted to invest in, or use, currently available software packages in their examination of taxpayers.[1]

The Model Regulation was developed because of a perception among taxpayers and state tax administrators that current state recordkeeping regulations should be updated to address EDI specifically and electronic recordkeeping requirements generally. Current state recordkeeping regulations have either become dated by the shift to electronic recordkeeping or, in some cases, may have inhibited adoption of new forms of doing business or maintaining records based on evolving electronic technologies, such as EDI or document imaging. While the Model Regulation addresses the current need for updated rules, the Regulation may itself be rendered passé by subsequent technological advances. More important, we believe the States should foster, rather than inhibit, technological advances that will make both business and government recordkeeping practices more efficient. Hence, we believe section 4.1.2 in the Model Regulation should be modified.

For example, outside of EDI transactions, a "standard record" format for *machine-sensible* records may not exist. Record formats vary from industry-to-industry, taxpayer-by-taxpayer, and State-by-State. Moreover, what is standard in 1997, may well be obsolete as early as the year 2000, especially as companies and governments begin to address the computer code and data-field limitations built into many current computer programs. As a result, we believe the requirement to convert machine-sensible records to a "standard record format" should be limited to EDI transactions governed by ANSI standards. Otherwise, the Regulation will likely stifle innovation and efficiency by imposing stasis on recordkeeping methodologies.

Thus, we recommend that section 4.1.2 be revised as follows: "At the time of an examination, the retained machine-sensible records must be capable of being retrieved. In addition, EDI transactions must be capable of being converted to a standard record format." Our

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[1] The unstated assumption of the Regulation may be that all computer records are currently capable of being converted to a universal standard such as ASCII text files.

recommended revision will mesh with section 6.2.3 which permits, *but does not require*, non-EDI machine-sensible records to be converted to a "standard record format" prescribed by the state taxing authority.

3. The Model Regulation is designed to preserve maximum access to all maintained records, whether machine-sensible or paper ("hard-copy documents" in the Regulation). Should the States desire to audit machine-sensible records, they may (*see* section 3.2); should they wish to audit paper records instead, they may, (*see, e.g.*, section 9.5). In addition, the taxpayer is permitted to demonstrate tax compliance through either traditional paper or machine-sensible records (*see* section 3.3).

Throughout the deliberations of the Task Force, the need for the States to conduct efficient audits of both paper and machine-sensible records was paramount. Taxpayer and state representatives agreed that efficient auditing practices require the taxpayer and the auditor to agree to determine at the outset of the audit which records — whether paper or machine-sensible — are most relevant and accessible. Hence, except for EDI transactions where no paper record may exist, the Regulation is not intended to create a preference or priority of one form of record (or one form of audit) over the other. Thus, notwithstanding the language in section 3.2 that the taxpayer "shall" make machine-sensible records available at the request of the State, the selection of the proper records for audit properly remains a subject of discussion between the taxpayer and the state auditor. We believe that the report of the audit workgroup of the FTA's Task Force will ultimately support this interpretation.

Nonetheless, in order to improve the balance between taxpayers and the States concerning the selection of paper or machine-sensible records for audit, we recommend that the MTC retitle section 6 "Access to Records," add the words "hard-copy or" immediately before the phrase "machine-sensible" in section 6.1, and change the cross-reference to subsection 3.2 contained in subsection 6.1 to cross-reference "subsections 3.1 or 3.2."[2] In addition, we recommend adding as the first sentence of section 6.2 the following: "In order to minimize disruption of the taxpayer's normal business processing and minimize its costs of retrieval, reproduction, or conversion, [*the state taxing authority*] will afford discretion to taxpayers concerning the manner in which the taxpayer provides access to machine-sensible records." The balance of section 6.2 (including the current introductory sentence) may remain as examples of the manner in which the taxpayer provides access to machine-sensible records. TEI's proposed revision does not mitigate or undermine the

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[2] The Regulation supplies copious examples of the manner of access to machine-sensible records, but says nothing of the manner in which hard-copy records must be supplied. Presumably hard-copy records must be legible and readable. The omission of any reference to the manner of providing access to hard-copy records is an implicit recognition by the EDI Task Force that, though the audit process is adversarial and at times contentious, it generally works.

taxpayer's obligation under section 3.2 to provide records in machine-sensible format where requested by the state taxing authority.

