Schedule C and Record Reconstruction Training

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Table of Contents

Introduction

Tax return preparers should always demonstrate due diligence when preparing returns. Paid tax return preparers generally can rely on the taxpayers' representations, but EITC due diligence requires the paid preparer to take additional steps to determine that the net self-employment income used to calculate the amount of or eligibility for EITC is correct and complete. EITC due diligence, IRC §6695(g), requires paid tax return preparers make additional inquiries of taxpayers who appear to be making inconsistent, incorrect or incomplete claims related to their self-employment when the tax return includes the earned income tax credit. The additional inquiries made and the client's responses must be documented.

Tax preparers should ensure that the amount of net self-employment income reported is correct. Taxpayers sometimes want to over-report or under-report their income to qualify for or maximize the amount of EITC. The preparer should ask sufficient questions of clients claiming self-employment income to be satisfied that the client is actually conducting a business, the client has records to support income and expenses, or can reasonably reconstruct income and expenses records, and the client has included all income and related expenses on Schedule C, *Profit or Loss from Business (Sole Proprietorship)*.

It is important to note that all preparers are held to the ethical standards defined in Circular 230 and are subject to consequences if the standards are not met. In addition, penalties may be assessed on a paid preparer for failure to comply with EITC due diligence. If after exercising EITC due diligence, a tax preparer is not satisfied the return is correct, the preparer may refuse to prepare the return.

This training module introduces the due diligence responsibilities involved with preparing returns with a Schedule C where EITC is claimed. The module also includes recordkeeping guidelines, recommendations on reconstructing records, and examples of how to comply with EITC due diligence in common Schedule C situations a preparer may encounter.

This module is divided into the following three sections:

1. EITC Due Diligence and Self-Employed Taxpayers
2. Recordkeeping
3. Due Diligence Scenarios

EITC Due Diligence and Self-Employed Taxpayers

Who is self-employed?

- You are self-employed if you carry on a trade or business with a profit motive as a sole proprietor or as an independent contractor.
- An individual, who performs services on a part-time basis or does occasional "odd jobs" and receives compensation for that work, may be self-employed. An individual doesn't need to have a business name, or a formal business structure, in order to be self-employed, and is required to report the income and related expenses from selling goods or performing services for others for money.

How is self-employment reported on a tax return?

- Income received from all sources in a self-employed taxpayer's business must be reported, unless it is excluded by law.
- All ordinary and necessary expenses incurred in a self-employed taxpayer's business must also be reported. See IRC § 1402(a).
- Form 1040, Schedule C, Profit or Loss From Business, is used to report the activity on the individual's tax return.

Why are Schedule C's an EITC issue?

- IRS estimates that between 21% - 26% of the EITC claims, or about $15 billion was paid in error in 2011.
- Income reporting errors are among the top three common EITC errors that account for more than 60% of the estimated $15 billion paid in error annually.
- The most common Schedule C errors, which fall into the income category, noted on EITC returns are:
    - Schedule C's with losses or over-stated expenses to bring income down to qualify for EITC,
    - Inflated Schedule C income to maximize the amount of EITC, and
    - Bogus Schedule C income to qualify for or maximize the amount of EITC.
- Approximately 21 million Schedule C forms are filed each year. Most of these represent small, often home-based businesses. Approximately one-third of the annual tax gap is a result of under-reported income or overstated deductions on Schedule C businesses.

What is EITC due diligence?

EITC due diligence is a law that requires paid preparers of EITC returns to take additional steps to ensure that the return information impacting EITC eligibility is correct.

The EITC Due Diligence regulations→ http://www.eitc.irs.gov/rptoolkit/dd/lawandregs/

Basically, EITC due diligence requires you, as a paid preparer, to:

- Evaluate the information received from the client,
- Apply a consistency and reasonableness standard to the information,
- Make additional reasonable inquiries when the information appears to be incorrect, inconsistent, or incomplete, and
- Document additional inquiries and the client's response.

How does EITC due diligence apply to Schedule C claims prepared by paid tax practitioners?

