

## Chapter 4

# Audit Techniques for Electronic Records and Data Systems

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*And*

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**INTERNAL REVENUE SERVICE  
TAX EXEMPT AND GOVERNMENT ENTITIES**

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## Overview

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### **Introduction**

Audit techniques for electronic records and data systems are generally computer based. Therefore, this lesson provides you with an understanding of how to use the computer as an examination tool with the assistance of a computer audit specialist (CAS). You will recognize the potential benefits from improved examination quality and reduced case time through computer audit assisted examinations, as well as the elimination of time-consuming and repetitive manual tasks.

Asking questions is important so that you and the CAS understand how the taxpayer sets up the records, and how to most efficiently get to the source documents. The best way to understand the taxpayer's accounting system is to ask the taxpayer to explain it in detail. This is a good idea whether you are examining a small corporation or an Employee Plans Team Audit (EPTA) case.

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## **Overview,** Continued

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### **Objectives**

At the end of this chapter, you will be able to:

- Request a Computer Audit Specialist (CAS);
  - Identify computer record keeping requirements;
  - Identify the type of computer records provided;
  - Recognize files that contain Employee Plans related data;
  - Review computer applications for Employee Plans Agents;
  - Prepare Information Document Requests for computer records;
  - Discuss basic Access software applications;
  - Discuss basic Excel software applications;
  - Discuss basic conversion of computer records;
  - Identify different types of computer research software applications.
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## **Request for a Computer Audit Specialist (CAS)**

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**Computer Audit Specialist**    The CAS is an experienced revenue agent who has completed an intensive computer-training program. This training concentrates on large multi-user computer systems that process voluminous data. Intensive classroom training at the University of North Texas spans almost a year and is supplemented by on-the-job training. The CAS also receives an advanced course in statistical sampling.

CPE courses for CAS are designed to keep them abreast of the latest trends in computers. While their primary focus is on LMSB cases, they are also assigned non-LMSB cases and work on selected projects.

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**Reason to Use a CAS**    The complexity of computer based records makes the use of a CAS a necessity. Most of the records of larger cases are computer-generated and frequently can involve millions of transactions per year. The use of a CAS is imperative to maintaining an efficient, well-organized examination and to effectively utilize resources.

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**Role of CAS**    The role of the CAS is varied and complex. From the perspective of the an EP agent, there are three main areas to consider:

- Systems analysis and record evaluation,
  - Computer applications (reports and downloading files, etc.), and
  - Statistical sampling.
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**Systems Analysis**    Systems analysis includes reviewing the internal controls for computer data and retention of necessary computer records. The CAS should understand the taxpayer's computer system and accounting system to determine what files to access and how. An initial audit will require a great deal of information from both the accounting and MIS (Management Information Systems) departments. Subsequent cycles would begin with a review of the prior cycle applications and administrative CAS file.

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## **Request for a Computer Audit Specialist (CAS),** Continued

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**Systems  
Analysis  
(continued)**

Because taxpayers frequently change both their computer hardware and software systems, understanding and coping with the changes are part of this process. Often, this systems analysis is part of getting the first audit report ready. This analysis is also an ongoing part of CAS participation and includes issuance of the retention letter (used in some areas).

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**Computer  
Applications**

Computer applications include both standard reports and specific issue-related reports and applications.

Standard reports include ones such as a general ledger summary by journal source (which is useful for reconciliation and the audit trail), accounts receivable files, accounts payable files, employee information/ payroll system files, Form 1099 files, stratification and selection of accounts, and vendor analyses.

Issue-related applications can be developed as needed, based on the interaction with the team and the data files available. Both standard applications and issue-oriented applications can produce hard copy reports, or data files that can be downloaded for use on the PC in databases. As the availability of hardware is changing, the CAS is changing to a more interactive approach. The prior approach was for the CAS to produce hard copy reports. The interactive approach may include the CAS creating databases for use in Access or other software products that allow the team to query the files. The CAS also may be able to assist the team with PC applications or problems as time permits.

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**Statistical  
Sample**

The CAS can assist in planning all stages involved in obtaining a statistical sample. The CAS involvement should begin early when sampling is being considered. The planning of a sample is vital to obtaining a satisfactory outcome, and early CAS involvement is crucial. The CAS should be involved in selecting the population to be sampled, generating random numbers, selecting the random sample, documenting the sampling process, and discussing the sample results with the taxpayer.

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## **Request for a Computer Audit Specialist (CAS), Continued**

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### **Requesting a CAS on SRS**

The request for a Computer Audit Specialists (CAS) should be made as far as possible in advance of the examination. This will ensure the maximum availability of a CAS to examine the computerized books and records in a timely matter with regard to the examination.

On October 1, 2002 the new Specialist Referral System (SRS) became operational and is the method to be used to request the services of a CAS and the other specialists. Manual forms were phased out starting after December 31, 2002.

The SRS automates the referral request process for LMSB, SBSE, W&I, and TEGE field specialists. Agents can generate a referral request online, which will automatically notify the appropriate Specialist Manager of the request.

To use the request the services of a specialist, click on the link indicated on the TEGE web site.

The system is totally electronic and web-enabled, providing management necessary information reports. Using the SRS, referrals can be generated for a Computer Audit Specialist (CAS), Economist, Employee Plans Agent, Employment Tax (LMSB) Agent, Employment Tax (SBSE) Agent, Employment Tax (TEGE) Agent, Engineer, Excise Tax Agent, Exempt Organizations Agent, Federal, State & Local Government Agent, Financial Products Agent, Indian Tribal Government Agent, International Agent, and Tax-Exempt Bonds Agent.

Many intended users of the Specialist Referral System will be unable to access the site due to COE settings and restrictions. To successfully connect to the SRS, the IRS Certificate Authority must be set up in your workstation's browser. BSP has created a page with a solution.

Those requesting a specialist do not need any special permission to access SRS. However, specialists (including management) must gain permission to use the case assignment areas of SRS. This permission is obtained through the use of a form 5081 through the online system.

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## **Computerized Record Keeping Requirements**

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**Revenue  
Procedure 98-  
25: Record  
Keeping  
Requirement**

When a taxpayer's records are maintained within an Automated Data Processing system, essential basic requirements are summarized in Revenue Procedure 98-25. A copy of Revenue Procedure 98-25 has been included as Exhibit 1.

Machine-sensible records must:

- Be retained so long as their contents may become material in the administration of any internal revenue law;
- Reconcile with the taxpayer's books and return;
- Contain sufficient transaction-level detail so that the information and the source documents underlying the machine-sensible records can be identified;
- Be made available to the Service upon request and be capable of being processed.

Taxpayers must also:

- Maintain system documentation relating to retained records;
  - Provide the Service at the time of an examination with computer resources that are necessary to process the machine-sensible records;
  - Notify its Field Director of any machine-sensible records lost, destroyed, or no longer capable of being processed, and describe its plan to replace or restore the affected records.
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**Third Party  
Services**

A taxpayer's use of a third party (such as a service bureau) to provide services with respect to machine-sensible records does not relieve the taxpayer of its record keeping obligations and responsibilities.

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**Revenue  
Procedure 97-  
22: Electronic  
Storage System**

Revenue Procedure 97-22 is applicable when a taxpayer's records are maintained by using an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media such as an optical disk. A copy of Revenue Procedure 97-22 has been included as Exhibit 2.

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## **Computerized Record Keeping Requirements, Continued**

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**Record Retention Agreement**

A taxpayer may request to enter into a Record Retention Limitation Agreement. The request must identify and describe those records the taxpayer proposes not to retain and explain why those records will not become material to the administration of any internal revenue law.