***Conclusion***

TEI is pleased to provide the foregoing comments in respect of the MTC's Model Recordkeeping and Retention Regulation. TEI's comments were prepared under the aegis of its State and Local Tax Committee, whose chair is Christopher W. Baldwin of Gannett Co., Inc. Should you have any questions concerning TEI's comments, you may contact either Mr. Baldwin at (703) 284-6801, or Jeffery P. Rasmussen of TEI's legal staff at (202) 638-5601.

Very truly yours,

James R. Murray
International President

cc: Stanley Arnold, Chair of the EDI Task Force
of the Federation of Tax Administrators
Harley T. Duncan, Federation of Tax Administrators

**Exhibit G** Revenue Procedure 91-59.

*26 CFR 601.105: Examination of returns and claims for refund, credits or abatement; determination of correct tax liability.*

Rev. Proc. 91-59

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to update Rev. Proc. 86-19, 1986-1 C.B. 558, and to specify the basic requirements that the Internal Revenue Service considers to be essential in cases where a taxpayer's records are maintained within an Automatic Data Processing (ADP) system. Rev. Proc. 86-19 provides guidelines for record requirements to be followed in cases where all or part of the accounting records are maintained within an ADP system. References to ADP systems include all accounting and/or financial systems and subsystems that process all or part of a taxpayer's transactions, records, or data by other than manual methods.

.02 The technology of ADP has evolved rapidly, and new methods and techniques are constantly being devised and adopted. The requirements set forth in Section 5 of this revenue procedure are intended to ensure that all machine-sensible records generated by a taxpayer's ADP system are retained so long as they may be or may become material in the administration of any internal revenue law. These requirements will be modified and amended as needed to keep pace with developments in ADP systems.

SEC. 2. BACKGROUND

.01 Section 6001 of the Internal Revenue Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep the records that the Secretary may from time to time prescribe.

.02 Rev. Rul. 71-20, 1971-1 C.B. 392, establishes that all machine-sensible data media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's ADP system are records within the meaning of section 6001 of the Code and section 1.6001-1 of the Income Tax Regulations, and are required to be retained so long as the contents may be material in the administration of any internal revenue law.

SEC. 3. SCOPE

.01 This revenue procedure encompasses all types of data processing systems including, but not limited to, microcomputer systems, Data Base Management Systems (DBMS), and all systems using Electronic Data Interchange (EDI) technology. For purposes of this revenue procedure: DBMS means a software system that creates, controls, retrieves, and provides accessibility to data stored in a data base; and EDI technology means the computer-to-computer

exchange of business information.

.02 The utilization of a service bureau, time-sharing service, or value-added network does not relieve the taxpayer of the responsibilities described in this revenue procedure.

.03 A taxpayer with assets of $10 million or more at the end of its taxable year shall comply with the record retention requirements of Rev. Rul. 71-20 and the provisions of this revenue procedure. For purposes of this revenue procedure, a controlled group of corporations, as defined in section 1563 of the Code, will be considered to be one corporation and all assets of all members of the group will be aggregated.

.04 A taxpayer that has assets of less than $10 million shall comply with the record retention requirements of Rev. Rul. 71-20 and the provisions of this revenue procedure if any of the following conditions exist:

(1) information required by section 6001 of the Code is not in the hardcopy books and records, but is available in machine-sensible records;

(2) machine-sensible records were used for computations that cannot be reasonably verified or recomputed without using a computer (e.g., Last-In, First-Out (LIFO) inventories); or

(3) the taxpayer is notified by the District Director that machine-sensible records must be retained to meet the requirements of section 6001 of the Code.

.05 The requirements of this revenue procedure pertain to all matters under the jurisdiction of the Commissioner of Internal Revenue including, but not limited to, income, excise, employment, and estate and gift taxes, as well as employee plans and exempt organizations.

