<u>A Guide to Reconstruct a Taxpayers Schedule C Return</u>

To comply with Schedule C 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.

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 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:

o Cash register receipts o Bank statement and deposit slips

o Receipt books o Invoices o Credit card charge slips

o Forms 1099 MISC o 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:

o Canceled checks

o Cash register tape receipts

o Credit card sales slips o 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:

o Canceled checks

o Cash register receipts

o Account statements

o Credit card sales slips

o Invoices

o 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:

o When and how an asset was acquired

o Purchase price including purchase invoice, real estate closing statements, cancelled checks, etc.

o Cost of any improvements including invoices and cancelled checks 7 Schedule C and Record Reconstruction Training

o Section 179 deduction taken

o Deductions taken for depreciation

o Deductions taken for casualty losses, such as losses resulting from fires or storms o How the asset was used

o When and how the asset was disposed of, including sales invoice or closing statement

o Selling price

o Expenses of sale

You may help reconstruct a taxpayers income and expenses on a profit and loss table, and then have the information transferred onto the Schedule C Due Diligence form. All forms need to be submitted into the clients file, including the questions you asked to determine their business, income, and expenses.