Currently, Record Retention Limitation Agreements are not commonly used.

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## **Types of Computer Records**

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**Acceptable Record Formats**

- ASCII (American Standard Code for Information Interchange for DOS),
  - ANSI (for Windows 3.1+),
  - Unicode (Windows 95, 98 and NT),
  - EBCDIC (Extended Binary Coded Decimal Interchange Code for IBM mainframe computers),
  - ACCESS '97 or 2000,
  - EXCEL '97 or 2000, and
  - Access can import data in ASCII, ANSI, and Unicode formats while EBCDIC files must be converted to a compatible format before they can be imported.
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## **Types of EP Data Files**

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**Types of EP Files**

EP audits utilize the data processing files normally encountered in taxable CEP corporate audits, in addition to those created and maintained solely for use in administering employee plans. These files include:

- General ledger summary/detail files,
  - Employee information/payroll system files,
  - Forms 1099-R and W-2 files, and
  - Participant account records.
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## **Applications For EP Agents**

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**EP Applications**

There are several types of applications that a CAS can perform for the EP agent. Although the following list is not all inclusive, applications include:

- Audit testing for coverage, eligibility and participation, allocations, termination of service, Internal Revenue Code (IRC) section 415 limitations, hardship distributions and in-service withdrawals; and
  - Compliance testing for highly compensated employees, actual deferral percentage test, actual contribution percentage test, IRC section 402(g) limitations, and contributions in excess of plan limits.
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## **Sample IDR's**

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**Preparation of IDR's**

The CAS or the EP agent can prepare and issue the IDR's for the computerized records. However, due to the time and expense incurred by the taxpayer, the CAS with the advice of the EP agent should request all computerized records, and do so as early as possible. Therefore, if the taxpayer has questions or problems regarding their data, the layout and type of acceptable records, or the request itself, the taxpayer has only one contact person, thereby cutting down on any possible delays.

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**Exhibit 3**

Exhibit 3 is a sample IDR that can be used to request Form W-2 and 1099 data files.

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## **Sample IDR's, Continued**

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### **Exhibit 4**

Exhibit 4 is a sample IDR that can be used to request the necessary employee census information. This information can come from several sources such as internal payroll and general ledger systems and from external vendors.

In addition, the taxpayer's field names may be different than what is listed on the IDR and the taxpayer may have to roll or combine more than one payroll system together to complete the IDR request. Therefore, this IDR is sometimes simply a place to start the process of securing the necessary computer records. Throughout the entire process of securing computer data, it is absolutely necessary to work directly with the taxpayer and the CAS to identify specific fields needed. This will not only save time, but will also lessen taxpayer burden.

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## **Using Access**

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### **Database**

As stated in the introduction, utilizing computer applications will produce benefits from improved examination quality and reduced case time. Microsoft Access is one of the computer applications referred to.

Examination quality is improved because redundant calculations performed by Access are always accurate. Mistakes can occur when these same redundant calculations are performed manually. Reduced case time is another benefit that results from using Access because calculations that take a lot of time manually can be performed almost instantaneously by Access.

Microsoft Access '97 and 2000 is a database management system, or DBMS. A database management system helps you to manage large quantities of data that is stored in a computer database.

In its simplest form, a database is a place where information is stored. A database created electronically on a computer, however, is much more flexible and powerful than a simple list of information kept on paper or in cabinets.

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## Using Access, Continued

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**Types of Data**      Virtually any data can be managed in an electronic database. Some examples are:

- Employee and Personnel Information,
- W-2 and 1099 Information,
- General Ledger Detail,
- Accounts Payable,
- Chart of Accounts, and
- Mapping of the Trial Balance to the Tax Return.

Besides being used for storage and retrieval, Access includes many features for manipulating the information that is stored. Examples include:

- Sort and reorganize,
  - Extract and work with subsets of data,
  - Design custom forms for entering and viewing the information, and
  - Produce sophisticated reports for presenting.
- 

**Queries**              Queries are a request for information. In Access, queries request information from a database. Queries can also be used to request or compare information from different databases.

Queries are used to view, change, and analyze data in different ways. They can also be used as the source of records for forms, reports, and data access pages.

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**Query Criteria**      Criteria are restrictions placed on a query or an advanced filter to identify the specific records you want to work with. Additionally, you can enter additional criteria for the same field or different fields. When expressions are typed in more than one criteria cell, Access combines them using either the "And" or the "Or" operator.

Criteria can also be specified to affect the results of a calculation. By adding criteria, you can limit the groups for which you're performing a calculation, limit the records included in the calculation, or limit the results that are displayed after the calculation is performed.

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## Using Access, Continued

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**Relevant Uses**      Specific examples of relevant uses in Access by an EP agent would be audit and compliance testing. When the investment in time to obtain the necessary computer records and to convert those computer records is beneficial in light of the increase in examination quality and decreased audit examination time, Access can produce great benefits.

As stated in the section titled Applications For EP Agents, testing for coverage, eligibility and participation, allocations, termination of service, Internal Revenue Code (IRC) section 415 limitations, hardship distributions, and in-service withdrawals are all examples of audit testing.

Examples of compliance testing would be the determination of highly compensated employees, actual deferral percentage test, actual contribution percentage test, IRC section 402(g) limitations, and contributions in excess of plan limits.

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**Audit Test Example**      An example of an audit test that could be performed on Access would be testing for IRC section 415 limitations. Using Access, the test could be instantaneously performed on the entire population using a query with specific criteria. For example, specific criteria limiting the results to only those individuals with contributions over \$35,000 or 25% of wages would identify the affected participants.

Manual testing would require the EP agent to review either all or a sample of the participants with regards to both the 25% and \$35,000 limitations. Depending on the number of participants and the presentation of the records, this test could be quite time consuming and errors could occur simply by testing only a portion of the population.

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**Learning Access**      You have to use Access to utilize it effectively. Because various workshops and self-study courses are available, no attempt will be made here to teach you how to specifically use Access. Please request a workshop or time from your Group Manager to complete a self-study course for additional training if you feel this training would be beneficial.

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## Using Excel

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**Worksheet**            In Excel, a workbook is the file in which you work and store your data. Because each workbook can contain many sheets, you can organize various kinds of related information in a single file. Excel helps you to manage small or modest quantities of computer data.

Worksheets are used to list and analyze data. You can enter and edit data on several worksheets simultaneously and perform calculations based on data from multiple worksheets. When you create a chart, you can place the chart on the worksheet with its related data, or on a separate chart sheet. The names of the sheets appear on tabs at the bottom of the workbook window. To move from sheet to sheet, click the sheet tabs.

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**Types of Data**        Excel and Access work with the same types of data that are listed in the preceding section discussing Access. Excel also sorts and reorganizes information, and allows for extracting and working with subsets of data. However, Excel is more limited than Access in the forms and reports available.

Excel is generally used when the quantities of computer data are small or modest in size. Access is generally used when working with large quantities of data. It is common to use both Excel and Access at the same time. The applications can be linked together, or subsets of Access data can be converted to Excel if necessary.

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**Formulas**            A worksheet formula is an equation that performs operations on worksheet data. Formulas can perform mathematical operations, such as addition and multiplication, or they can compare worksheet values or join text. Formulas can refer to other cells on the same worksheet, cells on other sheets in the same workbook, or cells on sheets in other workbooks.

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**Audit Test Example**    The same audit test example used in the Access section applies in Excel as well. The difference would be that, instead of using criteria, formulas are used. However, as stated before, Excel is generally used when the quantity of computer data is small or modest in size, and the reports generated by Excel are more limited than in Access.