.06 The requirements of this revenue procedure are applicable to the machine-sensible records generated by a Controlled Foreign Corporation (CFC), a domestic corporation that is 25 percent foreign-owned, and foreign corporations engaged in a trade or business within the United States at any time during a taxable year because the definition of "records" in sections 964(c), 982(d), 6038A, and 6038C of the Code and the regulations thereunder has the same meaning as "records" as used in section 6001 of the Code and section 1.6001-1(a) of the regulations.

.07 Machine-sensible records used by an insurance company to determine losses incurred under section 832(h)(5) of the Code shall be retained in accordance with the requirements of this revenue procedure and Rev. Proc. 75-56, 1975-2 C.B. 596. For this purpose, the machine-sensible files for a particular taxable

year include the files for that year and the seven preceding years, all of which shall be retained so long as they are material to the examination of the federal tax return. See, section 5.06 for a discussion of materiality.

.08 The requirements of this revenue procedure are applicable to any sections of the Code that have unique or specific recordkeeping requirements. For example, machine-sensible records maintained by the taxpayer to meet the requirements of section 274(d) relating to the amount, time, and place of a business expense must meet the requirements of this revenue procedure.

SEC. 4. DISTRICT DIRECTOR AUTHORITY

.01 In the case of a taxpayer that has less than $10 million in assets at the end of its taxable year, the District Director may notify a taxpayer that machine-sensible records must be retained to meet the requirements of section 6001 of the Code, and that Rev. Rul. 71-20 and the provisions of this revenue procedure apply to that taxpayer. Subsequent failure to comply with this notification may result in the imposition of the penalties described in section 7.

.02 The District Director has the authority to enter into or revoke a record retention limitation agreement with the taxpayer to modify or waive all or any of the specific requirements in this revenue procedure. The taxpayer remains subject to all requirements of this revenue procedure that are not specifically modified or waived by a record retention limitation agreement. A taxpayer that has questions regarding the application of this revenue procedure to a specific factual situation should contact the appropriate District Director.

(1) A record retention limitation agreement does not apply to a subsidiary company acquired, or accounting and tax systems added, subsequent to the completion of the record evaluation (see section 3.03 below) upon which the agreement is based. All machine-sensible records produced by a subsequently acquired company or a subsequently added accounting and tax system whose contents may be or may become material in the administration of the Code shall be retained by the taxpayer who signed the agreement until a new evaluation is conducted by the District Director.

(2) Upon the disposition of a subsidiary, the files being retained for the Service by, or for, the disposed subsidiary shall be retained by the taxpayer until a new evaluation can be made by the District Director.

.03 To determine if a taxpayer may limit its retention of machine-sensible records, a record evaluation may be conducted by the District Director. This evaluation of the data processing and accounting systems may be initiated by the District Director or requested by the taxpayer, and is not an "examination,"

"investigation," or "inspection" of the books and records within the meaning of section 7605(b) of the Code because the evaluation is not directly related to the determination of tax liability for a particular taxable period.

.04 The District Director may periodically initiate tests to establish the authenticity, readability, completeness, and integrity of the machine-sensible records retained as required by this revenue procedure. These tests may include the testing of EDI and/or other procedures, and a review of the internal controls and security procedures associated with the creation and storage of the records. These tests are not an "examination," "investigation," or "inspection" of the books and records within the meaning of section 7605(b) of the Code because these tests are not directly related to the determination of tax liability for a particular taxable period.

## SEC. 5. MACHINE-SENSIBLE RECORDKEEPING REQUIREMENTS

.01 All machine-sensible records whose contents may be or may become material to the administration of the Code shall be retained by the taxpayer. The retained records shall be in a retrievable format that provides the information necessary to determine the correct tax liability. The taxpayer shall ensure that the details and the source documents underlying any summary accounting data may be easily identified and made available to the Service upon request.

