

[How to limit QuickBooks files with Period Copy: http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html](http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html)

Use of Electronic Accounting Software Records; Frequently Asked Questions and Answers

Here are some frequently asked questions and answers for electronic accounting software records requests and submissions during Small Business/Self-Employed examinations

Q1. Why is the IRS using electronic accounting records instead of continuing to use traditional paper books and records in examinations?

A: Electronic information management has become the standard in the private sector and is now being used to enhance the IRS examination process. Obtaining accounting records in electronic format provides significant advantages:

- Reduces burden because taxpayers and/or representatives don't have to print records provided electronically.
- Provides a complete set of the taxpayer's accounting records, decreasing the number of items included in the initial document request and follow-up requests.
- Increases efficiency of the examiner's analysis and testing of the books and records.

Q2. How and when will the IRS request electronic accounting software records?

A: The IRS will request electronic accounting software backup files using Form 4564, *Information Document Request* (IDR), early in the examination. IRS will also request the administrator's username and password, as they are needed to read most data files.

The backup file should be provided on a CD, DVD, or a flash/jump drive. E-mail must *not* be used to transmit electronic records to or from the IRS, a taxpayer, or their representative, to ensure security.

Q3. What is the IRS doing to address concerns about sharing the accounting software administrator's username and password for the audit?

A: The taxpayer can preserve any favorite password by changing the administrator's password to a temporary one, such as "IRS Audit." Create the backup file for submission and then change the password back to the original "favorite" one within the main accounting software working file.

The temporary password must have administrator access to the backup file provided because the IRS needs to have the same access levels as the administrator. If the examiner does not have the administrative password, he or she will not be able to read the data as needed for the examination.

Q4. What if a taxpayer uses an accounting software program that is not readable by the IRS?

A: At this time, IRS has the ability to accept and read data files from accounting software programs that are used by most business taxpayers. Taxpayers should consult with the examiner before submitting any type of electronic files.

Whenever possible, the IRS will work with the taxpayer and their electronic accounting records to reduce the number of information document requests (IDR's). However if the examiner is unable to read the electronic accounting records, he or she will determine the best course of action to complete the audit in a timely, efficient manner.

Q5. Now that IRS has the ability to accept electronic information from accounting software programs, will backup files be requested in every examination where the taxpayer uses those programs to maintain their books and records?

A: Using electronic records to conduct examinations should make the audit more efficient for everyone. Examiners will be requesting these files in the majority of cases where the taxpayer already uses electronic accounting software to maintain their books and records. However, if the audit is limited in scope, such as auditing one specific expense item, the examiner may determine that requesting the electronic accounting software file may not be necessary. In broader scope audits, such as when verifying gross income, the backup file will likely be requested by the examiner.

The professional judgment of the examiner and his or her manager will be used on a case by case basis to determine whether it is appropriate for a particular examination.

Q6. How will the electronic data be used?

A: Most accounting software programs can generate a large number of pre-set reports. Each report can be modified to fit the examiner's needs. When working with these reports, the examiner can "drill down" to the underlying data and documents to further investigate items, as appropriate.

The software also allows the examiner to test the integrity and veracity of the accounting records in making a determination as to the reliability of the records for examination purposes. However, the examiner may still need to request other documents when such records are necessary to properly test a return item or issue.

Q7. What is the IRS's legal authority for requesting electronic files and other relevant accounting records? How does Revenue Procedure 98-25 impact the IRS' authority to request electronic records from small business taxpayers?

A: The legal authority for requesting accounting records in electronic format is based on [Internal Revenue Code section 7602\(a\)](#), [Internal Revenue Code section 6001](#), [Regulation 1.6001-1\(a\) and -1\(e\)](#) (PDF), Revenue Ruling 71-20 and [Revenue Procedure 98-25](#).

Note that, although Revenue Procedure 98-25 exempts certain taxpayers from the requirements of the Revenue Procedure, this does not create an exemption for any taxpayer from having to produce electronic books and records if they otherwise exist when a business chooses to use an electronic accounting software program to maintain their books and records.

Q8. What if a taxpayer refuses to provide the IRS with an electronic accounting software backup file or any other type of electronic data file?

[How to limit QuickBooks files with Period Copy: http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html](http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html)

[How to limit QuickBooks files with Period Copy: http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html](http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html)

A: Our tax system is set up in such a way that taxpayers fill out their own tax returns and are responsible for maintaining their own books and records.

