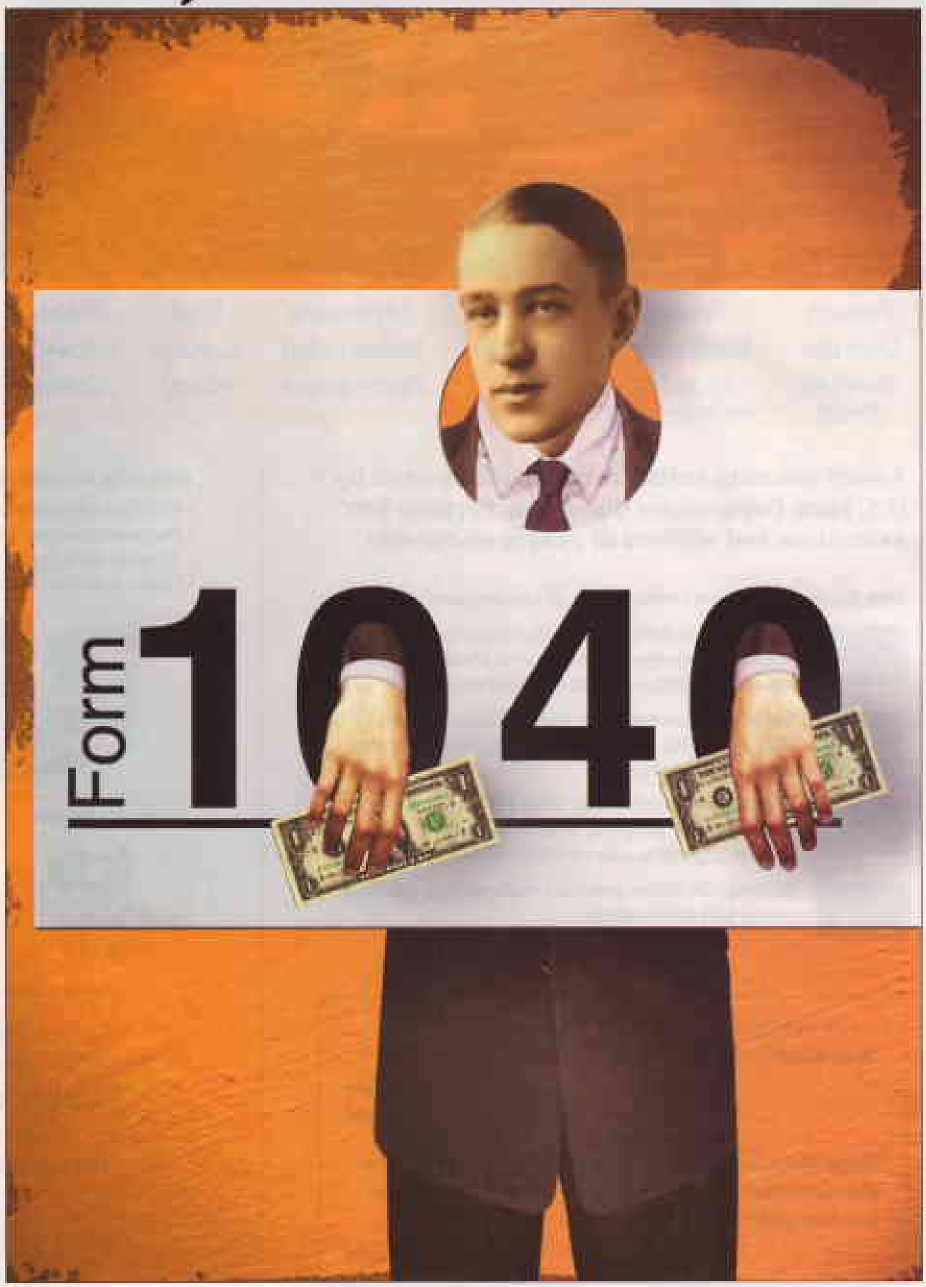
MONEY

Cheater, Cheater

EVEN HONEST CITIZENS CAN INADVERTENTLY BREAK TAX LAWS. HERE'S HOW TO STAY ON UNCLE SAM'S GOOD SIDE.
BY KRIS FRIESWICK



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Many years ago, as a nascent freelance writer sharpening my professional pencils for the first time, I broke the first rule of freelancing: I didn't pay quarterly estimated income tax. I figured that after I took all my allowable deductions, which I tracked meticulously, I probably wouldn't owe a cent. I was wrong.