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## **Using Excel, Continued**

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**Learning Excel**    You have to use Excel to learn it. Because various workshops and self-study courses are available, no attempt will be made here to teach you how to specifically use Excel. Please request a workshop or time from your Group Manager to complete a self-study course for additional training if you feel this training would be beneficial.

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## **Conversion of Computer Records**

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**Importing Files Into Access or Excel**    The conversion of computer records can be time consuming and troublesome. Any CAS has been trained to convert taxpayer's records from a variety of systems. Their knowledge base is broad and they can hopefully save time in the conversion of computer records. Various executable programs have been developed to convert taxpayer data that will take a CAS very little time to run.

Conversion of limited data in simple situations into Access by an EP agent can be accomplished by importing data into an Access file from external sources. Conversion of limited data in simple situations into Excel by an EP agent can be accomplished by opening the data in Excel and making specific changes to the data.

Consider the amount of time to convert the records, especially if auditing more than one year. The CAS can setup programs to convert the records the same way for both years, thus saving time.

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**Converting Files From Excel Into Access or From Access Into Excel**    Converting files from Excel into Access can be accomplished by importing data into an Access file from external sources.

Converting files from Access into Excel can be accomplished by exporting data from an Access file.

EP agents should only attempt to convert files in simple and limited circumstances. In more complicated circumstances, a CAS should be utilized for file conversion.

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## Computer Research

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**Types of  
Computer  
Research  
Available**

This discussion regarding computer research is strictly intended as an introduction because each type of computer research is a lesson in itself. Nor is the following list intended to be all-inclusive. Because various workshops and self-study courses are available, no attempt will be made here to teach you how to specifically research using the different products available. The types of computer research that will be discussed here are:

- Intranet
  - Internet
  - Lexis-Nexis
  - ChoicePoint
  - IDRS
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**Intranet**

The Intranet is generally available only to specific users. Unauthorized users are blocked from the Intranet by a firewall or a partition. An example of a site on the Intranet is our own IRWEB site. This site contains an incredible amount of information. Look to the 2002 CPE Text in Chapter 18 titled Navigation to find out what information is available and how to locate that information.

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**Internet**

The Internet is a global collection of thousands of freestanding and networked computers linked together through cables and/or telephone lines. The computers and computer systems can belong to:

- Individuals,
- Businesses,
- Universities,
- Government agencies, or
- Other organizations.

Collectively, Internet users have a wealth of information that they wish to share with other users. Used properly, some of this information can greatly enhance the quality of your examination by helping you to:

- Quickly locate pertinent information,
  - Retrieve the information in machine-sensible format, and
  - Manipulate the information for your specific needs.
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## **Computer Research, Continued**

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### **Internet Web Sites**

Many users establish a home page on the Internet to provide information about their company, organization, or subject of particular interest. These sites are often linked to other sites offering related information. By simply clicking on an Icon at a home page site, you can easily move from one area of interest to another. These individual sites comprise the World Wide Web, or WWW, which is responsible for the explosive growth of the Internet. Your taxpayer could very easily maintain a web site. If so, you would be wise to at least visit the site to see if it contains any information that might be useful for the current examination or for the planning file maintained for future examinations.

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### **Examples of Web Sites**

The following are examples of interesting and useful sites on the Internet specifically for an EP Agent. There are of course thousands of other sites, many of which are as good or even better than these, but there is not the time or the space to include everything of interest.

Copies of Form 5500: [www.Freeerisa.com](http://www.Freeerisa.com)

SEC Filings: [www.Sec.Gov./Edgarhp.htm](http://www.Sec.Gov./Edgarhp.htm)

Professional Information and Organizations: [www.Rutgers.Edu](http://www.Rutgers.Edu)

Tax Topics: [www.Taxsites.com](http://www.Taxsites.com)

Financial Information: <http://www.hooveronline.com/>

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### **Internet Research**

The Internet can, of course, be used for research in specific areas. For this you will need a tool called a search engine. There are several such engines including the ones listed below. Which search engine to use is a personal preference, and each one has qualities and features that some individuals find helpful, while other individuals find them intrusive. Some are also more useful for product searches than for information searches. Some of the more common search engines and their Web sites are listed in the table below. To access any of these you would simply type in WWW, followed by the name of the search engine, and ending with the dot com suffix (.com).

- Altavista
  - AskJeeves
  - Go
  - Google
  - Yahoo
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## **Computer Research, Continued**

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### **Lexis-Nexis**

Lexis-Nexis is a powerful research tool with access to approximately 25,000 sources (19,000 news and business and 6,000 legal). Users can research through libraries the following types of information:

- CCH Federal Tax Service
- RIA U.S. Tax Report
- BNA - Tax Management Portfolios, US Income
- Internal Revenue Code and Legislative History
- Regulations
- Internal Revenue Manual
- Federal Income, Estate and Gift, Employment, and Excise Taxes
- Internal Revenue and Cumulative Bulletins
- Revenue Rulings
- Revenue Procedures
- Announcements
- Notices
- Private Letter Rulings
- Technical Advice Memoranda
- General Counsel Memoranda
- Actions on Decisions
- Bankruptcy Court
- US Tax Court (Regular and Memorandum Decisions)
- US District Court
- US Court of Court of Federal Claims
- US Circuit Court of Appeals
- US Court of Appeals for the Federal Circuit
- US Supreme Court
- IRS Industry Specialization Program
- Coordinated Issue Papers IRS Market Segment
- Specialization Program (MSSP) Audit Technique
- Guides - IRS Publications
- Magazines, Newspapers, and Daily Reports

Lexis-Nexis can be researched many ways, including through various installed software programs and the IRWEB or SPDER web sites.

Electronic learning materials are at the SPDER web site.

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## **Computer Research, Continued**

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**ChoicePoint**      ChoicePoint enables employees to locate individuals and businesses, and to confirm basic asset information nationwide. Users have access to a wide range of public record information, including:

- Credit Header Data
- Bankruptcy data
- Judgments
- Liens
- Real Property Records
- Grantee/Grantor data
- Tax assessor data
- Secretary of State/State Corporation Commission data, and Corporate officer/principal data and corporate asset data (where such data is not available via the Secretary of State)
- State Department of Motor Vehicle records (where available commercially)
- Additional Business Information Sources
- Date of birth
- Coast Guard data
- Court Docket information
- Federal Aviation Administration data
- Security Exchange Commission data
- Social Security Administration Master Death Files

ChoicePoint can be researched through the SPDER web site.

Electronic learning materials are at the SPDER web site.

Helpful hints regarding ChoicePoint have been included as Exhibit 5.

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## **Computer Research, Continued**

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**IDRS**                      Use Form 5644, *TE/GE Inquiry Request*, for requesting AIMS documents through the Integrated Data Retrieval System (IDRS). Group or Case Manager approval is needed on Form 5644.

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**AIMS Documents**

The following AIMS documents are commonly requested:

- INOLET: To verify information regarding the taxpayer such as current address, fiscal year end, and filing requirements.
- INOLEP: To verify all companies that have Form 5500 filing requirements and for information on those companies such as plan number, plan year-end, effective date of the plan, current filing requirements, and plan name.
- CFOL Command Codes: To verify whether the copy of the return is correct (i.e., IMFOL, BMFOL, EMFOL, etc.).

Other IDRS research capabilities include:

- AMDISA: To verify current status of cases established on AIMS.
  - PMFOL: To verify filing of Forms 1099.
  - ERTVU: To view Form 5500 returns on line.
  - BRTVE: To view Form 1120 returns on line.
  - RTVUE: To view Form 1040 returns on line.
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## **Summary**

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**Summary**                      You have learned in this chapter that utilizing the computer as an examination tool, with the assistance of a computer audit specialist (CAS), can result in potential benefits from improved examination quality and reduced case time. In addition, time-consuming and repetitive manual tasks are eliminated.

