STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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June 5, 2015

Dear Interested Party:

Enclosed is the Initial Discussion Paper on Regulation 1698, *Records*. Before the issue is presented at the Board's October 27, 2015 Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

June 17, 2015
Room 122 at 10:00 a.m.
450 N Street, Sacramento, CA

If you would like to participate by teleconference, call 1-888-808-6929 and enter access code 7495412. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Susanne.Buehler@boe.ca.gov by July 1, 2015. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to our webpage at (http://www.boe.ca.gov/meetings/btcommittee.htm) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. We look forward to your comments and suggestions. Should you have any questions, please feel free to contact our Business Taxes Committee staff member Ms. Tracy McCrite at 1-916-323-0536, who will be leading the meeting.

Sincerely,

Susanne Buehler

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB:tmc

Enclosures

cc: (all with enclosures)
Honorable Jerome E. Horton, Chairman, Third District
Senator George Runner (Ret.), Member, First District (MIC 71)
Honorable Fiona Ma, Member, Second District (via email)
Honorable Diane L. Harkey, Member, Fourth District (via email)
Honorable Betty T. Yee, State Controller

(via email)
Mr. David Hunter, Board Member’s Office, Third District
Ms. Shellie Hughes, Board Member’s Office, Third District
Mr. Sean Wallentine, Board Member’s Office, First District
Mr. Lee Williams, Board Member’s Office, First District
Mr. Alan Giorgi, Board Member’s Office, First District
Mr. Brian Wiggins, Board Member's Office, First District
Mr. James C. Kuhl, Board Member's Office, Second District
Ms. Kathryn Asprey, Board Member's Office, Second District
Mr. John Vigna, Board Member's Office, Second District
Mr. Tim Morland, Board Member's Office, Second District
Mr. Russell Lowery, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member’s Office, Fourth District
Mr. Clifford Oakes, Board Member's Office, Fourth District
Ms. Lynne Kinst, Board Member's Office, Fourth District
Ms. Cynthia Bridges (MIC 73)
Mr. Randy Ferris (MIC 83)
Mr. David Gau (MIC 101)
Mr. Jeffrey L. McGuire (MIC 43)
Mr. Todd Gilman (MIC 70)
Mr. Robert Tucker (MIC 82)
Mr. Mark Durham (MIC 67)
Mr. Jeff Vest (MIC 85)
Mr. Wayne Mashihara (MIC 46)
Mr. Kevin Hanks (MIC 49)
Mr. John Thiella (MIC 73)
Mr. Bradley Heller (MIC 82)
Mr. Lawrence Mendel (MIC 82)
Mr. Jeff Angeja (MIC 85)
Mr. David Levine (MIC 85)
Ms. Pam Mash (MIC 82)
Ms. Kirsten Stark (MIC 50)
Mr. Bill Benson (MIC 67)
Mr. Marc Alviso (MIC 101)
Mr. Chris Lee (MIC 101)
Mr. Bradley Miller (MIC 92)
Ms. Karina Aguilar (MIC 46)
Ms. Laureen Simpson (MIC 70)
Mr. Robert Wilke (MIC 50)
Ms. Tracy McCrite (MIC 50)

INITIAL DISCUSSION PAPER

Regulation 1698, *Records*

Issue

Whether the Board should amend Regulation 1698, *Records,* to include and define electronic cash registers, computerized point of sale systems, and electronic records.

Background

Currently, there are two statutes related to the retention and examination of records. Revenue and Taxation Code (RTC) section 7053, *Records,* provides that every seller, every retailer as defined in subdivision (b) of section 6015, and every person storing, using, or otherwise consuming in this State tangible personal property purchased from a retailer shall keep such records, receipts, invoices, and other pertinent papers in such form as the board may require.

RTC section 7054, *Examination of Records,* specifies that the board or any person authorized in writing by it may examine the books, papers, records, and equipment of any person selling tangible personal property and any person liable for the use tax. It further specifies that the board may investigate the character of the business of the person in order to verify the accuracy of any return made, or, if no return is made by the person, to ascertain and determine the amount required to be paid.

Regulation 1698, *Records,* implements and makes specific RTC sections 7053 and 7054 with regards to the types of records that must be maintained. The regulation prescribes the allowable format of the records and the records retention requirements.

Discussion of Electronic Cash Registers

Cash registers have existed for many years offering business owners an organized place to ring up sales and store money for the sales transactions. An electronic cash register includes a wide range of devices. Generally, an electronic cash register is a device that keeps a register or supporting documents through the means of an electronic device or computer system designed to record transaction data for the purpose of computing, compiling, or processing retail sales transaction data in whatever manner. This can include integrated point of sale (POS) systems.