.02 Documentation that provides a complete description of the ADP portion of the accounting system, including all subsystems and files that feed into the accounting system, shall be retained and made available to the Service upon request. The statements and illustrations as to the scope of operations shall be sufficiently detailed to indicate:

(1) the application being performed;

(2) the procedures employed in each application;

(3) the controls used to ensure accurate and reliable processing; and

(4) the controls used to prevent the unauthorized addition, alternation, or deletion of retained records.

.03 The following specific documentation for all retained files shall also be kept:

(1) record formats (including the meaning of all "codes" used to represent information);

(2) flowcharts for a system and a program;

(3) label descriptions;

(4) source program listings of programs that created the retained files;

(5) detailed charts of accounts (for specific periods);

(6) evidence that periodic checks of the retained records that are prescribed in section 5.08 were performed; and

(7) evidence that the retained records reconcile to the books and the tax return. This reconciliation shall establish the relationship between the total of the amounts in the retained records by account to the account totals in the books and to the tax return.

.04 Any change to the ADP system which affects the accounting system and/or subsystems, together with their effective dates, shall be documented in order to preserve an accurate chronological record. This documentation shall include any changes to software or systems and any changes to the formats of files.

.05 In addition to the documentation described in section 5.02 through 5.04, the Service may require that the taxpayer furnish any other evidence (e.g., internal audit reports) that pertains to the authenticity and integrity of the records.

.06 Machine-sensible records are required to be retained until their contents are no longer material to the administration of the Code. At a minimum, this materiality continues until the expiration of the statute of limitations, including extensions, for each tax year. In certain situations, records should be kept for a longer period of time. For example, records that pertain to fixed assets, losses incurred under section 832(b)(5) of the Code, and LIFO inventories should be kept for longer periods of time.

.07 All machine-sensible records that must be retained shall be clearly labeled and stored in a secure environment. For example, supplemental labels with the statement "Tax Year 19XX Records -- Retain for IRS until 0000" or "Retain for IRS, Consult Tax Manager Before Releasing" should be used and affixed to each tape reel, cartridge, disk pack, diskette, or other device being retained, and a retention date should be written on the internal label. Back-up copies of machine-sensible records retained for the Service should be stored at an off-site location. The Service recommends that taxpayers refer to the [*11] National Archives and Record Administration's (NARA) standards for additional guidance on the maintenance and storage of electronic records. See, Standards for the Creation, Use, Preservation, and Disposition of Electronic Records, 36 C.F.R. Ch. XII, Part 1234, Subpart C (1990).

.08 The taxpayer shall make periodic checks on all records retained for the

Service. The Service recommends using the NARA standard for making periodic checks of retained machine-sensible records. See, 36 C.F.R. §1234.28(g)(4) (1990). In general, this standard requires a recordkeeper to annually select and test a random sample of all reels of magnetic tape to identify any loss of data, and to discover and correct the causes of data loss. In libraries with 1800 or fewer storage units (e.g., magnetic tape reels), a 20 percent random sample or a sample size of 50 units, whichever is larger, shall be read. In libraries with more than 1800 units, a sample of 384 units shall be read.

.09 If any machine-sensible records required to be retained are lost, destroyed, damaged, or found to be incomplete or materially inaccurate, the taxpayer shall report this to the District Director and recreate the files within a reasonable period of time.

.10 Although the NARA sampling standard referred to in section 5.08 is specifically for magnetic computer tape, the Service recommends that all retained machine-sensible media be randomly sampled and tested as described by NARA. A taxpayer whose data maintenance practices conform with the NARA standards and who loses only a portion of the data from a particular storage unit will not be subject to the penalties described in section 7. However, this taxpayer remains responsible for substantiating the information on its return as required by section 6001 of the Code.

.11 The taxpayer must be able to process the retained records at the time of a Service examination. Processing shall include the ability to print a hardcopy of any record. When the data processing system that created the records is being replaced by a system with which the records would be incompatible, the taxpayer shall convert pre-existing records to a format that is compatible with the new system. Any changes in the ability to process the retained records shall be reported to the District Director.