A CAS is a very important part of an audit team when the taxpayer utilizes computerized records. A CAS is requested using the Specialist Referral System (SRS).

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## **Summary, Continued**

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**Summary**  
(continued)

Computer record keeping requirements are discussed in Revenue Procedures 98-25. Electronic storage system requirements are discussed in Revenue Procedure 97-22.

The taxpayer can provide various types of computer records. Data files that EP agents will work with include general ledger summary/detail files, employee information/payroll system files, Forms 1099-R and W-2 files, and participant account records.

Computer applications that can be performed on the computer by an EP agent include audit testing for coverage, eligibility and participation, allocations, termination of service, IRC section 415 limitations, hardship distributions and in-service withdrawals. Compliance testing would include testing for highly compensated employees, actual deferral percentage test, actual contribution percentage test, IRC section 402(g) limitations, and contributions in excess of plan limits.

Sample IDR's have been provided as examples to use. However, these samples or templates have to be tailored for the specific audit you are performing.

Access is a database management system that helps you to manage large quantities of data that is stored in a computer database. Excel is a spreadsheet application that uses workbooks in which you work and store your data. Excel helps you to manage small or modest quantities of computer data.

Any CAS has been trained to convert taxpayer's records from a variety of systems. The conversion of computer records can be time consuming and troublesome, so a referral to a CAS should be considered when converting records.

There are many types of computer research software applications. Examples would be the Intranet, the Internet, Lexis-Nexis, ChoicePoint, and IDRS.

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**Exhibit 1**

**Rev. Proc. 98-25 (1998-11 I.R.B.)**

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SECTION 1. PURPOSE

The purpose of this revenue procedure is 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 system (ADP). This revenue procedure updates and supersedes Rev. Proc. 91-59, 1991-2 C.B. 841.

SECTION 2. BACKGROUND

.01 Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

Whenever necessary, the Secretary may require any person, by notice served upon that person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not that person is liable for tax.

.02 Section 1.6001-1(a) of the Income Tax Regulations generally provides that persons subject to income tax, or required to file a return of information with respect to income, must keep such books or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by that person in any return of such tax or information.

.03 Section 1.6001-1(e) provides that the books or records required by section 6001 must be kept available at all times for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law.

.04 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 and section 1.6001-1, and

are required to be retained so long as the contents may become material in the administration of any internal revenue law.

**SECTION 3. SCOPE****.01 Records.**

(1) 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.

(2) 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, place, and business purpose of a business expense must meet the requirements of this revenue procedure.

(3) Except as otherwise provided in this revenue procedure, all requirements of section 6001 that apply to hardcopy books and records apply as well to machine-sensible books and records that are maintained within an ADP system.

**.02 Taxpayers.**

(1) A taxpayer with assets of \$10 million or more at the end of its taxable year must 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, is considered to be one corporation and all assets of all members of the group are aggregated.

(2) A taxpayer with assets of less than \$10 million at the end of its taxable year must comply with the record retention requirements of Rev. Rul. 71-20 and the provisions of this revenue procedure if any of the following conditions exists:

(a) all or part of the information required by section 6001 is not in the taxpayer's hardcopy books and records, but is available in machine-sensible records;

(b) 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

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

(3) A Controlled Foreign Corporation (CFC), a domestic corporation that is 25 percent foreign-owned, and a foreign corporation engaged in a trade or business within the United States at any time during a taxable year that maintains machine-sensible records within an ADP system must comply with the requirements of this revenue procedure to satisfy the recordkeeping requirements of sections 964(c), 982(d), 6038A(c)(4), and 6038C (and the regulations thereunder).

(4) An insurance company that maintains machine-sensible records within an ADP system to determine losses incurred under section 832(b)(5) must comply with the requirements of this revenue procedure and Rev. Proc. 75-56, 1975-2 C.B. 596. For this purpose, the machine-sensible records for a particular taxable year include the records for that year and the seven preceding years, all of which must be retained so long as they may become material to the examination of an insurance company's federal tax return.

(5) A taxpayer's use of a third party (such as a service bureau, time-sharing service, value-added network, or other third party service) to provide services (e.g., custodial or management services) in respect of machine-sensible records does not relieve the taxpayer of its recordkeeping obligations and responsibilities under section 6001 and this revenue procedure.

**SECTION 4. DEFINITIONS**

.01 An "ADP system" consists of an accounting and/or financial system (and subsystems) that processes all or part of a taxpayer's transactions, records, or data by other than manual methods. An ADP system includes, but is not limited to, a mainframe computer system, stand-alone or networked microcomputer system, Data Base Management System (DBMS), and a system that uses or incorporates Electronic Data Interchange (EDI) technology or an electronic storage system.

.02 "Capable of being processed" means the ability to retrieve, manipulate, print on paper (hardcopy), and produce output on electronic media. This term does not encompass any requirement that the program or system that created the computer data be available to process the data unless that program or system is necessary to:

- (1) a tax-related computation (e.g., LIFO inventories, insurance company loss reserve computations, and foreign tax credit computations); or
- (2) the retrieval of data (e.g., some data base systems processes where the taxpayer chooses not to create a sequential extract (see section 5.02 of this revenue procedure)).

.03 A "DBMS" is a software system that creates, controls, relates, retrieves, and provides accessibility to data stored in a data base.

.04 "EDI technology" is the computer-to-computer exchange of business information.

.05 An "electronic storage system" is a system used to prepare, record, transfer, index, store, preserve, retrieve, and reproduce books and records by either: (1) electronically imaging hardcopy documents to an electronic storage media; or (2) transferring computerized books and records to an electronic storage media using a technique such as "COLD" (computer output to laser disk), which allows books and records to be viewed or reproduced without the use of the original program. See Rev. Proc. 97-22, 1997-13 I.R.B. 9, for electronic storage system requirements.

.06 A "machine-sensible record" is data in an electronic format that is intended for use by a computer. Machine-sensible records do not include paper records or paper records that have been converted to an electronic storage medium such as microfilm, microfiche, optical disk, or laser disk.

**SECTION 5. RETAINING MACHINE-SENSIBLE RECORDS**

.01 General.

(1) The taxpayer must retain machine-sensible records so long as their contents may become material to the administration of the internal revenue laws under section 1.6001-1(e). At a minimum, this materiality continues until the expiration of the period of limitation for assessment, 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), and LIFO inventories should be kept for longer periods of time.

(2) The taxpayer's machine-sensible records must provide sufficient information to support and verify entries made on the taxpayer's return and to determine the correct tax liability. The taxpayer's machine-sensible records will meet this requirement only if they reconcile with the taxpayer's books and the taxpayer's return. A taxpayer establishes this reconciliation by demonstrating the relationship (i.e., audit trail):

(a) between the total of the amounts in the taxpayer's machine-sensible records by account and the account totals in the taxpayer's books; and

(b) between the total of the amounts in the taxpayer's machine-sensible records by account and the taxpayer's return.

(3) The taxpayer must ensure that its machine-sensible records contain sufficient transaction-level detail so that the information and the source documents underlying the machine-sensible records can be identified.

(4) All machine-sensible records required to be retained by this revenue procedure must be made available to the Service upon request and must be capable of being processed.

(5) Except as otherwise required by sections 5.01(2) or (3) of this revenue procedure, a taxpayer is not required to create any machine-sensible record other than that created either in the ordinary course of its business or to establish return entries. For example, a taxpayer who does not create, in the ordinary course of its business, the electronic equivalent of a traditional paper document (such as an invoice) is not required by this revenue procedure to construct such a record, provided that the requirements of sections 5.01(2) and (3) are met. For requirements relating to hardcopy records, see section 11 of this revenue procedure.