- EITC due diligence, IRC §6695(g), requires paid tax return preparers to make additional inquiries of taxpayers who appear to be making inconsistent, incorrect or incomplete claims related to their self-employment when the tax return includes the earned income tax credit.
- <u>All additional inquiries made to comply with EITC due diligence and the client's responses must be documented.</u>
- <u>The statute requires the EITC return preparer to be reasonable, well-informed, and knowledgeable in the tax law.</u>
- Paid tax return preparers generally can rely on the taxpayer's representations, but EITC due diligence requires the paid preparer to take additional steps to determine that the net self-employment income used to calculate the amount of or eligibility for EITC is correct and complete.

Tax preparers should ensure that the amount of net self-employment income reported is correct.

- <u>Taxpayers sometimes want to over-report or under-report their income to qualify for or maximize the amount of EITC.</u>
- <u>The preparer should ask sufficient questions of clients claiming self-employment income to be satisfied that:</u>

1. The client actually conducts a business,
2. The client has records to support income and expenses, or can reasonably reconstruct income and expenses records, and
3. The client has included all income and related expenses on Schedule C, *Profit or Loss from Business (Sole Proprietorship)*.

What are the consequences for not meeting your due diligence and filing incorrect EITC returns?

Incorrect EITC returns may adversely affect both you and your clients. The consequences may include:

- Your clients may be subject to accuracy or fraud penalties and be banned from claiming EITC for a period of 2 or 10 years depending on the reason the Earned Income Tax Credit was disallowed.
- Return preparers who fail to comply with EITC due diligence requirements can be assessed a $100 penalty for each failure. The most common reason for assessing due diligence penalties is failure to meet the knowledge requirement. Refer to Internal Revenue Code section 6695(g) and Treasury Regulation 1.6695-2. http://frwebgate.access.gpo.gov/cgi-bin/get-cfr.cgi?TITLE=26&PART=1&SECTION=6695-2&TYPE=TEXT
- Other return preparer penalties ranging from $1,000 to $5,000 may also be assessed for negligence or intentional disregard of the rules and regulations when preparing an EITC returns. See IRC § 6694.

The assessment of return-related penalties against a tax preparer may result in:

- Suspension of the preparer from participation in IRS e-File and preparer registration
- Injunctions barring the preparer from preparing tax returns
- Referral for criminal investigation
- Disciplinary action by the IRS Office of Professional Responsibility

It is important to note that all registered preparers are held to the ethical standards defined in Circular 230 and are subject to consequences if the standards are not upheld. This could include revocation of your PTIN.

What Schedule C situations should raise a red flag for you as a tax preparer?

- Schedule C income in round numbers
- Schedule C cash businesses as the only income on a return claiming EITC
- Schedule C with little or no expenses when expenses would be expected
- Schedule C taxpayers with little or no records for income and expenses
- Any Schedule C income that brings the taxpayer to the maximum EITC
- Schedule C without a Form 1099

What techniques can be used to obtain information from your client?

- Conducting a thorough and in depth interview with your client about the business activity.
- When the basic question/answer format does not seem to be creating a clear and consistent picture, asking your client to describe daily and weekly activities can provide a great deal of information.
- Casual conversations about business practices may prove insightful.
- Return preparers should take the time to educate their clients on the need for recordkeeping and the consequences of failure to keep records. Thought should be given to reaching out to existing clients at the beginning of the tax year to educate them and to help them to establish a good recordkeeping system so that come the next filing season they will have a much easier time of filing an accurate return.
- Form 11652, Questionnaire and Supporting Documentation Form 1040 Schedule C (Profit or Loss from Business), used during IRS examinations of Schedule C, provides a starting point for addressing client's recordkeeping. http://www.cclib.lib.pa.us/irs/pdf_files/f11652.pdf
- Reviewing supporting material. If supporting material is not provided, return preparers should inform their clients that the IRS may audit them. In that event, the client would need to provide receipts to support the figures. Taxpayer claims of having supporting documentation is not sufficient to meet tax preparer due diligence. Preparers should inquire how income and expenses were computed and document the responses. In circumstances where you feel the information is not accurate or the supporting material is sufficient, you may ask to see the supporting material.

Recordkeeping

Why should taxpayers conducting a trade or business keep records?