Under [Internal Revenue Code section 6001](#) and [Regulation 1.6001-1](#) (PDF), taxpayers are responsible for maintaining sufficient books and records to support the income and deductions claimed on their tax returns and for presenting this information to the IRS when requested to do so in an examination.

Further, [section 7602\(a\)\(1\)](#) grants the IRS the authority to examine any books, papers, records or other data that may be relevant or material to a tax examination. [Section 7602\(a\)\(2\)](#) grants the IRS the authority to summons the books and records.

If the taxpayer has concerns with providing a copy of their original accounting software backup file, they have the right to discuss the matter with the examiner's manager.

If a taxpayer declines to submit the requested materials voluntarily, the IRS has the right to summons the information requested, use indirect methods to reconstruct income and/or disallow the items reported for lack of substantiation.

If the taxpayer or the taxpayer's representative has concerns that the records contain sensitive or privileged information, please see Q&As #14 and #15 for guidance.

Q9. What if the taxpayer's representative refuses to provide a copy of the taxpayer's electronic accounting backup file?

A: If the taxpayer's representative chooses to decline to voluntarily submit the requested materials, the IRS has the right to summons the information and the representative could be in violation of [Treasury Department Circular No. 230](#) (PDF).

Subpart B, section 10.20(a)(1), of the [Treasury Department Circular No. 230](#) (PDF) regulations states that "[a] practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged."

If the taxpayer or the taxpayer's representative has concerns that the records contain sensitive or privileged information, please see Q&As #14 and #15 for guidance.

Q10. What if the taxpayer or representative agrees to provide a copy of the taxpayer's company backup file; however, rather than providing an exact copy of the original file they create a new file for the IRS?

A: If the taxpayer or representative creates or reconstructs a new company file, for example, by re-inputting the transactions for only the year under examination, this new file does not satisfy the requirements or needs of the Internal Revenue Service. The new or modified company file is not a copy of the books and records of original entry. The altered electronic file would not meet the requirements of the Information Document Request or a summons and the taxpayer's representative could be in violation of [Treasury Department Circular No. 230](#) (PDF).

If the taxpayer or representative wants to condense old or closed transactions for dates prior to the years under examination, see Q&A #13 for guidance.

Q11. Why should a taxpayer submit an accounting software backup file rather than simply export selected reports to Excel? What are the advantages to using the backup file over Excel?

A: The backup file is an exact copy of the original books of entry and allows the IRS to review and test the integrity of the original electronic records using the software program. This testing cannot adequately be performed on records that have already been converted into Excel spreadsheets. Examiners are required under [IRM 4.10.3.4, Evaluating Taxpayer's Internal Controls](#), and the related subsections, to acquire an understanding of the accounting system for all types of business returns. An integral part of this process is an evaluation of the taxpayer's internal controls. Examiners use the information obtained during this process to determine the appropriate audit techniques to be used during the examination process.

Through tests and analysis of the electronic records in their original format examiners can properly evaluate the accounting system (including internal controls) to consider the reliability of the books and records. This process is not unique to examinations where the electronic accounting records have been requested.

The control structure of an accounting system is often times dependent on the size and nature of the business. Frequently, smaller businesses are not able to establish sophisticated control and accounting processes. This is unlike larger entities where resources are more likely to be available for systems and processes. An examiner will determine the appropriate method(s) for examination based on the accounting system and control structure of the business.

By reviewing an exact copy of the original backup file, the examiner can view transactions to see the date the transaction was originally created, dates of subsequent changes, what changes were made, and the username of the person who entered or changed the transaction. This type of information is directly relevant to the evaluation of the taxpayer's accounting system and internal controls. If the various reports that are needed for the examination are only provided in spreadsheet format, there is a possibility that certain information, including metadata, could be lost or altered, leaving no reliable audit trail to identify these changes.

Q12. The accounting software backup file can contain transactional data for several years that are outside the scope of the audit. What, if anything, will the IRS do with that information?

A: If IRS is given a backup file that includes data for years not under examination, IRS will not utilize that data during the examination of the current year. If based on the results from the current year examination a decision is made to expand the scope of the examination to prior or subsequent years, the taxpayer will be notified. The records may be utilized after that notification.

