

6.4: Record Keeping, Preparation, and Filing

Learning Objectives

1. Identify sources of tax information.
2. Explain the importance of verifiable records and record keeping.
3. Compare sources of tax preparation assistance.
4. Trace the tax review process and its implications.

The Internal Revenue Code (IRC), the federal tax law, is written by the U.S. Congress and enforced by the Internal Revenue Service (IRS), which is a part of the U.S. Department of Treasury. The IRS is responsible for the collection of tax revenues. To collect revenues, the IRS must inform the public of tax obligations and devise data collection systems that will allow for the collection and verification of tax information so that collectible revenues can be verified. In other words, the IRS has to figure out how to inform the public and collect taxes while also collecting enough information to be able to check that those taxes are correct.

To inform the public, the IRS has published over six hundred separate publications covering various aspects of the tax code. There are more than a thousand forms and accompanying instructions to file complete tax information, although most taxpayers actually file about half a dozen forms each year. In addition, the IRS provides [online](#) and telephone support to answer questions and assist in preparing tax filings.

By far, most income taxes from wages are collected through withholding as earned. For most taxpayers, wages represent the primary form of income, and thus most of their tax payments are withheld or paid as wages are earned. Still, everyone has to file to summarize the details of the year's income for the IRS and to calculate the final tax obligation. In 2021, the IRS collected 160,824,340 individual returns representing \$2.1 trillion of tax revenue^[1].

Keeping Records

The individual filer must collect and report the information on tax forms and schedules. Fortunately, this is not as difficult as the volume of data would suggest. Employers are required to send Form W-2 to each employee at the end of the year, detailing the total wages earned and taxes and contributions withheld. If you have earned other kinds of income, your clients, customers, retirement fund, or other source of income may have to file a Form 1099 to report that income to you and to the IRS. Interest and dividend income is also reported by the bank or brokerage firm on Form 1099. The W-2 and the Form 1099 are reported to both the IRS and you.

The system for filing tax information has purposeful redundancies. Where possible, information is collected independently from at least two sources, so it can be verified. For example, your wage data is collected both from you and from your employer, your interest and dividend incomes are reported by both you and the bank or brokerage that paid them, and so on. Those redundancies, wherever practical, allow for a system of cross-references so that the IRS can check the validity of the data it receives.

Incomes may be summarized and reported to you, but only you know your expenses. Expenditures are important if they are allowed as deductions, such as charitable gifts, medical and dental expenses, and so on, so data should be collected throughout the tax year. If you do nothing more than keep a checkbook, then you will have to go through it and identify the deductible expenses for the tax year. Financial software applications will make that task easier; most allow you to flag deductible expenses in your initial setup.

You should also keep receipts of purchases that may be deductible; credit or debit card statements and bank statements provide convenient backup proof of expenditures. Proof is needed in the event the IRS questions the accuracy of your return.

Tax Preparation and Filing

After you have collected the information you need, you fill out the forms. The tax code is based on the idea that citizens should create revenues for the government based on their ability to pay—and the tax forms follow that logic. Most taxpayers need to complete only a few schedules and forms to supplement their Form 1040. Most taxpayers have the same kinds of taxable events, incomes, and deductions year after year and file the same kinds of schedules and forms.

The IRS offers several [electronic filing](#) (e-filing) options, available to filers depending on their specific tax situation. You may prefer to consult a professional tax preparer. Professional help is useful if you have a relatively complicated tax situation: unusual sources of income or expenditures that may be deductible under unusual circumstances. Some taxpayers use a tax preparer simply

to protect against making a mistake and having the error, however, innocent, prove costly to fix. Fees for tax preparers depend on how complex your return is, the number of forms that need to be completed, and the type of professional you consult.

Professional tax preparers may be Enrolled Agents, Certified Public Accountants (CPAs), lawyers, personal financial planners, or tax consultants. You may have an ongoing relationship with your tax preparer who may also be your accountant or financial planner, working with you on other financial decisions. Or, you may consult a tax preparer only on tax issues. You may want your tax preparer to fill out and file the forms for you, or you may be looking for advice about future financial decisions that have tax consequences. Tax preparers may be independent practitioners who work during tax season or employees of a national chain that provides year-round tax services.

