

Rev. Proc. 98-25

Maintenance of Records Within an Automatic Data Processing System

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 § 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 § 6001 and § 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 § 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 § 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 § 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 § 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 § 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 §§ 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 § 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 § 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 § 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 § 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 § 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 § 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. § 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. § 1234.30(g)(4) (1996) (the NARA sampling standard). However, the taxpayer remains responsible for substantiating the information on its return as required by § 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 § 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 § 7605 (b) of the Code, 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 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 § 7605(b) of the Code, 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.

(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.