.12 The taxpayer shall provide the Service, at the time of an examination, with computer resources (e.g., terminal access, computer time, personnel, etc.) that are necessary for the processing of the retained records. Failure to provide these resources will be a failure to maintain books and records under section 6001 of the Code.

.13 The use of a DBMS necessitates the implementation of procedures to ensure that appropriate records and documentation are retained. A taxpayer is in compliance with the provisions of this revenue procedure if a sequential file exists and is available to the Service. The sequential file shall contain the detail necessary to identify the underlying source documents. The process to create a sequential file should be reviewed by the District Director prior to destruction of the DBMS records. Sections 5.01 through 5.12 of this procedure shall apply to the resultant sequential file(s).

.14 In addition to the documentation described in section 5.02 through 5.05,

the following documentation pertaining to each DBMS system shall be retained:

(1) Data Base Description (DBD);

(2) Record layout of each segment with respect to the fields in the segment;

(3) Systems Control Language;

(4) Program Specification Block (PSB); and

(5) Program Communication Block (PCB).

.15 In order to be in compliance with this revenue procedure, a taxpayer that uses EDI technology must retain machine-sensible records that, in combination with any other records (e.g., the underlying contracts, price lists, and price changes), contain all of the detailed information required by section 6001 of the Code. The extent of the detail in the retained electronic and other records, if any, must be equivalent to the level of detail contained in an acceptable paper record. For example, the retained records for an electronic invoice must contain identification of the vendor by name, invoice date, product description, quantity purchased, price, etc. The taxpayer may capture this information at any level within the accounting system provided the audit trail, authenticity, and integrity of the retained records can be established.

SEC. 6. IMPACT ON HARDCOPY RECORDKEEPING REQUIREMENTS

.01 Except as otherwise provided in this section, the provisions of this revenue procedure do not relieve taxpayers of the responsibility to retain hardcopy records that are created or received in the ordinary course of business as required by existing law and regulations. Hardcopy records may be retained in microfiche or microfilm format in accordance with the requirements outlined in Rev. Proc. 81-46, 1981-2 C.B. 621. These records are not a substitute for the machine-sensible records required to be retained by this revenue procedure.

.02 Hardcopy records generated at the time of a transaction (e.g., credit card receipts) need not be retained if all the details relating to the transaction are subsequently received by the taxpayer in an EDI transaction and are retained by the taxpayer in accordance with this revenue procedure.

.03 If hardcopy records are not produced or received in the ordinary course of transacting business (as may be the case when utilizing EDI technology), or are not retained pursuant to section 6.02, hardcopy printouts of computerized records need not be created unless requested by the Service. These requests may be made either at the time of an examination or in conjunction with the testing described in section 4.04.

.04 Computer printouts that are created for validation, control, or other temporary purposes need not be retained.

## SEC. 7. PENALTIES

The District Director may issue a Notice of Inadequate Records pursuant to section 1.6001-1(d) of the regulations if machine-sensible records are not properly retained as required by this revenue procedure. Failure to comply with the provisions of this revenue procedure may also result in the imposition of an accuracy related civil penalty under section 6662(a) of the Code that is attributable to negligence or disregard of rules or regulations as provided under section 6662(b)(1). A criminal penalty under section 7203 may also be applicable. See Rev. Rul. 81-205, 1981-2 C.B. 225, which explains the applicability of the predecessor of the section 6662(a) civil penalty and the section 7203 criminal penalty.

## SEC. 8. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 86-19 is superseded for taxable years beginning after December 31, 1991. However, if a taxpayer complies with this revenue procedure for prior taxable years, the taxpayer will be treated as having complied with Rev. Proc. 86-19 for those years.

## SEC. 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning after December 31, 1991.

## SEC. 10. EXAMINATION OFFICE CONTACT

All questions regarding this revenue procedure should be directed to the Office of the Assistant Commissioner (Examination). The telephone number for this office is (202) 566-6856 (not a toll-free number). Written questions should be addressed to: Assistant Commissioner (Examination)

Attention: EX
Internal Revenue Service
1111 Constitution Ave. N.W.
Washington, D.C. 20224