Good records will help the taxpayer do the following:

- **Monitor the progress of their business.** A taxpayer conducting a business needs good records to monitor the progress of the business. Records can show whether the business is improving, which items are selling, or what changes may need to be made. Good records can increase the likelihood of business success.
- **Identify source and amount of receipts.** A taxpayer will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate business from non-business receipts and taxable from nontaxable income.
- **Keep track of deductible expenses.** A taxpayer is required to deduct the correct amount of expenses, and only the allowable expenses on their tax return. Good records are necessary to record the source and amount of expenses incurred in the business.
- **Prepare tax returns.** Taxpayers need good records to prepare tax returns. These records must support the income, expenses, and credits reported.
- **Support items reported on tax returns.** Taxpayers must keep business records available at all times for inspection by the IRS. If the IRS examines the tax returns, the taxpayer will be asked to explain the items reported. A complete set of records will speed up the examination.

What should be included in the taxpayer’s books and records?

A system of books and records may be as simple as a calendar showing business income earned each day and business expenses paid each day or they may be a detailed accounting system. The system of records should include enough information to correctly determine gross receipts, business expenses incurred and the purchase price of assets acquired for use in the business. These records should also include inventory purchases, payroll, and other transactions occurring in the course of operating the business.

The taxpayer’s books and records should include supporting documents. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents are important to support the entries in the books and the tax return. These records will also help the taxpayer determine the value of inventory at the end of the year.

What are examples of supporting documents?

- **Gross receipts.** Gross receipts are the income received by the business. The taxpayer should keep supporting documents that show the amounts and sources of gross receipts. Documents that show gross receipts include the following:
    - Cash register receipts
    - Bank statement and deposit slips
    - Receipt books
    - Invoices
    - Credit card charge slips
    - Forms 1099 MISC
    - Any format (calendar, income ledger, etc.) that the taxpayer consistently uses to record receipts of the business

- **Purchases.** Purchases are the items bought to resell to customers. Supporting documents should show the amount paid and that the amount was for purchases. Documents for purchases include the following:
    - Canceled checks
    - Cash register tape receipts
    - Credit card sales slips
    - Invoices

- **Expenses.** Expenses are the costs incurred (other than purchases) to carry on the business. The supporting documents should show the amount paid and that the amount was for a business expense. Documents for expenses include the following:
    - Canceled checks
    - Cash register receipts
    - Account statements
    - Credit card sales slips
    - Invoices
    - Petty cash slips for small cash payments

- **Assets.** Assets are the property, such as machinery and furniture owned and used in the business. Taxpayers must keep records to verify certain information about business assets. They need records to figure the annual depreciation and the gain or loss when assets are sold. The records should show the following information:
    - When and how an asset was acquired
    - Purchase price including purchase invoice, real estate closing statements, cancelled checks, etc.
    - Cost of any improvements including invoices and cancelled checks

- Section 179 deduction taken
- Deductions taken for depreciation
- Deductions taken for casualty losses, such as losses resulting from fires or storms
- How the asset was used
- When and how the asset was disposed of, including sales invoice or closing statement
- Selling price
- Expenses of sale

What Business Expenses can be claimed on Schedule C?

Schedule C should include current operating costs of running the business. To be deductible, a business expense must be both ordinary and necessary.

- An ordinary expense is one that is common and accepted in your field of business, trade, or profession.
- A necessary expense is one that is helpful and appropriate for your business, trade, or profession.

To be correct and complete, the Schedule C should include all allowable business expenses. The taxpayer's records should not include any personal expenses. The following is a brief list of some common business expenses. See the Schedule C instructions and IRS Publication 535, *Business Expenses*, Publication 946, *How to Depreciate Property*, and Publication 587, *Business Use of the Home*, for more information. Common business expenses include the following:

- Advertising
- Supplies
- Insurance
- Payroll or contract labor
- Utilities
- Interest on business loans
- Legal and professional fees
- Repairs
- Taxes
- Utilities
- Car and truck expenses
- Depreciation
- Business use of the home - Most of your clients won't qualify as they do not meet the exclusive use requirement. Most day care providers will not qualify as the statute requires a license or proof of exemption from the license requirement.
- Travel, transportation, entertainment, and gift expenses. Specific recordkeeping rules apply to these expenses. For more information, see IRS Publication 463.
- Employment taxes. There are specific employment tax records a taxpayer must keep. For a list, see IRS Publication 15.

What should you do if the taxpayer does not have records?

