



Schedule C and Record Reconstruction Training

Scenario 2 - False Business Income

Client, Linda, comes into your office to have her tax return prepared. She tells you:

- She has three children (ages 4, 6, and 8) that live with her and for whom she provides support.
- She is not listing any childcare expenses.
- She has a hairdressing business which had gross receipts of \$11,000.
- The business is cash basis and there are no 1099's documenting the gross receipts.
- She has no expenses listed for the hairdressing business.

What due diligence issues are present in this scenario?

In this example, the information regarding the client's business appears incomplete. It is also inconsistent with the normal income and expense profile of this type of business. These inconsistencies could include:

- Cash businesses don't generally have round numbers for gross receipts and that the amount of gross receipts maximizes EITC.
- A legitimate business almost always has some expenses.
- A legitimate hairdresser would have a license.
- This type of business will generally have operating expenses such as equipment, supplies and advertising expenses.
- Those who are working during the day usually need assistance in caring for their children.
- There is no information on the children's other biological parent and his involvement.

Further inquiries may be needed to determine if there are reasonable explanations for these inconsistencies.

What steps must you take to comply with due diligence?

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

1. Make additional reasonable inquiries to determine if the business is real. 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.
5. Make the appropriate inquiries to make sure that the client is entitled to claim the three children.

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?

Do you have any of the normal information or documentation that may be required to prove the business is operational?

- Do you have a license since one is required?
- Are you listed in the yellow pages?
- Do you have business cards?
- How do your customers find out about you?

The numbers listed here on the Schedule C are rounded and probably do not reflect actual business accounting numbers.

- How did you compute your income? Do you have records to support this figure?
- What kind of services do you offer?
- How much do you charge for each service?
- Do you keep an appointment calendar or schedule each day?
- Do you have a license?

Businesses almost always have expenses. Please explain why there are no expenses.

If there are expenses, they can be reconstructed using appropriate techniques and recorded on the Schedule C.

Do you purchase hair dryers, combs, brushes, dyes, sprays, supplies, or other items necessary for the business?

- If the client 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 of 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 the supplies that you purchased for the business?

Is there anyone else who lives in the home who is NOT listed on the tax return?

Do you have any other sources of support? Please list.

You did not list any dependent care expenses. Who cared for the child while you worked?

There is no information on the children's other biological parent(s). Please explain the extent of the other parent(s) involvement?