(6) A taxpayer's disposition of a subsidiary company does not relieve the taxpayer of its responsibilities under this revenue procedure. The files and documentation retained for the Service by, or for, a disposed subsidiary must be retained as otherwise required by this revenue procedure.

#### .02 DBMS.

(1) A taxpayer has the discretion to create files solely for the use of the Service. For example, a taxpayer that uses a DBMS may satisfy the provisions of this revenue procedure by creating and retaining a sequential file that contains the transaction-level detail from the DBMS and otherwise meets the requirements of this revenue procedure.

(2) A taxpayer that creates a file described in section 5.02(1) of this revenue procedure must document the process that created the sequential file in order to establish the relationship between the file created and the original DBMS records.

#### .03 EDI.

(1) A taxpayer that uses EDI technology must retain machine-sensible records that alone, or in combination with any other records (e.g., underlying contracts, price lists, and price changes), contain all the information that section 6001 requires of hardcopy books and records. For example, a taxpayer that uses EDI 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 retain the incoming EDI transactions. Neither the EDI transactions, nor the accounts payable system, contain product descriptions or vendor names. To satisfy the requirements of section 6001, the taxpayer must supplement its EDI records with product code description lists and a vendor master file.

(2) A taxpayer may capture the required detail for an EDI transaction at any level within its accounting system. However, the taxpayer must establish audit trails between the retained records and the taxpayer's books, and between the retained records and the tax return.

(3) Section 11.02 of this revenue procedure provides additional guidance concerning hardcopy requirements related to EDI transactions.

### SECTION 6. DOCUMENTATION

.01 The taxpayer must maintain and make available to the Service upon request documentation of the business processes that:

(1) create the retained records;

(2) modify and maintain its records;

(3) satisfy the requirement of section 5.01(2) of this revenue procedure to support and verify entries made on the taxpayer's return and determine the correct tax liability; and

(4) evidence the authenticity and integrity of the taxpayer's records.

.02 The documentation described in section 6.01 of this revenue procedure must be sufficiently detailed to identify:

- (1) the functions being performed as they relate to the flow of data through the system;
- (2) the internal controls used to ensure accurate and reliable processing;
- (3) the internal controls used to prevent the unauthorized addition, alteration, or deletion of retained records; and
- (4) the charts of accounts and detailed account descriptions.

.03 With respect to each file that is retained, the taxpayer must maintain, and make available to the Service upon request, documentation of:

- (1) record formats or layouts;
- (2) field definitions (including the meaning of all "codes" used to represent information);
- (3) file descriptions (e.g., data set name);
- (4) evidence that periodic checks (described in section 9.01(3) of this revenue procedure) of the retained records were performed to meet section 9.02(1) of this revenue procedure, if the taxpayer wants to take advantage of section 9.02 of this revenue procedure;
- (5) evidence that the retained records reconcile to the taxpayer's books; and
- (6) evidence that the retained records reconcile to the taxpayer's tax return.

.04 The system documentation must include any changes to the items specified in sections 6.01, 6.02, and 6.03 of this revenue procedure and the dates these changes are implemented.

#### SECTION 7. RESOURCES

.01 The taxpayer must provide the Service at the time of an examination with the resources (e.g., appropriate hardware and software, terminal access, computer time, personnel, etc.) that the District Director determines is necessary to process the taxpayer's machine-sensible books and records. At the request of the taxpayer, the District Director may, at the District Director's discretion:

- (1) identify the taxpayer's resources that are not necessary to process books and records;
- (2) allow a taxpayer to convert machine-sensible records to a different medium (e.g., from mainframe files to microcomputer diskette(s));
- (3) allow the taxpayer to satisfy the processing needs of the Service during off-peak hours; and
- (4) allow the taxpayer to provide the Service with third-party equipment.

.02 An ADP system must not be subject, in whole or in part, to any agreement (such as a contract or license) that would limit or restrict the Service's access to and use of the ADP system on the taxpayer's premises (or any other place where the ADP system is maintained), including personnel, hardware, software, files, indexes, and software documentation.

#### SECTION 8. NOTIFICATION

.01 Except as provided in section 9.02 of this revenue procedure, the taxpayer must promptly notify its District Director if any machine-sensible records are lost, stolen, destroyed, damaged, or otherwise no longer capable of being processed (as defined in section 4.02 of this revenue procedure), or are found to be incomplete or materially inaccurate (affected records).

.02 The taxpayer's notice must identify the affected records and include a plan that describes how, and in what timeframe, the taxpayer proposes to replace or restore the affected records in a way that assures that they will be capable of being processed. The plan must demonstrate that all of the requirements of this revenue procedure will continue to be met with respect to the affected records.

.03 The District Director will notify the taxpayer of any objection(s) to the taxpayer's plan.

.04 A District Director may consider, whenever warranted by the facts and circumstances, the possibility of requiring less than a total restoration of missing data.

.05 Examples.

(1) Taxpayer A replaces its general ledger software system with a new general ledger software system with which the original system's records are incompatible. However, A's original records are retrievable and capable of being processed on A's hardware system. A is not required to notify its District Director of the change in its software system because A's records remain capable of being processed.

(2) Taxpayer B replaces its original ADP hardware system with a new system that cannot process the machine-sensible records created and maintained by B's original system. B must notify its District Director of this hardware system change and propose a plan for assuring that the machine-sensible records created and maintained by the original ADP hardware system are capable of being processed. To that end, B considers the following options: (1) having all records in the taxpayer's original system immediately reformatted so that the new system can retrieve and process those records; (2) having all records in its original system reformatted by a designated future date; or (3) having an arrangement with a third party to process all records in its original system on a compatible system. Any of these options may be acceptable provided the option selected enables the taxpayer to meet the requirements of this revenue procedure with respect to those records. The taxpayer must be able to demonstrate that any third party reformatting or processing is done with the quality controls in place that will ensure the continued integrity, accuracy, and reliability of the taxpayer's records.

#### SECTION 9. MAINTENANCE

.01 Recommended Practices.

(1) The implementation of records management practices is a business decision that is solely within the discretion of the taxpayer. Recommended records management practices include the labeling of records, providing a secure storage environment, creating back-up copies, selecting an offsite storage location, and testing to confirm records integrity.

(2) The National Archives and Record Administration's (NARA) Standards for the Creation, Use, Preservation, and Disposition of Electronic Records, 36 C.F.R., Ch XII, Part 1234, Subpart C (1996), is one example of a records management resource that a taxpayer may choose to consult when formulating its records management practices.

(3) The NARA standard in 36 C.F.R. section 1234.30(g)(4) (1996) requires an annual reading of a statistical sampling of magnetic computer tape reels to identify any loss of data and to discover and correct the causes of data loss. In libraries with 1,800 or fewer storage units (e.g., magnetic tape reels), a 20 percent random sampling or a sample size of 50 units, whichever is larger, should be read. In libraries with more than 1,800 units, a sample of 384 units should be read. Although this NARA sampling standard is specifically for magnetic computer tape, the Service recommends that all retained machine-sensible records be sampled and tested as described in the NARA standard.

.02 Partial Loss of Data. A taxpayer that loses only a portion of the data from a particular storage unit will not be subject to the penalties described in section 12 of this revenue procedure if the taxpayer can demonstrate to the satisfaction of the District Director that the taxpayer's data maintenance practices conform with 36 C.F.R. section 1234.30(g)(4) (1996) (the NARA sampling standard). However, the taxpayer remains responsible for substantiating the information on its return as required by section 6001.