In fact, I owed more income tax than I would have if I'd kept my salaried job (employers pay half your Social Security tax – as a freelancer, you pay the whole nut). The second hit came when I got penalized for failing to pay the quarterly estimated taxes. In order to pay my taxes that year, I took out a big advance on my credit card, which came with an additional kick to the head, a 19.5 percent interest rate.

It's the kind of mistake you make only once. Today, 20 years later, I can't believe that I was so clueless about income taxes. My one consolation is that I was far from alone. Each year, as the tax laws in the United States undergo their annual extreme makeover, courtesy of the U.S. Congress, millions of Americans break tax laws. The violations have three basic causes: 1) lack of common sense and/or lack of intellectual curiosity about the basics of income tax (see above); 2) failure to keep abreast of new tax laws or old laws that now affect you because of changing circumstances/income; and 3) desire to not pay taxes (and while most of us share that desire, only a special few act on it).

Not surprisingly, the penalties for violations ramp up as the level of taxpayer bad faith increases. Making a mathematical or typing goof on a return will mean you have to pay whatever tax you really owed, and maybe some overdue penalties. The same generally holds true for disallowed deductions. But hide income or fail to file at all – that's when Uncle Sam can get ugly. He hates it when you hide money.

Still, it says a lot about the American character to note that of those people who will break a tax law this year, far more will fall into the first category (oblivious) than the last (corrupt). Mostly what it says is that we are a fundamentally honest people who aren't good at following directions.

UH, DID I MISS SOMETHING?

The IRS reports that the most common mistake made by individual income tax filers is this: listing an incorrect Social Security number for themselves or a dependent, or not listing one at all. Although this doesn't break any laws, it is a profoundly dumb mistake that more than 421,000 people made this past tax year, all of whom lose the exemption for the person with the missing number. If filers can make a mistake that basic (and expensive), imagine what happens when the questions get more complicated.

As hard as it is to believe, many taxpayers make an even simpler mistake, one that increasingly does result in a violation of tax law. Many people, intimidated by the hydra that is the income tax return, turn to professional tax preparers. Many of these preparers make wild promises that they will reduce the tax that filers owe by finding deductions they never knew they had. The filers didn't know they had those deductions because, in fact, they didn't. The unscrupulous tax preparers artificially lower the tax owed by listing a variety of illegal deductions, as well as other fictitious figures, none of which the trusting taxpayer ever sees because he does not read the tax return before signing it and sending it off to the IRS. Then one day the IRS calls, looking for more money. Sometimes lots more.

"There are a lot of good tax preparers out there," says Eva Rosenberg, an Enrolled Agent (a designation that allows her to represent the interests of taxpayers in front of the IRS) and founder of TaxMama.com, a free online tax-advice service. But, Rosenberg says, "there are a lot of high-volume phonies." They deliver on their promises of getting clients' taxes down by making up numbers, but when they get caught, "the IRS comes after the client, not the tax preparer. After all, you signed it," she says. Rosenberg says she gets many letters from visitors to her website who owe thousands in back taxes because of unscrupulous preparers and, if they're honest with themselves, their own lack of oversight. "Tax Mama says grow up," Rosenberg says. "Take responsibility for your own taxes." Read your return carefully before sealing the envelope – and make sure you spell your name right (No. 11 on the IRS hit parade).

I HAVE TO PAY TAXES ON WHAT?

Changing circumstances – marriage, divorce, children, a death in the family, higher income, sudden riches – come with changing sets of tax laws. It can seem impossible to keep up, especially when you suddenly find yourself subject to an entirely different and unexpected set of rules and regulations.

Chief among these snakes in the grass is the Alternative Minimum Tax, a complicated alternative system of taxation that was enacted by Congress in the 1960s to make sure that the wealthiest Americans were paying their fair share of federal income tax. The result, as with most well-intentioned legislation, is that it now affects millions of taxpayers it was never intended to touch: the middle class who now have types of income, tax credits, and deductions that only the wealthy once enjoyed. It is one of the trickiest tax laws because the rules

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state that taxpayers must pay whichever scheme generates the largest tax amount due – regular income tax or the AMT. The only way to determine which is higher is to compute both. How do you know if you're in a category that needs to compute both?