POS systems are sophisticated computer systems that use commercially available operating systems (OS) to record each sale when it happens. POS systems have grown in popularity for business owners over traditional cash registers because of their user-friendly interface, data tracking capabilities, and increased affordability. These systems can be integrated with third-party accounting software, online ordering, and credit and debit card processors.

As new technologies and business practices emerge, the Board of Equalization must adapt to the new processes and keep taxpayers informed with guidance relevant to the industry. Regulation 1698 currently does not define electronic cash registers or POS systems. As explained below, staff proposes clarifying Regulation 1698 by adding a definition of such systems, including an example of record retention, clarifying terms, and making format changes.

INITIAL DISCUSSION PAPER

Regulation 1698, *Records*

Definitions
A definition for “electronic cash register” has been added to subdivision (a) of Regulation 1698. The definitions in the regulation are in alphabetical order, therefore “Electronic cash register” was inserted as subdivision (a)(2), and the remaining definitions were renumbered. The definition explains that these devices may include basic electronic cash registers and integrated POS systems.

Record Retention
Subdivision (i) explains that records must be kept for a period of not less than four years. Staff added an example to this subdivision explaining that if the taxpayer’s electronic cash register periodically overwrites stored data, the taxpayer should maintain a copy of any and all records for the specified period as required for record retention. For example, if a taxpayer has a POS system that resets every year, they should save copies of each prior year's data, for all periods that record retention statutes require.

Other Amendments
Staff proposes to update the term "Machine-Sensible Records" to "Electronic Records" throughout the regulation. Staff believes that “machine-sensible records” is an outdated term and that “electronic records” is a readily understood term.

Staff also proposes to change the formatting of the regulation in subdivision (c)(2)(A) where it provides examples of what retained records should contain when a taxpayer uses electronic data interchange. The proposed amendments format the examples to a numbered list for easier reading and consistent formatting with other subdivisions in the regulation.

Summary

Staff welcomes any comments, suggestions, and input from interested parties on this issue. Staff invites interested parties to participate in the June 17, 2015, interested parties meeting. The deadline for interested parties to provide written responses regarding this discussion paper is July 1, 2015.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 06/05/2015

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REGULATION 1698. RECORDS.

Reference: Sections 6455, 7053, and 7054, Revenue and Taxation Code.

(a) DEFINITIONS.

(1) "Database Management System"—a software system that controls, relates, retrieves, and provides accessibility to data stored in a database.

(2) "Electronic cash register"—means a device that keeps a register or supporting documents through the means of an electronic device or computer system designed to record transaction data for the purpose of computing, compiling, or processing retail sales transaction data in whatever manner. This can include integrated point of sale systems.

(~~2~~3) "Electronic data interchange" or "EDI technology"—the computer to computer exchange of business transactions in a standardized structured electronic format.

~~(3) "Hardcopy"—any document, record, report or other data maintained in a paper format.~~

(4) "~~Machine sensible~~Electronic records"—a collection of related information in an electronic, machine-sensible format. ~~Machine-sensible~~Electronic records do not include hardcopy records that are created or recorded on paper or stored in or by a storage-only imaging system such as microfilm or microfiche. Electronic records include records recorded and maintained by electronic cash registers.

(5) "Hardcopy"—any document, record, report or other data maintained in a paper format.

(~~5~~6) "Taxpayer"—every seller or retailer of tangible personal property in this state and every person storing, using or otherwise consuming in this state tangible personal property purchased from a retailer, and every lessor and lessee of tangible personal property for use in this state.

(b) GENERAL.

(1) A taxpayer shall maintain and make available for examination on request by the Board or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the sales and use tax return. Such records include but are not limited to:

(A) Normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question.

(B) Bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account.

(C) Schedules or working papers used in connection with the preparation of tax returns.

(2) ~~Machine-sensible~~Electronic records are considered records under Revenue and Taxation Code sections 7053 and 7054.

(c) ~~MACHINE-SENSIBLE~~ELECTRONIC RECORDS.

(1) GENERAL.

(A) ~~Machine-sensible~~Electronic records used to establish tax compliance shall contain sufficient source document (transaction-level) information so that the details underlying the ~~machine-sensible~~electronic records can be identified and made available to the Board upon request. A taxpayer has discretion to discard duplicated records and redundant information provided the integrity of the audit trail is preserved and the responsibilities under this regulation are met.

(B) At the time of an examination, the retained records must be capable of being retrieved and converted to a standard magnetic record format e.g., Extended Binary Coded Decimal Interchange Code (EBCDIC) or American Standard Code for Information Interchange (ASCII) flat file.