#### SECTION 10. DISTRICT DIRECTOR AUTHORITY

**.01 Record Retention Limitation Agreement.**

(1) A taxpayer who maintains machine-sensible records may request to enter into a Record Retention Limitation Agreement (RRLA) with its District Director. This agreement provides for the establishment and maintenance of records as agreed upon by the District Director and the taxpayer.

(2) The taxpayer's request must identify and describe those records the taxpayer proposes not to retain and explain why those records will not become material to the administration of any internal revenue law. The District Director will notify the taxpayer whether or not the District Director will enter into an RRLA.

(3) In an RRLA, the District Director may waive all or any of the specific requirements in this revenue procedure. A taxpayer remains subject to all the requirements in this revenue procedure that are not specifically modified or waived by an RRLA.

(4) Unless an RRLA otherwise specifies, an RRLA shall not apply to accounting and tax systems added subsequent to the completion of the record evaluation upon which the agreement is based. All machine-sensible records produced by a subsequently added accounting and tax system, the contents of which may be or may become material in the administration of the Code must be retained by the taxpayer signing the RRLA until a new evaluation is conducted by the District Director.

(5) Unless an RRLA specifies otherwise, it does not apply to a subsidiary acquired subsequent to the completion of the record evaluation upon which the RRLA is based. All machine-sensible records produced by the acquired subsidiary, the contents of which may be or may become material in the administration of the Code must be retained pursuant to this revenue procedure and any pre-acquisition RRLA ("former RRLA") that applies to the acquired subsidiary. The former RRLA applies to the acquired subsidiary until the District Director either revokes the former RRLA (in whole or in part) or enters into a new RRLA that applies to the acquired subsidiary.

(6) Upon the disposition of a subsidiary, the files being retained for the Service pursuant to an RRLA by, or for, the disposed subsidiary must be retained by the taxpayer until a new evaluation is conducted by the District Director.

(7) A District Director's decision to revoke an RRLA, or not to enter into an RRLA, does not relieve the taxpayer of its recordkeeping obligations under section 6001 or its responsibilities described in this revenue procedure.

**.02 Records Evaluation.**

(1) The District Director may conduct a records evaluation at any time the District Director deems it appropriate to review the taxpayer's record retention practices, including the taxpayer's relevant data processing and accounting systems.

(2) The records evaluation described in section 10.02(1) of this revenue procedure is not an "examination", "investigation," or "inspection" of the books and records within the meaning of section 7605(b) of the Code, or a prior audit for purposes of section 530 of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. 119, as amended by section 1122 of the Small Business Job Protection Act of 1996, because this evaluation is not directly related to the determination of the tax liability of a taxpayer for a particular taxable period.

(3) The District Director will inform the taxpayer of the results of a records evaluation.

**.03 Testing.**

(1) The District Director may periodically initiate tests to establish the authenticity, readability, completeness, and integrity of a taxpayer's machine-sensible records retained in conformity with this revenue procedure.

(2) These tests may include a review of integrated systems such as EDI or an electronic storage system, and a review of the internal controls and security procedures associated with the creation and maintenance of the taxpayer's records.

(3) The tests described in section 10.03(1) of this revenue procedure are not an "examination", "investigation," or "inspection" of the books and records within the meaning of section 7605(b) of the Code, or a prior audit for purposes of section 530 of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. 119, as amended by section 1122 of the Small Business Job Protection Act of 1996, because these tests are not directly related to the determination of the tax liability of a taxpayer for a particular taxable period.

(4) The District Director will inform the taxpayer of the results of these tests.

#### SECTION 11. HARDCOPY RECORDS

.01 The provisions of this revenue procedure do not relieve taxpayers of their 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 conformity with Rev. Proc. 81-46, 1981-2 C.B. 621. Hardcopy records may also be retained in an electronic storage system in conformity with Rev. Proc. 97-22. These records are not a substitute for the machine-sensible records required to be retained by this revenue procedure.

.02 A taxpayer need not create or retain hardcopy records if:

(1) the hardcopy records are merely computer printouts created only for validation, control, or other temporary purposes;

(2) the hardcopy records are not produced in the ordinary course of transacting business (as may be the case when utilizing EDI technology); or

(3) all the details relating to the transaction are subsequently received by the taxpayer in an EDI transaction and are retained as machine-sensible records by the taxpayer in conformity with this revenue procedure. For example, a taxpayer need not retain credit card receipts generated at the time of a transaction if all pertinent information on the receipts is subsequently received in an EDI transaction and retained as a machine-sensible record. See section 5.03 of this revenue procedure for requirements relating to EDI.

.03 A taxpayer need not create hardcopy printouts of its machine-sensible records unless requested to do so by the Service. The Service may request such hardcopy printouts either at the time of an examination or in conjunction with the tests described in section 10.03(1) of this revenue procedure.

#### SECTION 12. PENALTIES

The District Director may issue a Notice of Inadequate Records pursuant to section 1.6001-1(d) if a taxpayer fails to comply with this revenue procedure (including a failure to satisfy the resource requirements of section 7 of this revenue procedure). Failure to comply with this revenue procedure may also result in the imposition of the applicable penalties under subtitle F of the Code, including the section 6662(a) accuracy-related civil penalty and the section 7203 willful failure criminal penalty.

#### SECTION 13. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 91-59 is modified and superseded for machine-sensible records relating to taxable years beginning after December 31, 1997. However, a taxpayer that complies with this revenue

procedure for taxable years beginning prior to that date is treated as having complied with Rev. Proc. 91-59 for those years.

**SECTION 14. EFFECTIVE DATE**

This revenue procedure is effective for machine-sensible records relating to taxable years beginning after December 31, 1997.

**SECTION 15. INTERNAL REVENUE SERVICE OFFICE CONTACT**

.01 Questions regarding this revenue procedure should be directed to the Office of the Assistant Commissioner (Examination). The telephone number for this office is (202) 622-5480 (not a toll-free number). Written questions should be addressed to:

Assistant Commissioner (Examination)

Attention: CP:EX

Internal Revenue Service

1111 Constitution Ave., N.W.

Washington, D.C. 20224

.02 Questions regarding the application of this revenue procedure to a specific factual situation should be directed to the appropriate District Director's office.

**SECTION 16. PAPERWORK REDUCTION ACT**

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1595.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in this revenue procedure are in sections 8 and 10 of this revenue procedure. This information is required to ensure that machine-sensible records will constitute records within the meaning of section 6001. The collections of information are mandatory for a taxpayer whose machine-sensible records are kept within an ADP system. The likely respondents are individuals, state or local governments, farms, business or other for-profit institutions, federal agencies or employees, nonprofit institutions, and small businesses or organizations.

The estimated total annual recordkeeping burden is 120,000 hours.

The estimated annual burden per recordkeeper will vary from 20 hours to 60 hours, depending on individual circumstances, with an estimated average of 40 hours. The estimated number of recordkeepers is 3,000.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

**Exhibit 2**

**Rev. Proc. 97-22**

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

(Also Part I, Section 6001; 1.6001-1.)

1997-1 C.B. 652; 1997 IRB LEXIS 101; 1997-13 I.R.B. 9; REV. PROC. 97-22

March 31, 1997

[\*1]

**SECTION 1. PURPOSE**

This revenue procedure provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records, or transfers their computerized books and records, to an electronic storage media, such as an optical disk. Records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of § 6001 of the Internal Revenue Code.

**SECTION 2. BACKGROUND**

.01 Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever necessary, the Secretary may require any person, by notice served upon that person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not that person is liable for tax.