To comply with their EITC due diligence requirements, a paid preparer should make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete.

In the event of a loss of client records or due to poor recordkeeping, a paid preparer may need to help his client reconstruct the records. The reconstruction will demonstrate that the paid preparer exercised due diligence and it will also teach the client about recordkeeping.

The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared. Although the taxpayer may not have formal books and records with supporting documentation, they may have partial records that can be used as a basis for reconstruction.

The knowledgeable tax preparer can guide their client on how to use these partial records to develop support for the Schedule C. This reconstruction can also provide support for the return in the case of an audit. Numerous court cases exist that support the use of reasonable estimates and reconstruction of income and expenses to determine a taxpayer's correct tax liability. However, if the tax preparer is not satisfied with the accuracy of the reconstructed records, he has the right to refuse to prepare the return.

The following is a table of helpful example options and tools to use in reconstructing records:

Example source	How to use to reconstruct records
Appointment books or calendars	An appointment book could be used to develop: • Where a taxpayer traveled to provide services, and how many trips • A count of how many people were provided services • A count of how many of each type of service was rendered; for example, how many haircut appointments, how many manicure appointments Using summary counts of the number of each kind of service rendered, the taxpayer could apply an average or standard cost to come up with an estimate of total receipts. The number of trips made and the locations traveled to could be combined with online map tools data to support total business miles driven.
Online map tools	Online map tools can be used to reconstruct mileage calculations.
IRS standard allowances	The IRS provides standard expense allowances including per diem expenses for truck drivers and standard mileage rates.
Checkbook, cancelled checks, bank statements or credit card statements	These documents can be used to gain information about expenses incurred and what types of services were performed for clients. Using summary counts of the number of each kind of service rendered, the taxpayer could apply an average or standard cost to come up with an estimate of total costs and receipts.
List of regular clients	Using a list of regular clients, a taxpayer could reconstruct a reasonable calendar of services. Regular expenses could be extrapolated from that information. The taxpayer could apply an average or standard cost to come up with an estimate of total receipts.
Partial receipts or sales tax records	Partial receipts can lend information regarding what expenses were incurred for services. The taxpayer could apply an average or standard cost to come up with an estimate of total receipts.
Cell phone records and call history or computer logs	Cell phone records and call history can be used to develop a list of clients served during specific timeframes.
Prior year returns	Prior year returns can provide the basis for records if activities are similar from year to year.

What choices do you have if you are not satisfied with the records?

As a preparer you must make a decision whether you are comfortable that the information presented by your client is substantially correct.

If you are not satisfied with the taxpayer's records, you may:

- Request the taxpayer attempt to reconstruct his records on his own.
- Assist him with reconstructing his records.
- Suggest filing without an EITC claim.
- Refuse to prepare the Schedule C return altogether.

You have a professional responsibility to prepare returns that are accurate. The taxpayer is ultimately responsible for the figures computed through record reconstruction, and you should inform the taxpayer of possible repercussions of filing a false EITC claim whether with or without your assistance. However, as a tax preparer you must exercise due diligence and apply reasonableness as you may be subject to penalties and additional consequences.

Where can you get additional guidance on EITC due diligence?

IRS.gov	http://www.irs.gov/
EITC Central Toolkit	http://www.eitc.irs.gov/central/main/
CPE module	http://www.eitc.irs.gov/rptoolkit/ddmodule/
Tax Forum presentations	http://www.irs.gov/pub/irs-utl/check_ive_met_my_eitc_due_diligence.pdf
	http://www.irs.gov/pub/irs-utl/lifes_easier_when_you_know_eitc.pdf
Tax Forum Tax Tales videos	http://www.eitc.irs.gov/rptoolkit/ddvideos/

Due Diligence Scenarios

The following scenarios are examples of how a practitioner can meet their due diligence requirements and assist a client with Schedule C record reconstruction.

Scenario 1 – No expenses:

A 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 of 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 child care?
    - 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.

Scenario 2 - False Business Income:

A client, Linda, comes in to 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 child care 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 clients 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 in order 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?

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

Advertising	60
Contract labor	7,200
Insurance	150
Interest	2,025
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 of 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 <u>reasonable</u> 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 the amount of 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 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 child care.

Scenario 4 – No Expenses:

John & Shelly Smith, a married couple, come into your office to have their taxes prepared.