Generally, there is no standard certification to be a professional tax preparer. An [enrolled agent](#) is someone who has successfully passed training courses from the IRS or previously worked for the IRS. A CPA has specific training and experience in accounting. When looking for a tax preparer, your lawyer, accountant, or financial planner may be appropriate or may be able to make a recommendation. If your information is fairly straightforward, you may minimize costs by using a preparer who simply does taxes. If your situation involves more complications, especially involving other entities such as businesses or trusts, or unusual circumstances such as a gain, gift, or distribution, you may want to consult a professional with a range of expertise, such as an Enrolled Agent, CPA, or a lawyer who specializes in taxes. Many professionals also offer a “guarantee,” that is, that they will also help you if the information on your return is later questioned by the IRS.

Whether you prepare your tax return by yourself or with a professional, it is you who must sign the return and assume responsibility for its details. You should be sure to review your return with your tax preparer so that you understand and can explain any of the information found on it. You should question anything that you cannot understand or that seems contrary to your original information. You should also know your tax return because understanding how and why tax obligations are created or avoided can help you plan for tax consequences in future financial decisions.

Tax Preparation and Filing Software Applications

You may choose to prepare the return yourself using a tax preparation software application. There are many available, and several are compatible with personal financial software applications, enabling you to download or transfer data from your financial software directly into the tax software. Software applications are usually designed as a series of questions that guide you through Form 1040 and the supplemental schedules, filling in the data from your answers. Once you have been through the “questionnaire,” it tells you the forms it has completed for you, and you can file them electronically with the IRS. Most programs also allow you to enter data into the individual forms directly.

Many tax preparation software packages are available, and many are reviewed in the business press or online. Start with an internet search for “free tax filing” or “free tax software” and compare the results to your personal goals and needs.

If the IRS free online filing option does not work for you, you have many other choices. There are many tax preparation software packages available, and many are reviewed in the business press or online. Some popular programs include TurboTax, TaxSlayer, and FreeTaxUSA, but there are others. Compare features and reviews before selecting a tool.

These tools can be useful in that they automatically calculate unusual circumstances, limitations, or exceptions to rules using your complete data. Some programs even prompt you for additional information based on the data you submit. Overlooking exceptions is a common error that software programs can help you avoid. The programs have all the forms and schedules, but if you choose to file hard copy versions, you can download them directly from the IRS website, or you can call the IRS and request that they be sent to you. Once your return is completed, you must file it with the IRS, either by mail or by e-file, which has become increasingly popular.

Following Up

After you file your tax return it will be processed and reviewed by the IRS. If you are owed a refund, it will be sent; if you paid a payment, it will be deposited. The IRS reviews returns for accuracy, based on redundant reporting and its “sense” of your data. For example, the IRS may investigate any discrepancies between the wages you report and the wages your employer reports. As another example, if your total wages are \$23,000 and you show a charitable contribution of \$20,000, that contribution seems too high for your income—although there may be an explanation.

The IRS may follow up by mail or by a personal interview. It may just ask for verification of one or two items, or it may conduct a full **audit**—a thorough financial examination of your return. In any case, you will be asked to produce records or receipts that will

verify your reported data. Therefore, it is important to save a copy of your return and the records and receipts that you used to prepare it. The IRS has the following recommendations for the number of years to save your tax data:

1. If you owe additional tax and situations 2, 3, and 4 below do not apply to you, keep records for three years.
2. If you do not report income that you should report, and it is more than 25 percent of the gross income shown on your return, keep records for six years.
3. If you file a fraudulent return, keep records indefinitely.
4. If you do not file a return, keep records indefinitely.
5. If you file a claim for credit or refund after you file your return, keep records for three years from the date you filed your original return or two years from the date you paid the tax, whichever is later.
6. If you file a claim for a loss from worthless securities or bad debt deduction, keep records for seven years.
7. Keep all employment tax records for at least four years after the date that the tax becomes due or is paid, whichever is later.

If you have a personal interview, your tax preparer may accompany you to help explain and verify your return. Ultimately, however, you are responsible for it. If you have made errors, and if those errors result in a larger tax obligation (if you owe more), you may have to pay penalties and interest in addition to the tax you owe. You may be able to negotiate a payment schedule with the IRS.

The IRS randomly chooses a certain number of returns each year for review and possible audit even where no discrepancies or unusual items are noticed. The threat of a random audit may deter taxpayers from cheating or taking shortcuts on their tax returns. Computerized record keeping has made it easier for both taxpayers and the IRS to collect, report, and verify tax data.