.02 Section 1.6001-1(a) of the Income Tax Regulations provides that, except for farmers and wage-earners, any [\*2] person subject to income tax, or any person required to file a return of information with respect to income, must keep such books and records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by that person in any return of such tax or information.

.03 Section 1.6001-1(e) provides that the books or records required by § 6001 must be kept available at all times for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law.

**SECTION 3. SCOPE**

.01 This revenue procedure applies to taxpayers who maintain books and records using an "electronic storage system." An electronic storage system is a system to prepare, record, transfer, index, store, preserve, retrieve, and reproduce books and records by either:

(1) electronically imaging hardcopy documents to an electronic storage media; or

(2) transferring computerized books and records to an electronic storage media using a technique such as "COLD" (computer output to laser disk), which allows books and records to be viewed [\*3] or reproduced without the use of the original program.

.02 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.

.03 A taxpayer's use of a third party (such as a service bureau or time-sharing service) to provide the taxpayer with an electronic storage system for its books and records does not relieve the taxpayer of the responsibilities described in this revenue procedure.

.04 Except as otherwise provided in this revenue procedure, all requirements of § 6001 that apply to hardcopy books and records apply as well to books and records that are stored electronically pursuant to this revenue procedure.

#### **SECTION 4. ELECTRONIC STORAGE SYSTEM REQUIREMENTS**

##### **.01 General Requirements**

(1) An electronic storage system must ensure an accurate and complete transfer of the hardcopy or computerized books and records to an electronic storage media. The electronic storage system must also index, store, preserve, retrieve, and reproduce the electronically stored books and records. [\*4]

(2) An electronic storage system must include:

(a) reasonable controls to ensure the integrity, accuracy, and reliability of the electronic storage system;

(b) reasonable controls to prevent and detect the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of electronically stored books and records;

(c) an inspection and quality assurance program evidenced by regular evaluations of the electronic storage system including periodic checks of electronically stored books and records;

(d) a retrieval system that includes an indexing system (within the meaning of section 4.02 of this revenue procedure); and

(e) the ability to reproduce legible and readable hardcopies (within the meaning of section 4.01(3) of this revenue procedure) of electronically stored books and records.

(3) All books and records reproduced by the electronic storage system must exhibit a high degree of legibility and readability when displayed on a video display terminal and when reproduced in hardcopy. The term "legibility" means the observer must be able to identify all letters and numerals positively and quickly to the exclusion of all other letters or numerals. The term "readability" [\*5] means that the observer must be able to recognize a group of letters or numerals as words or complete numbers. The taxpayer must ensure that the reproduction process maintains the legibility and readability of the electronically stored document.

(4) The information maintained in an electronic storage system must provide support for the taxpayer's books and records (including books and records in an automated data processing system). For example, the information maintained in an electronic storage system and the taxpayer's books and records must be cross-referenced in a manner that provides an audit trail between the general ledger and the source document(s).

(5) For each electronic storage system used, the taxpayer must maintain, and make available to the Service upon request, complete descriptions of:

- (a) the electronic storage system, including all procedures relating to its use; and
- (b) the indexing system (see section 4.02 of this revenue procedure).

(6) At the time of an examination, or for the tests described in section 5 of this revenue procedure, the taxpayer must:

- (a) retrieve and reproduce (including hardcopies if requested) electronically stored books and records; [\*6] and
- (b) provide the Service with the resources (e.g., appropriate hardware and software, personnel, documentation, etc.) necessary to locate, retrieve, read, and reproduce (including hardcopies) any electronically stored books and records.

(7) An electronic storage system must not be subject, in whole or in part, to any agreement (such as a contract or license) that would limit or restrict the Service's access to and use of the electronic storage system on the taxpayer's premises (or any other place where the electronic storage system is maintained), including personnel, hardware, software, files, indexes, and software documentation.

(8) The taxpayer must retain electronically stored books and records so long as their contents may become material in the administration of the Internal Revenue laws under § 1.6001-1(e).

(9) The taxpayer may use more than one electronic storage system. In that event, each electronic storage system must meet the requirements of this revenue procedure. Electronically stored books and records that are contained in an electronic storage system with respect to which the taxpayer ceases to maintain the hardware and the software necessary to satisfy [\*7] the conditions of this revenue procedure will be deemed destroyed by the taxpayer, unless the

electronically stored books and records remain available to the Service in conformity with this revenue procedure.

(10) Taxpayers may use reasonable data compression or formatting technologies as part of their electronic storage system so long as the requirements of this revenue procedure are satisfied.

**.02 Requirements of an Indexing System.**

(1) For purposes of this revenue procedure, an "indexing system" is a system that permits the identification and retrieval for viewing or reproducing of relevant books and records maintained in an electronic storage system. For example, an indexing system might consist of assigning each electronically stored document a unique identification number and maintaining a separate database that contains descriptions of all electronically stored books and records along with their identification numbers. In addition, any system used to maintain, organize, or coordinate multiple electronic storage systems is treated as an indexing system under this revenue procedure. The requirement to maintain an indexing system will be satisfied if the indexing system [\*8] is functionally comparable to a reasonable hardcopy filing system. The requirement to maintain an indexing system does not require that a separate electronically stored books and records description database be maintained if comparable results can be achieved without a separate description database.

(2) Reasonable controls must be undertaken to protect the indexing system against the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of any entries.

**.03 Recommended Practices.** The implementation of records management practices is a business decision that is solely within the discretion of the taxpayer. Records management practices may include the labeling of electronically stored books and records, providing a secure storage environment, creating back-up copies, selecting an off-site storage location, retaining hardcopies of books or records that are illegible or that cannot be accurately or completely transferred to an electronic storage system, and testing to confirm records integrity.

**SECTION 5. DISTRICT DIRECTOR TESTING**

**.01** The District Director may periodically initiate tests of a taxpayer's electronic storage system. These tests may include [\*9] an evaluation (by actual use) of a taxpayer's equipment and software, as well as the procedures used by a taxpayer to prepare, record, transfer, index, store, preserve, retrieve, and reproduce electronically stored documents. In some instances, the District Director may choose to review the internal controls, security procedures, and documentation associated with the taxpayer's electronic storage system.

**.02** The tests described in section 5.01 of this revenue procedure are not an "examination," "investigation," or "inspection" of the books and records within the meaning of § 7605(b), or a prior audit for purposes of § 530 of the Revenue Act of 1978, 1978-3 (Vol.1) C.B. 119, as amended by § 1122 of the Small Business Job Protection Act of 1996, because these tests are not directly related to the determination of the tax liability of a taxpayer for a particular taxable period.

## CHAPTER 4    AUDIT TECHNIQUES FOR ELECTRONIC RECORDS

.03 The District Director must inform the taxpayer of the results of any tests under this section.  
SECTION 6. COMPLIANCE

.01 A taxpayer's electronic storage system that meets the requirements of this revenue procedure will be treated as being in compliance with the recordkeeping requirements of § 6001 and [\*10] the regulations thereunder.

.02 A taxpayer's electronic storage system that fails to meet the requirements of this revenue procedure may be treated as not being in compliance with the recordkeeping requirements of § 6001 and the regulations thereunder. See section 9 of this revenue procedure for applicable penalties. However, even though a taxpayer's electronic storage system fails to meet the requirements of this revenue procedure, the penalties described in section 9 of this revenue procedure may not apply if the taxpayer maintains its original books and records, or maintains its books and records in micrographic form in conformity with *Rev. Proc. 81-46, 1981-2 C.B. 621*.  
SECTION 7. DESTRUCTION AND DELETION OF ORIGINAL BOOKS AND RECORDS

This revenue procedure permits the destruction of the original hardcopy books and records and the deletion of the original computerized records (other than "machine-sensible" records required to be retained by *Rev. Proc. 91-59, 1991-2 C.B. 841*), after the taxpayer:

(1) has completed its own testing of the electronic storage system that establishes that hardcopy [\*11] or computerized books and records are being reproduced in compliance with all the provisions of this revenue procedure; and

(2) has instituted procedures that ensure its continued compliance with all the provisions of this revenue procedure.