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

(2) ELECTRONIC DATA INTERCHANGE REQUIREMENTS.

(A) Where a taxpayer uses electronic data interchange (EDI) processes and technology, the level of record detail, in combination with other records related to the transactions, must be equivalent to that contained in an acceptable paper record. For example, the retained records should contain such information as:

1. vendor name,

2. invoice date,

3. product description,

4. quantity purchased,

5. price,

6. amount of tax,

7. indication of tax status (e.g., for resale), and

8. shipping detail.

Codes may be used to identify some or all of the data elements, provided the taxpayer maintains a method which allows the Board to interpret the coded information.

(B) The taxpayer may capture the information necessary to satisfy subdivision (c)(2)(A) at any level within the accounting system and need not retain the original EDI transaction records provided the audit trail, authenticity, and integrity of the retained records can be established. For example, a taxpayer using

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 to retain the EDI transactions themselves. Since neither the EDI transaction nor the accounts payable system capture information from the invoice pertaining to product description and vendor name (i.e., they contain only codes for that information), the taxpayer must also retain other records, such as its vendor master file and product code description lists, and make them available to the Board. In this example, the taxpayer need not retain its EDI transaction for tax purposes.

(3) ELECTRONIC DATA PROCESSING SYSTEMS REQUIREMENTS.
The requirements for an electronic data processing (EDP) accounting system should be similar to that of a manual accounting system, in that an adequately designed accounting system should incorporate methods and records that will satisfy the requirements of this regulation.

(4) BUSINESS PROCESS INFORMATION.

(A) Upon request of the Board, the taxpayer shall provide a description of the business process that created the retained records. Such description shall include the relationship between the records and the tax documents prepared by the taxpayer and the measures employed to ensure the integrity of the records.

(B) The taxpayer shall be capable of demonstrating:

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, and;

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

(C) The following specific documentation is required for ~~machine-sensible~~electronic records retained pursuant to this regulation:

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); and

4. detailed charts of accounts and account descriptions.

(d) ~~MACHINE-SENSIBLE~~ELECTRONIC RECORDS MAINTENANCE REQUIREMENTS.

(1) The taxpayer's computer hardware or software shall accommodate the extraction and conversion of retained electronic~~machine-sensible~~ records to a standard magnetic record format as provided in subdivision (c)(1)(B).

(2) The Board recommends but does not require that taxpayers refer to the National Archives and Record Administration's (NARA) standards for guidance on the maintenance and storage of electronic records, such as the labeling of records, the location and security of the storage environment, the creation of back-up copies, and the use of periodic testing to confirm the continued integrity of the records.

(e) ACCESS TO ~~MACHINE-SENSIBLE~~ELECTRONIC RECORDS.

(1) The manner in which the Board is provided access to ~~machine-sensible~~electronic records may be satisfied through a variety of means that shall take into account a taxpayer's facts and circumstances through consultation with the taxpayer.

(2) Such access will be provided in one or more the following manners:

(A) The taxpayer may arrange to provide the Board with the hardware, software, and personnel resources to access the ~~machine-sensible~~electronic records.

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

(C) The taxpayer may convert the ~~machine-sensible~~electronic records to a standard record format specified by the Board, including copies of files, on a magnetic medium that is agreed to by the Board.

(D) The taxpayer and the Board may agree on other means of providing access to the ~~machine-sensible~~electronic records.

(f) TAXPAYER RESPONSIBILITY AND DISCRETIONARY AUTHORITY.

(1) In conjunction with meeting the requirements of subdivision (c), a taxpayer may create files solely for the use of the Board. For example, if a data base management system is used, it is consistent with this regulation for the taxpayer to create and retain a file that contains the transaction-level detail from the data base management system and that meets the requirements of subdivision (c). The taxpayer should document the process that created the separate file to show the relationship between that file and the original records.

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

(g) HARDCOPY RECORDS.

(1) Except as specifically provided, taxpayers are not relieved of the responsibility to retain hardcopy records that are created or received in the ordinary course of business as required by existing law and regulations. Hardcopy records may be retained on a record keeping medium as provided in subdivision (h).

(2) If hardcopy transaction level documents are not produced or received in the ordinary course of transacting business (e.g., when the taxpayer uses electronic data interchange technology), such hardcopy records need not be created.

(3) Hardcopy records generated at the time of a transaction using a credit or debit card must be retained unless all the details necessary to determine correct tax liability relating to the transaction are subsequently received and retained by the taxpayer in accordance with this regulation. Such details include those listed in subdivision (c)(2)(A).

