



Schedule C and Record Reconstruction Training

Scenario 1 - No Expenses

Client, Dana, comes in to have her tax return prepared. She tells you:

- She has a babysitting business.
- She has two children ages 8 and 10.
- She wants to claim the EITC.
- She also tells you that she earned \$14,000 from babysitting, but that she has no expenses.

What due diligence issues are present in this scenario?

In this example, the information provided by the taxpayer appears to be both inconsistent and incomplete, because it is unlikely that someone who operates this type of business:

1. Has no business expenses. Most businesses have expenses, even if it is just a few dollars here and there.
2. Has annual gross receipts from the business that are an exact round dollar amount, and that amount maximizes EITC.

To meet your EITC due diligence requirements you need to ask more questions of the client to determine if she did incur allowable business expenses and that the income, she reported is correct.

The tax code requires the taxpayer report all the income and allowable expenses to determine their correct net profit from self-employment. If a taxpayer has no or minimal records of income and expenses, you may be able to guide your client through a reconstruction of business income and expenses. If your client has some basic information, it may be enough to recreate their income and expenses. The reconstruction process can be an opportunity for you to educate your client on recordkeeping. If Dana works out of her own home, it would be reasonable to pose the additional questions.

What steps must you take to comply with due diligence?

Before you decide to prepare Dana's return you must first:

1. Make additional reasonable inquiries regarding the taxpayer's business to determine whether the information regarding both income and expenses is substantially correct. Ask your client applicable questions and document her responses.
2. Explain that the IRS requires all income and allowable expenses be reported on the tax return.
3. Advise your client that if the IRS or other agency examines the tax return, she will have to provide support for the income and expenses claimed on the return.
4. You may guide your client through a reconstruction process to arrive at a substantially correct net profit from the business.

Asking the following questions and documenting your client's reasonable answers should provide you with enough information to make a reasonable reconstruction of her records and satisfy your due diligence requirements.

What additional inquiries might you make?

- How did you compute your income? What types of records, if any, do you keep?
- How many children do you care for? Full-time, part-time?
- How much do you charge for full-time and part-time care?
- Do you keep a calendar or schedule of the children present each day?
- Does the business require any licenses or permit? If so, do you have one?
- Did you watch the children in your own home or your daycare facility or in the client's home?
 - If Dana answers that she cares for the children in the client's home, it may be reasonable to assume she had no expenses after all.
 - If Dana answers that she watches the children in her home or her facility, you should follow-up with additional questions regarding common business expenses for individuals who provide childcare services in their home.
- Do you purchase food, diapers, toys, supplies, or other items necessary for the business?
 - If Dana answers no, you should consider the reasonableness of this response.
 - If Dana answers yes, you should follow-up with additional questions to help her establish the amount of her expenses. You can guide her through the reconstruction process or simply offer tips and ask her to return when she is complete.
 - Are the supplies always the same? Where are they purchased? How often are they purchased? How much are they?
 - Do you have any receipts for food, diapers, toys, supplies, etc. that you purchased for the babysitting business?

As part of business expenses, you may need to establish whether she is entitled to claim a portion of her house for business use.

- Were there specific rooms in your home used primarily for childcare?

- You may need to work with Dana to establish if any portion of her home expenses may be claimed as a business expense.

Record Reconstruction Techniques

Based on your client's answers, you could:

1. Use the calendar or schedule kept by the client to verify the number of children cared for.
2. Multiply the number of children by the charged rate to determine if the income figure appears correct.
3. Use a sample of grocery store receipts that Dana has or can produce from third party sources, or cancelled checks, credit card statements, etc. along with her testimony of how often she buys these items to calculate a reasonable estimate of expenses incurred.
4. Determine if Dana should be claiming expenses for business use of her home. If so, IRS Publication 587 should be reviewed, and additional information will be needed to make that computation.