



Schedule C and Record Reconstruction Training

Scenario 3 - Overstated Expenses

Charlie comes in to have his return prepared. He tells you:

- He has a construction\remodeling business with \$50,000 in gross income
- He is single with two children ages 7 and 9
- He wants to claim the EITC
- He has detailed records of his income and Forms 1099-MISC he received.
- He has the following list of expenses

Expense Type	Expense Amount
Advertising	60
Contract labor	7,200
Insurance	150
Interest	2,025

Expense Type	Expense Amount
Legal & professional	250
Office expense	75
Machine rent	750
Repairs	1,975
Supplies	2,972
Taxes	4,222
Meals & entertainment	1,427
Utilities	3,012
Mileage of 25,721 total miles and 7,554 commuting miles	

What due diligence issues are present in this scenario?

In this example, the information provided by the taxpayer appears complete, but the accuracy of the list cannot be determined without asking questions. Potential issues may include:

- Although the client presents detailed income records, he has only a list of the expenses.
- These expenses are such that they will reduce his income and maximize the amount of EITC.
- The client is not knowledgeable in the tax law; you need to ask more questions of the client to determine if the expenses listed are ordinary and necessary business expenses.
- Meals and entertainment require specific documentation that he may not understand.
- Whether the children are qualifying children for Charlie.

The tax code requires the taxpayer to report all the income and allowable expenses to determine their correct net profit from self-employment.

What steps must you take to comply with due diligence?

Before you decide to prepare Charlie's return, first:

1. You must make additional reasonable inquiries regarding the taxpayer's business to determine whether the information regarding both income and expenses is correct. Ask your client applicable questions and document his responses.
2. You should make additional inquiries to determine if the expenses claimed are allowable business expense and that he has documentation to back up the amount claimed.
3. Explain that the IRS requires all income and only allowable expenses be reported on the tax return.
4. Advise your client that if the IRS or other agency examines the tax return, he will have to provide support for the income and expenses claimed on the return.

Asking the following questions, and documenting your client's reasonable answers should provide you with enough information to prepare a correct Schedule C and satisfy your due diligence requirements

What additional inquiries might you make?

Are there any personal expenses included in the expenses on this list?

- If Charlie answers no, a reasonable follow up procedure would be to ask for details on how he made sure personal expenses were not included in his expense list- does he have separate bank accounts, checkbooks, credit cards for the business.
- If Charlie answers yes, you should ask for the details behind the expense listing and determine what is and is not deductible.

Do you carry a balance on credit cards used for business purchases?

- If Charlie answers yes, you should follow-up with additional questions to determine if the interest expense includes only interest related to business expenses.

Does the \$1,975 of repairs include any expenses related to the vehicle you use for business?

- If Charlie answers yes, you should ask for a detailed list of the expenses. Since vehicle expense is being deducted using a mileage method, including the vehicle repair expense is overstating the cost to repair the vehicle.

Are any personal expenses included in supplies?

- If Charlie answers no, you should consider the amount of the supplies expense and if the dollar amount seems reasonable for income reported.
- If Charlie answers yes, you should follow-up with additional questions to determine if the supplies expense includes only supplies related to the business.

Are any income taxes included in taxes expense?

- If Charlie answers yes, you should follow-up with additional questions to determine if Charlie knows what types of taxes are deductible.

Does the utility expense include any amounts for residential or vacation properties?

- If Charlie answers yes, you should follow-up with additional questions to determine if the utility expense includes only properties related to the business.

Does the mileage amount you provided include any personal travel other than commuting?

- If Charlie answers no, you should document that no other personal travel was included and should ask if another vehicle is available for personal travel.

Do the children live with Charlie?

- If Charlie answers yes, follow-up with a question to determine what portion of the year the children are in his care.
- If Charlie answers yes, follow-up with questions about childcare.