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

(h) ALTERNATIVE STORAGE MEDIA.

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

(2) Storage-only imaging media such as microfilm and microfiche systems shall meet the following requirements.

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

(B) Procedures must be established for the effective identification, processing, storage, and preservation of the stored documents and for making them available for the period they are required to be retained under subdivision (i).

(C) Upon request by the Board, a taxpayer must provide facilities and equipment for reading, locating, and reproducing any documents maintained on storage-only imaging media.

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

(E) All data on storage-only imaging media must be maintained and arranged in a manner that permits the location of any particular record.

(F) There is no substantial evidence that the storage-only imaging medium lacks authenticity or integrity.

(i) RECORD RETENTION—TIME PERIOD. All records required to be retained under this regulation must be preserved for a period of not less than four years unless the State Board of Equalization authorizes in writing their destruction within a lesser period.

For reporting periods beginning before January 1, 2003 that are subject to the extended ten-year statute of limitations contained in Revenue and Taxation Code section 7073(d), records required to be retained under this regulation must be preserved for a period of not less than ten years.

<u>For example, if you have a point of sale system that overwrites data after a period of time less than four years, you should transfer, maintain, and have available, all data that would have been overwritten or otherwise removed from the system for the required time periods indicated above.</u>

(j) RECORD RETENTION LIMITATION AGREEMENTS.

(1) The Board has the authority to enter into or revoke a record retention limitation agreement with the taxpayer to modify or waive any of the specific requirements in this regulation. A taxpayer's request for an agreement must specify which records (if any) the taxpayer proposes not to retain and provide the reasons for not retaining such records, as well as, proposing any other terms of the requested agreement. The taxpayer shall remain subject to all requirements of this regulation that are not modified, waived, or superseded by a duly approved record retention limitation agreement.

(A) If a taxpayer seeks to limit its retention of electronic~~machine-sensible~~ records, the taxpayer may request a record retention limitation agreement, which shall;

1. document understandings reached with the Board, which may include, but is not limited to, any one or more of the following issues:

a. the conversion of files created on an obsolete computer system;

b. restoration of lost or damaged files and the actions to be taken;

c. use of taxpayer computer resources, and

2. specifically identify which of the taxpayer's records the Board determines are not necessary for retention and which the taxpayer may discard, and

3. authorize variances, if any, from the normal provisions of this regulation.

(B) The Board shall consider a taxpayer's request for a record retention limitation agreement and notify the taxpayer of the actions to be taken.

(C) The Board's decision to enter or not to enter into a record retention limitation agreement shall not relieve the taxpayer of the responsibility to keep adequate and complete records supporting entries shown on any tax or information return.

(2) A taxpayer's record retention practices shall be subject to evaluation by the Board when a record retention limitation agreement exists. The evaluation may include a review of the taxpayer's relevant data processing and accounting systems with respect to EDP systems, including systems using EDI technology.

(A) The Board shall notify the taxpayer of the results of any evaluation, including acceptance or disapproval of any proposals made by the taxpayer (e.g., to discard certain records) or any changes considered necessary to bring the taxpayer's practices into compliance with this regulation.

(B) Since the evaluation of a taxpayer's record retention practices is not directly related to the determination of tax reporting accuracy for a particular period or return, an evaluation made under this regulation is not an "examination of records" under section 7054 of the Revenue and Taxation Code.

(C) Unless otherwise specified, an agreement shall not apply to accounting and tax systems added subsequent to the completion of the record evaluation. All ~~machine-sensible~~electronic records produced by a subsequently added accounting or tax system shall be retained by the taxpayer in accordance with this regulation until a new evaluation is conducted by the Board.

(D) Unless otherwise specified, an agreement made under this subdivision shall not apply to any person, company, corporation, or organization that, subsequent to the taxpayer's signing of a record retention limitation agreement, acquires or is acquired by the taxpayer. All ~~machine-sensible~~electronic records produced by the acquired or the acquiring person, company, corporation, or organization, shall be retained pursuant to this regulation.

(3) In addition to the record retention evaluation under subdivision (j)(2), the Board may conduct tests to establish the authenticity, readability, completeness, and integrity of the ~~machine-sensible~~electronic records retained under a record retention limitation agreement. The state shall notify the taxpayer of the results of such tests. These tests may include the testing of EDI and other procedures and a review of the internal controls and security procedures associated with the creation and storage of the records.

(k) FAILURE TO MAINTAIN RECORDS.

Failure to maintain and keep complete and accurate records will be considered evidence of negligence or intent to evade the tax and may result in penalties or other appropriate administrative action.