- They have two children, ages 6 and 9 that live with them full time.
- John's only income is from a W-2 in the amount of $9,000.
- Shelly is a stay at home mom who has a small business cleaning homes for extra income that made $6,663 this year. Shelly's customers all pay in cash. Shelly provides the following documentation:
    - Bank statements that show cash deposits to substantiate the income, and
    - A notebook that lists of her regular clients including name, address, cleaning fee, and dates cleaned.
- Shelly says that she does not have any expenses for her business.

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 <u>unlikely</u> 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 maximizes EITC

Also, supporting a family of four does not seem feasible on just $15,663 of income.

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 to report all of 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 expense, 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.

What steps must you take to comply with due diligence?

Before you decide to prepare the Smiths' return you must first:

1. Make additional reasonable inquiries regarding Shelly'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 <u>reasonable</u> 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?

There are certain items that are essential to a cleaning business, how are those items obtained?

- If Shelly responds that her client provide the supplies, it is reasonable to believe that she does not have expenses as they relate to supplies.
- However, if Shelly responds that she brings her supplies and equipment to her client locations, you should follow-up with additional questions regarding the cost of common household cleaning supplies and depreciation of the equipment.
- Does she have receipts for the cleaning supply purchases? A single receipt could be used to estimate the annual cost.

What type of transportation does Shelly use to travel to her client locations?

- If Shelly uses a personal vehicle for transportation, you should explain how to calculate expenses. Using her notebook record, she could reconstruct mileage expenses.
- If Shelly uses public transportation, she could use her notebook record to reconstruct the cost of the fares.

Do you have a business license? Are you listed in the yellow pages? Do you have business cards? How do you get your customers?

- These answers can establish whether the business is legitimate.
- Expenses related to licensing and advertising can be deducted.

Supporting a family of four does not seem feasible on just $15,663 of income**.** Do you have any other sources of income? If yes, please list.
How did you determine the income figure?

- As the preparer, you should confirm the cash receipts and notebook documentation are in agreement.

Scenario 5 – Rounded Expenses:

Murray and Lydia Laramie, a married couple, come in to have their taxes prepared. Murray tells you:

- Lydia stays at home with their one child.
- He is a carpenter.
- He has records of his income that he received for the year.
- Total income $30,000.
- His expenses:

Advertising	100
Insurance	500
Legal & Professional	200
Office Expenses	50
Machine Rental	400
Small Tools	500
Supplies	12,000
Cell phone	300

Mileage of 15,000 total miles and 5,000 non-business miles.

What due diligence issues are present in this scenario?

In this example, the information regarding the clients business appears inconsistent with the normal income and expense profile of this type of business. These inconsistencies include:

- Businesses don't often have round numbers for gross receipts.
- Businesses don't often have round numbers for business expenses.
- Client states he has records for income, but not for business expenses.
- The income seems relatively low to support three people.
- The income allows the maximum credit.
- In some states, a carpenter should be licensed.

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 the Laramies' return, you must first:

1. Make additional reasonable inquiries to determine if the business is real. Ask your client applicable questions and document his 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, he 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?

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?
    - If no, is it reasonable that the services he provides do not require a license?
- Are you listed in the yellow pages?
- Do you have business cards?
- How do you get your customers?

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? What records do you have 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?
- What records do you have to support the expenses reported here.

It seems unlikely that all the expenses are round numbers.

- Are these numbers estimates?
- Does this amount include any personal expenses? How do you separate your personal expenses from your business expenses?
- 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 any of the supplies that you purchased for the business?

The net income from the business is relatively low to support 3 people.

- Do you have any other sources of support?

1099 MISC Income Treatment Scenarios:

The following scenarios address 1099 MISC issues that frequently occur where taxpayers may be unaware of their reporting requirements/responsibilities. Some of the scenarios might erroneously qualify a user for EITC. The intent is to determine if a taxpayer truly has a Schedule C in which the income would then qualify them for the EITC.

Examples include situations where:

- Client correctly receives a 1099 MISC but does not understand what it is for
- Client correctly receives a 1099 MISC but has no expenses
- Client receives a 1099 MISC when they should have received a W-2
- Client has not received 1099 MISC but should have received it
- Client received 1099 MISC and the income is incorrectly classified

The preparer should always ask the client if he/she had any other income that they have not presented to the practitioner.

