



Another Resource Available from the
National Community Tax Coalition

a project of the Center for Economic Progress

www.tax-coalition.org

The Q Word

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Comments and Advice to Help Improve the Tax Returns That We Prepare

I'm a cab driver, I braid hair, I do child care, and I have...

NO RECORDS

Now what?

Often self-employed clients have insufficient information to prepare a complete and accurate tax return. They have few records, the wrong (or hopelessly disheveled) records, or no records at all. Sometimes they don't even realize that they're self-employed. It's often up to the preparer to assist the client in patching information together to determine realistic numbers. This process involves three basic steps:

1. income reconstruction
2. approximation of reasonable expenses
3. education and prevention

This process means asking lots of questions, taking notes, and guiding the client to reveal appropriate and reasonable data. This all needs to be accompanied with words of caution and warning to the client. The client needs to leave with the full understanding that filing without records is not acceptable and that it is the client's responsibility to avoid this situation in the future.

The best way to reconstruct is to start with general information and move to the specifics. For example, start with a question like: How did you get paid for your services? What were your expenses? Then hone it down to questions like: How often were you paid? How often did you buy office supplies and how much did you usually spend? Don't hesitate to ask questions that seem important or relevant: What things did you have to pay for out of your own pocket? Did you have to buy any tools or equipment? Did you receive any reimbursement for your expenses? Be sure to take notes and provide the client with the information to keep with the tax return records.

Make sure that you understand the kind of work that the client is doing and use your own knowledge to ask pertinent questions. Keep in mind the kind of expenses that are likely for the business. You might ask a day care provider: How much did you spend each month on diapers? But you would ask a cab driver: How often did you replace the air fresheners?

SAMPLE INCOME CONVERSATION

Ruth is a home-based child care provider. She brought a Form 1099-MISC that she received from the state showing \$4,100 nonemployee compensation in box 7. She has some receipts for expenses, but no other records.

Prep: Did you do child care all year?

Ruth: Yes. I started my business right after New Years. I got busy fast and never had time to write down anything or keep track of the money.

Prep: Were you open all year, all of 2009, then?

Ruth: Yes. Except I closed a week for Thanksgiving and a week for Christmas.

Prep: So you were in business for 50 weeks? Did you get paid when you were closed?

Ruth: No. And 50 weeks sounds about right.

Prep: How many children did you take care of?

Ruth: Four families most of the time – more in the summer.

Prep: OK. What did other income did you get in your business, besides the state payments?

Ruth: This is the only form I got. What do you mean? I didn't give out receipts or anything.

Prep: All the money that you collected for doing child care needs to be reported on your return. Did the parents in the state program make co-payments?

Ruth: Two families were covered by the state and were supposed to make co-payments, but only one family did. They paid \$10 a week. They were with me the whole time.

Prep: So that's \$10 for 50 weeks: \$500. Right?

Ruth: Yeah.

Prep: What about the other two families, the ones not covered by the state?

Ruth: They had to pay all the cost of child care. One had two children and paid about \$200 per week. The other family had one toddler and they paid \$110 a week.

Prep: OK. The people that paid \$200 a week, were they with you all year?

Ruth: No. They started in the summer – I don't remember when - and they are still coming.

Prep: Did they start before the 4th of July?

Ruth: No. I remember now that they started right after the weekend of the 4th!

Prep: So that would mean that they were there 23 weeks. So 23 X \$200 is \$4,600. Right?

Ruth: Yes, that's it. The other folks were there all year. They never missed.

Prep: So that's 50 weeks X \$110 = \$5,500. Sound right?

Ruth: Yes. I guess so. I should've kept receipts, right?

Prep: You need to make the time to write all this down somehow: a calendar, a journal, a receipt book - some way so you know how much money is paid to you. IRS expects you to have records for everything. It's your responsibility as a self-employed businesswoman to record the information needed to determine your net profit every year. Just the 1099-MISC is not enough. Now, you mentioned that you had more kids in the summer?

Ruth: *Right. Two neighbors sent their kids in the afternoons in June and July. I charged them \$50 a week.*

Prep: So that's an extra \$100 a week for 9 weeks? So, \$900?

Ruth: Yes.

Prep: So, we're coming up with:	1099-MISC	\$ 4,100
	co-payments	\$ 500
	other payments	<u>\$11,000</u>
	total income	\$15,600

Does that sound right?

Ruth: *Yes. But I didn't really make that much!*

Prep: Right. Now we're going to talk about expenses.

SAMPLE EXPENSE COVERSATION

Fred was a bike messenger during 2009. He has some invoices that reflect most of the income, but nothing else. The preparer has determined that Fred was a bike messenger for six weeks and had \$1,800 income during that period.

Prep: How much were your expenses?

Fred: *I didn't have any. I already had a bicycle and helmet.*

Prep: Did you ever have flat tires?

Fred: *Yes, all the time.*

Prep: How often? How much did it cost to repair?

Fred: *I fixed them myself – about 2 a week. The materials cost \$12 every time.*

Prep: So that's 12 tires, at \$12 each. So \$144, right? What else?

Fred: *\$144 sounds right.*

Prep: What about locks?

Fred: *I went through several.*

Prep: How much did they cost?

Fred: *I guess about \$20 each. I think I bought three.*

Prep: So that's three locks at \$20 each, so \$60. OK?

Fred: *Yes. Are we about done?*

Prep: OK, hang on. We're coming up with \$204 total expenses. Anything else? Advertising, maybe?

Fred: *No. I was having business cards printed, but after the accident my mom said that I had to quit. So I cancelled the order.*

Prep: OK. I'll enter this information and then we'll discuss the outcome.

Q! Warning

- Don't lead the client or provide answers. The information must come entirely from the client and the client must understand - and agree to – every piece of information that goes on the return.
- This type of reconstruction assumes that the client was actually engaged in the business activity and is telling the preparer the truth. If a preparer has any doubts in this regard, the site should decline to prepare the tax return.
- Often a preparer will encounter the EITC paradox: The more expenses claimed, the higher the EITC and the ultimate refund. It is best to ignore this phenomenon and just concentrate on getting reasonable estimates from the client. If the client seems to be providing answers in order to maximize EITC, don't prepare the return.

CLIENT EDUCATION

Before the client leaves, it is important to provide information and resources to avoid the problem in the future. This can be brief (for example, Fred seems to be finished with his messenger business) or, time permitting, more comprehensive. It is important that the client understands the importance of developing some kind of record system, be aware of estimated tax payment requirements, and know the risks of filing a tax return that is incorrect or incomplete. This is sometimes not easy to do. The cosmetic-selling ladies will cry and the cab drivers may get angry, but a conscientious preparer will provide education and point out available resources. Recommend www.irs.gov , which offers excellent information and publications such as:

Publication 334 – Tax Guide for Small Business

Publication 535 – Business Expenses

Publication 560 – Retirement Plans for Small Business

Publication 583 – Starting a Business and Keeping Records

Publication 587 - Business Use of Home

The Small Business administration www.sba.gov has additional information, including online classes and a variety of general and local resources.

Warning! You've seen lots of "generallys" and "usually" and "in most cases." Whenever the situation appears unusual or complex, please research before you proceed.

The Q Word is written to provide commentary, information, opinions and observations from a grass roots perspective to all preparers, managers, and coordinators that are involved in free income tax preparation programs. If you have any suggestions for the Q Word, or would just like to submit comments, questions, praise, or bitter criticism, please e-mail:

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