However, the examiner may review transactions that occurred in the month prior to and the month after the tax year or the tax periods before and after the ones under examination if the transactions in those timeframes are relevant to the examination. Examiners may also review any transactional data created or changed during the tax year under examination.

[How to limit QuickBooks files with Period Copy: http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html](http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html)

[How to limit QuickBooks files with Period Copy: http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html](http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html)

For example, if a business under examination uses the accrual accounting basis, then it will be relevant for the IRS to examine transactions for the month prior to and the month after the tax years under examination to test the cut-off of reported income and expenses. The same is true if a taxpayer creates a transaction to record sales during the year under examination, but the actual transaction is dated in a prior or subsequent year, then the examiner can inquire as to why the taxpayer determined the transaction would not properly be recorded in the year under examination.

As another example, if the IRS was exploring whether to reconstruct income by an indirect method (e.g., bank deposits or net worth method), then certain information for the tax periods immediately preceding and following the year under audit would clearly be relevant.

An inspection of the tax returns which are prior or subsequent to the tax years under audit does not constitute an examination of books and records. Examiners are expected to inspect such tax returns in all examinations, and to compare them to the tax returns that are under examination.

Q13. Can a taxpayer or representative condense or "clean up" the electronic accounting software data file before submission?

A: Many accounting software programs will condense old, closed transactions occurring prior to a manually selected date. For example, the closing of a prior year. Often this is done to reduce the size of the company data file. The process essentially removes the details of those transactions from the data file and replaces them with summary journal entries, allowing monthly financial statements to be created for old years if needed.

The ongoing data file (working file) will no longer have the details of old, closed transactions which occurred prior to the manually selected date. However, during the condensing process, the software creates a backup or archive copy of the company data file and this archive copy provides the original detailed records of each old transaction. If you do not have a complete understanding of your software's condensing feature, please contact your software provider for additional guidance before using it.

Condensed data is not acceptable for the tax year(s) under audit. However, if you choose, the company data file can be condensed (through the clean up or purge feature) for dates **prior** to the year(s) under audit, as long as they do not include transactions created or changed for time periods under audit, or for transactions from prior years that have an effect on the years under audit.

If the scope of an audit is expanded, the IRS may request another backup file that was created prior to the date the company file was condensed or request a copy of the archive file created during the condensing process.

Q14. Accounting software backup files contain sensitive customer, vendor, or other information. Since it is possible that any release of this vital information would damage a business, what assurance does the IRS provide that this information is secure?

A: The security and privacy of information provided by taxpayers is taken very seriously by IRS. [Internal Revenue Code section 6103](#) prohibits the unauthorized disclosure of information obtained during the course of a tax examination (including any sensitive business information). IRS employees receive annual training on protecting taxpayer information from unauthorized disclosure and are reminded that they could face disciplinary action (up to and including removal) for such disclosures. Also [Internal Revenue Code section 7213](#) provides for criminal penalties for willful violations of [section 6103](#).

In addition to the [section 6103](#) restriction on disclosure, IRS has procedures in place for examiners on how to protect portable electronic media containing any taxpayer sensitive information. Once the IRS no longer has a business need for the portable electronic media, examiners can return the data to the taxpayer or dispose of it following internal procedures for destruction of sensitive portable electronic media. In addition, any copies made of the taxpayer's electronic files on the examiner's computer will be deleted once the case has been completely closed.

Q15. What if the accounting software backup file contains privileged information or information that is protected from disclosure by statute?

A: The issue of privileged communications is the same whether IRS is asking for electronic or paper records. [IRM 25.5.5.4.3, Privileged Communications and Summons](#), provides guidance to examiners when a claim of privileged communication is made. Paragraph (2) of the IRM section states, "[p]rivileged communications cannot be obtained by issuing a summons."

The taxpayer is encouraged to discuss with the examiner if the electronic backup file contains privileged communications or information that is protected from disclosure by statute. The examiner may ask an IRS Counsel attorney for assistance, if a taxpayer claims that records contain privileged communication or that a statute, such as the Health Insurance Portability and Accountability Act (HIPAA), prevents him from complying with a request for the records. Generally, a customer list would not be privileged but there may be unusual circumstances in a particular case that could possibly make the information, when combined with other information, privileged.

[How to limit QuickBooks files with Period Copy: http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html](http://kaufmann-cpa.com/FAQ/quickbooks-irs-audit.html)