Filing Strategies

Most citizens recognize the need to contribute to the government's revenues but want to avoid paying more than they need to. **Tax avoidance** is the practice of ensuring that you have no excess tax obligations. Strategies for minimizing or avoiding tax obligations are perfectly legal. However, **tax evasion**—fraudulently reporting tax obligations, for example, by understating incomes and gains or overstating expenses and losses—is illegal.

Timing can affect the value of taxable incomes or deductible expenses. If you anticipate a significant increase in income—and therefore in your tax rate—in the next tax year, you may try to defer a deductible expense. When you have more income and it is taxed at a higher rate, a deductible expense may be worth more as tax savings to offset your income. For example, if your tax rate is 20 percent and your deductible expense of \$100 saves you from paying taxes on \$100, then it saves you \$20 in taxes. If your tax rate is 35 percent, that same \$100 deductible saves you \$35. Likewise, if you anticipate a decrease in income that will decrease your tax rate, you may want to defer receipt of income until the next year when it will be taxed at a lower rate. In addition, some kinds of incomes are taxed at different rates than others, so how your income is created may bear on how much tax it creates.

The definition of expenses and the way you claim them can affect the tax they save. You may be able to deduct more expenses if you itemize your deductions than if you do not, or it may not make a difference. Also, there is some discretion in classifying expenses. For example, suppose you are a high school Spanish teacher. You also tutor students privately. You buy Spanish books to improve your own language skills and to keep current with the published literature. Are the costs of those books an unreimbursed employee expense related to your job as a teacher, or are they an expense of your private tutoring business? If it is a cost of your tutoring business, you may be able to fully expense it from your business income.

An income that is not taxed or taxed at a lower rate is more valuable than an income that is taxed or taxed at a higher rate. An expense that is fully deductible is more valuable than an expense that is not. Taxes deferred—by delaying income or accelerating expense—create more liquidity and thus more value. However, taxable income is still income, and a deductible expense is still an expense. Tax consequences should not obscure the benefits of enjoying income and the costs of incurring expenses.

There are many ideas about how to avoid an audit or what will trigger one: certain kinds of income or expenses, or filing earlier or later, for example. In truth, with the increased sophistication of computerization, the review process is much better at noticing real discrepancies and at choosing audits randomly. Time and effort (and cost) invested in outsmarting a possible audit is usually wasted. The best protection against a possible audit is to have verification—a receipt, a bill or a canceled check—for all the incomes and expenses that you report.

Summary

- Tax code information is available from the Internal Revenue Service.
- Verifiable records must be kept for all taxable incomes and expenses or other taxable events and activities.
- Professional tax assistance and tax preparation software are readily available.
- The Internal Revenue Service reviews tax returns for errors and may follow up through an informal or formal audit process.
- Tax avoidance is the legal practice of minimizing tax obligations.
- Tax evasion is the illegal process of fraudulently presenting information used in calculating tax obligations.
- Tax avoidance strategies can involve the timing of incomes and/or expenses to take advantage of changing tax circumstances.

? Exercises

1. Read the article [Policy Basics: Where Do Our Federal Tax Dollars Go](#). In 2023, what were the federal government's three largest expenditures of tax dollars?
2. According to the IRS.gov article [How to choose a tax return preparer](#), when should you look for a professional tax preparation service provider, and what fees should you avoid paying?
3. Gather a current sample of the kind of records you will use to calculate your tax liability this year and to verify your tax return. List each type of record and identify exactly what information it will give you, your tax preparer, and the IRS about your tax situation. What additional records will you need that are not yet in your possession?
4. Do searches online to compare and contrast tax preparation software. What are the chief differences among the top three or four programs? Also, check out the [IRS Free File program](#). Would you qualify for Free File?
5. Use your spreadsheet program to develop a document showing monthly cash flows for income and expenses to date for which you have written records. If you continue to develop this document for the remaining months, how will it help you prepare your tax returns?
6. Research how can you reduce your tax liability and/or avoid paying taxes when you file this year. Work with classmates to develop a tip sheet for students on tax avoidance.

[1] IRS, "SOI Tax Stats - Individual Statistical Tables by Filing Status", Tax Year 2021, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-filing-status#_grp3

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