### SECTION 8. IMPACT ON MACHINE-SENSIBLE RECORDS

The provisions of this revenue procedure regarding electronically stored books and records do not relieve taxpayers of the responsibility of retaining any other books and records required to be retained under § 6001. Such other books and records may include "machine-sensible" records required to be retained by *Rev. Proc. 91-59* in connection with the taxpayer's use of an automatic data processing (ADP) system.

### SECTION 9. PENALTIES

The District Director may issue a Notice of Inadequate Records pursuant to § 1.6001-1(d) if the taxpayer's books and records are available only as electronically stored books and records and the taxpayer's electronic storage system fails to meet the requirements of this revenue procedure. Taxpayers whose electronic storage system fails to meet the requirements of this revenue procedure may also be subject to applicable penalties [\*12] under subtitle F of the Code, including the § 6662(a) accuracy-related civil penalty and the § 7203 willful failure criminal penalty.

### SECTION 10. INTERNAL REVENUE SERVICE OFFICE CONTACT

.01 Questions regarding this revenue procedure should be directed to the Office of the Assistant Commissioner (Examination). The telephone number for this office is (202)622-5480 (not a toll-free number). Written questions should be addressed to: Assistant Commissioner (Examination)

Attention: CP:EX

Internal Revenue Service

1111 Constitution Ave., N.W.

Washington, D.C. 20224

.02 Questions regarding the application of this revenue procedure to a specific factual situation should be directed to the appropriate District Director.

**SECTION 11. PAPERWORK REDUCTION ACT**

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (*44 U.S.C. 3507*) under control number 1545-1533.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid [\*13] control number.

The collections of information are in sections 4 and 5 of this revenue procedure. This information is required to ensure that records maintained in an electronic storage system will constitute records within the meaning of § 6001. The collections of information are mandatory for a taxpayer who chooses to electronically store its books and records. The likely respondents are individuals, state or local governments, farms, business or other for-profit institutions, federal agencies or employees, nonprofit institutions, and small businesses or organizations.

The estimated total annual recordkeeping burden is 1,000,400 hours.

The estimated annual burden per recordkeeper will vary from 20 hours to 22 hours, depending on individual circumstances, with an estimated average of 20 hours. The estimated number of recordkeepers is 50,000.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by *26 U.S.C. 6103*.

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**CHAPTER 4    AUDIT TECHNIQUES FOR ELECTRONIC RECORDS**

**Exhibit 3**

Form <b>4564</b> (Rev. June 1988)	Department of the Treasury – Internal Revenue Service <b>Information Document Request</b>	Request number <b>27</b>
To: (Name of Taxpayer and Company Division or Branch)		Subject <b>Employee Plans Planning</b>
Tax Years: <b>December 31, 2001</b>		Sain number <b>004</b>
		Submitted to:
Please return Part 2 with listed documents to requester identified below		Dates of previous requests <b>N/A</b>

Description of documents requested

Please provide the following information for

**DATA FILES**

1. Form W-2
2. Form 1099 Series (i.e., all Forms 1099 filed)

**SUPPORTING INFORMATION**

- Copy of Form 6559, Transmitter Report and Summary of Magnetic Media
- Copy of Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically

**MEDIA:**

- 3480 18-track tape cartridge
- 3490e 36-track cartridge
- CD-ROM
- 3 ½ diskette

The record format can be a fixed length flat file in ASCII or EBCDIC.  
Must have a standard label that contains both volume and data set labels.  
Do not use undefined.

Information due by \_\_\_\_\_

From:	Name and title of requester	Employee ID number	Date
	Office location	Telephone number	

Catalog No. 23145K  
Form **4564** (Rev. 6-1988)

**Exhibit 4**

Form <b>4564</b> (Rev. June 1988)	Department of the Treasury – Internal Revenue Service <b>Information Document Request</b>	Request number <b>27</b>
To: <i>(Name of Taxpayer and Company Division or Branch)</i>		Subject <b>Employee Plans Planning</b>
Tax Years: <b>December 31, 2001</b>		Sain number <b>004</b>
		Submitted to:
Please return Part 2 with listed documents to requester identified below		Dates of previous requests  <b>N/A</b>

Description of documents requested

Please provide the following information for

1. The following fields in a sequential file for all employees regardless if they are participating in any of the plans (one file for each calendar year).
  - a. Social Security Number
  - b. Name
  - c. Employee ID, Payroll Number or Record Number
  - d. Job or Business Title
  - e. Type or category of employee (Occupation codes, Job Class, Bargaining Unit)
  - f. Collectively bargained agreement between employee representatives and employer (code)
  - g. Hours worked, full-time or part-time, months of year worked
  - h. Birth Date
  - i. Hire Date
  - j. Rehire Date
  - k. Service Date
  - l. Termination Date
  - m. Termination reason
  - n. Date of plan participation for each plan
  - o. Compensation – Includible Compensation and Gross Compensation
  - p. Section 125 Benefits offered and index key.
  - q. Section 125 Amount per benefit or type for each employee (i.e.;Flexible Spending Agreement, Child Care, Health Care)
  - r. Amount of income deferred by employee (for each type of contribution, actual by plan type)
  - s. Contributions of employer (for each type of contribution)
  - t. Total amount of income deferred by employee in all pension plans in all prior years.
  - u. Total employer contributions to all pension plans in all prior years.
  - v. Deduction information not stated above by employee (Code, Class, and Amounts)

**CHAPTER 4    AUDIT TECHNIQUES FOR ELECTRONIC RECORDS**

**MEDIA:**

- 3480 18-track tape cartridge
- 3490e 36-track cartridge
- CD-ROM
- 3 ½ diskette

The record format can be a fixed length flat file in ASCII or EBCDIC. Must have a standard label that contains both volume and data set labels. Do not use undefined.

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Information due by \_\_\_\_\_

From:	Name and title of requester	Employee ID number	Date
	Office location		Telephone number

Catalog No. 23145K  
Form **4564** (Rev. 6-1988)

## **Exhibit 5**

### **Helpful Hints for Choice Point**

Information regarding Choice Point is available on the SPDER web site. The Choice Point link is on the left.

Info is also available directly at the site. Click the "electronic research" tab, then click the "Choice Point" toolbar.

#### Basic Instructions:

1. Enter the SPDER web site name.
2. Select Choice Point on the left
3. Continue
4. OK
5. Enter User ID and Password
6. I like to use "Info Probe Business - All Immediate Access Databases for a Region or State" and "Nationwide (All available States)" This will give you all the data Choice Point has from every category (i.e. bankruptcy, UCC Filings, Corporations & Limited Partnerships, etc.).
7. Type in your Plan Name
8. Place a check mark in the boxes you would like to search (I check them all, unless there are too many).
9. Process Selected Searches
10. Display Detailed Information
11. Full Report
12. Begin Next Search
13. Etc. - The rest is self-explanatory depending on how in depth you want your search to be.
14. "Close Report"
15. "Log Off"

FYI: I did an SSN search under my own SSN and the following data was listed: Property owned; Drivers at my address; Vehicles at my address; neighbors (two houses) on each side of me; my last address and the current owner of it. That was it. Appears to be state of MN filing data. There were no credit reports, etc.