"There's no absolute way to tell if you're going to have to pay it," without first doing both computations, says Bill White, a certified public accountant and founder of Online Taxes (www.olt.com), a St. Joseph, Missouri-based online tax-filing site. "The IRS expects you to just compute both, figure out if you owe money, and send in the money." If you had a lot of itemized deductions, dividend income, or capital gains, White says you should consult a tax specialist to find out if you're subject to this rule, which some politicians have been trying to eliminate for years and many taxpayers aren't aware exists. "It's an area ripe for correction," White says, "but it does bring in a lot of tax revenue." In other words, it's probably going nowhere.

The unexpected tax surprises don't stop there. People who have inherited an interest in a company, stock, or anything that generates an income are often shocked to learn that they owe taxes on it. People are equally stunned to learn that if they pay a household employee more than $1,400 a year, they are responsible for paying employment taxes on that individual, as well as filing a W-2 form with the government.

The most ignored tax law has to be the one that states that if you sell something – a house, some stock, your car, a ratty T-shirt, anything – for more than you paid for it, that is considered profit and you owe tax on it, Rosenberg says.

Many residents of the United States, especially permanent residents, are unaware that they must report all income earned anywhere in the world to the IRS. They must also report the existence of any and all bank accounts, brokerage accounts, or other money-holding accounts to which they have access (that contain more than $10,000).

One of the most onerous of these gotcha rules is the requirement that any U.S. taxpayer who owns 10 percent or more of a foreign-based business must file extensive paperwork with the IRS outlining the specifics of the company. These foreign-asset rules were written to help the U.S. government identify and stop money laundering associated with drug trafficking and terrorism, says Alan Lips, a CPA and partner at Gerson, Preston, Robinson & Company in Miami Beach, Florida. As such, no one is exempt from disclosure.

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"The vast majority of people [affected by this rule] have legitimate interests in foreign corporations," Lips says. "A lot of these rules come down to telling the IRS what is going on. It doesn't mean there's necessarily a tax associated with it." But failure to disclose, he adds, can come with big fines and possible criminal prosecution.

SOMETHING FOR NOTHING

The final category of tax lawbreakers consists of little more than scofflaws – those who know the rules but choose to break them anyway. The ways that some people dream up to avoid paying taxes are varied and range from the creative to the devious. Tax experts report that many taxpayers apply for the child-care tax credit, but do not list the child-care provider's tax ID number or SSN. This is often because the provider is a live-in nanny who wants to be paid cash under the table. "You can't have it both ways," says Neil Becourtney, a CPA with JH Cohn LLP in Roseland, New Jersey. "No provider Social Security number, no child-care tax credit."

Rosenberg has seen people try to deduct employee commuting expenses to and from the office (not allowed), business expenses for which they've already been reimbursed (very not allowed), and dry cleaning (not unless you're traveling on business). Experts report tales of self-employed taxpayers simply making up numbers to use for deductions without any documentation to support the claim. Newspapers are filled with reports of wealthy individuals taking part in highly dubious tax-shelter arrangements that have now been determined to be illegal.

And, of course, there is the granddaddy of all tax law violations – simply not filing an income tax return at all. Some experts say this happens a lot more than you might imagine, especially if the taxpayer has gone through a trauma, like a divorce, death in the family, or prolonged unemployment. Uncle Sam is as compassionate as the next national mascot, and is willing to listen to any mitigating circumstances surrounding a failure to file or pay. But the excuse had better be good: Penalties for failure to file start at 5 percent of the total tax owed for each month the filing is overdue for a maximum of five months or 25 percent of the tax owed. Fraudulent failure to file penalties can jump up to 75 percent of the tax owed. Eventually, if you purposely avoid paying taxes over a period of time, or in large enough amounts, the IRS will consider you a tax evader, and then you're looking at large civil and potentially criminal fines and even jail time.

The good news: If you owe no tax, you can't be penalized. So there's at least one thing about the tax code that's simple to remember.

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