Form 1099 Scenario 1

Mia is a 24 year old college student who did some part-time web development work over the summer.
She loved the job because she could do it late in the evening which is the best time for her to get work done. Her boss didn't care when or where she got the work done as long as it was done by a certain date.
She received a 1099 MISC for the $10,000 she earned and doesn't know what it is or what to do with it.

How should Mia report her income?

Since Mia was able to do the work whenever she wanted and wherever she wanted, this is income that she received as an independent contractor, and therefore it should be reported on Schedule C subject to self-employment taxes. She can offset it with any expenses she incurred while doing the work. It would be reasonable to expect that she had business expenses; however, Mia did not keep any records of her expenses related to this activity.

How do you help Mia reconstruct her records?

- Ask Mia if she incurred any travel expense or drove her car to attend meetings to discuss details related to this work. If she says no then probe on how she worked with the team/group?
- Did Mia purchase any software for this web development? Print supplies? Computer equipment?

- Did she use personal equipment primarily for this work? She can claim depreciation but she would need to determine what percentage was used for business and what was used for personal purposes.
- Consider business use of the home: Mia may not qualify because no one part of the home was used exclusively for business and she could have performed the services at the business location.
- Probe to determine if she did similar work for other people or organizations? Does her total income lead you to believe that it was enough to support her?
- Explain to Mia that it is her responsibility to maintain good records of her income and expenses.

1099 MISC Scenario 2

Consuelo worked as a maid in a hotel. She received a 1099 MISC with income earned doing this work. She is required to work set hours at her employer's business location. She uses equipment and supplies that are provided by the employer. Based on the facts, Consuelo should be classified as an employee and should receive a W-2.

How should Consuelo report her income?

1099 MISC should be reported on a Schedule C. She may not reasonably have any expenses. However you should probe to determine if this is correct. Establishing a conversation about the type of work she performed may lead you to a different conclusion.

As the preparer you should ask sufficient questions to determine she has no other jobs or expenses and document the conversation and reasons for your classification of her employment type (employee or Schedule C).

1009 Misc Scenario 3

James is a college student who worked as an intern during the school year. He was required to report to the office on the days that he worked and his boss would give him a list of items to be accomplished that day. The working environment was very positive in that James basically worked side-by-side with his boss, learning all that he could. James received a form 1099 MISC for the income he earned doing this work.

How should James report his income?

James should file his return with a Schedule C with the 1099 MISC amount as income, this will avoid any penalties from late filing or taxes owed. Since James went to the office and his boss controlled when and how he did his work James should have received a W-2 for the work performed. He could then file a Form SS-8 Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. The IRS will then follow up with the employer to determine if James should have been treated as an employee. If James receives a notice of determination from

IRS indicating that he should have been an employee, James can file an amended return to correct his original filing.

As the preparer you should ask enough questions to determine James should have been treated as an employee and has no expenses.

<u>1099 MISC Scenario 4</u>

Henry tells you that he received payment in 2010 for work done on a contractor basis, however the company has yet to send a 1099 MISC and it's now early April.

How should Henry report his income?

Henry should file his return with a Schedule C including the amounts that were paid to him by this company. The fact that a 1099 MISC was not issued does not mean that the income does not have to be reported.

If needed you should help Henry to reconstruct his income and determine what allowable expenses he has to report for this business.

<u>1099 MISC Scenario 5</u>

Mary won a prize from a local community sponsored activity. She received a Form 1099 MISC with the prize amount reflected in Box 7 as “Nonemployee Compensation”. Upon reading the instructions for Form 1099 MISC she sees that the amount should have been correctly reported in Box 3 “Other Income” and is not subject to self-employment tax because she did not “earn” the income.

How should Mary report her income?

Before filing her return, Mary should contact the entity that sent her the 1099 MISC and ask them to file a corrected Form 1099 MISC with the amount correctly reflected in Box 3 instead of Box 7. Among other tax implications, reporting the amount on the Schedule C might inadvertently qualify her to take the EITC when it is obvious that this is not earned income and should not be included in the calculation for qualification of EITC. In addition reporting the income on Schedule C would require Mary to pay self-employment that she doesn’t owe.