PERSPECTIVE

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Don't Inflate Deductions, Even When IRS Audits Are Down

By Robert W. Wood

Even in this information age aided by great strides in technology, we probably all have occasional difficulty finding receipts. Sometimes, we may even estimate how much cash we dropped for that airport taxi or cash tip to a maître d'. Make no mistake, the Internal Revenue Service and California's Franchise Tax Board want receipts — meaning they want you to keep them and be able to present them if the tax authorities ask.

Even so, sometimes you can convince them that your deduction is legit *without* the documentation. But do not confuse slipshod recordkeeping of real expenses with artificially enhancing those deductions. Padding deductions — or making them up out of whole cloth — is downright dangers. Making up deductions — or artificially enhancing the ones you have — isn't keeping to the straight and narrow.

Indeed, the IRS has specifically warned people about what it calls padding of deductions. The IRS warns to avoid the temptation to falsely inflate deductions or expenses. In fact, the IRS includes the issue on its 2017 Dirty Dozen list of tax scams. In the IRS's words, the majority of taxpayers file honest and accurate tax returns each year.

However, each year, as the IRS puts it, some people "fudge" their information. Falsely claiming deductions, expenses or credits on tax returns is serious, regardless of their type. The IRS notes that it happens with overstating deductions such as charitable contributions, padding business expenses, or including tax credits to which you are not entitled.

Two big ones to watch? The Earned Income Tax Credit and the Child Tax Credit. The IRS is also putting the public on notice that IRS automated systems are increasingly efficient, and they generate most IRS audits. Even if the ranks of IRS audit personnel have been cut, you could be caught. Remember, you sign tax returns under penalties of perjury.

The IRS can normally audit returns filed within the last three years. But not only three years are at risk. The IRS can add additional years for big errors or fraud. If being audited is not bad enough, the IRS warns about the penalties or worse. Significant penalties can apply to taxpayers who file incorrect returns including:

- 20 percent of the disallowed amount for filing an erroneous claim for a refund or credit.
- $5,000 if the IRS determines a taxpayer has filed a "frivolous tax return." A frivolous tax return is one that does not include enough information to figure the correct tax or that contains information clearly showing that the tax reported is substantially incorrect.
- In addition to the full amount of tax owed, a taxpayer could be assessed a penalty of 75 percent of the amount owed if the underpayment on the return resulted from tax fraud.

If these costs are not scary enough, the IRS also reminds taxpayers that they could even be subject to criminal prosecution. The range of potential criminal offenses includes such items as tax evasion; Willful failure to file a return, supply information, or pay any tax due; Fraud and false statements; Preparing and filing a fraudulent return; or Identity theft.

Criminal prosecution could lead to additional penalties, and even prison time. But what is willful conduct? If you gave $100 to the maître d' at that business dinner, but somehow wrote down $1,000, is it credible to say that you mistakenly added a zero?

Innocent, even *stupid* mistakes can be forgiven. Intentional wrongdoing, no. Since taxes are complex, you might assume that just about *anything* can be called an innocent mistake. However, you can be *attributed* knowledge.

Willfulness involves a voluntary, intentional violation of a known legal duty. In taxes, it applies for civil and criminal violations. This definition causes many people to think they are home free. If you didn't *know*, how can you be prosecuted? It's not that simple. You may not have *meant* any harm, but that may not be enough. Many people think that even civil penalties cannot be imposed if you weren't actually trying to cheat anyone.

Unfortunately, willfulness can be shown by your knowledge of reporting requirements and your conscious choice not to comply. "Gee, I didn't know," can get you off the hook in a variety of circumstances. Sometimes it can even work with the IRS. But it is hardly a get-out-of-jail-free card.

Everyone has heard that ignorance of the law is no excuse. Even if it can explain one failure, repeated failures to comply can morph conduct from inadvertent neglect into reckless or deliberate disregard. Even willful blindness — a conscious effort to *avoid* learning about reporting requirements — may be enough.

With most tax mistakes, the question is just whether you pay penalties on top of taxes and interest when they catch your mistake. The size of penalties varies but often, 25 percent is at stake. Civil fraud is 75 percent, but it is not often asserted. Criminal violations are asserted even less frequently.

Still, most criminal tax cases start with civil audits. Even a smidgen of fraud or intentional misstatements can be serious enough to be potentially criminal. The burden can be placed on you to prove you are right or that your mistakes were innocent.

Remember Jersey Shore's Mike "The Situation" Sorrentino? He was indicted on $8.9 million tax evasion charges. The case still has not gone to trial. The feds claim that the Situation and his brother failed to pay taxes on income from two companies they controlled, MPS Entertainment, LLC and Situation Nation, Inc. U.S. Attorney Paul J. Fishman said. "The brothers allegedly also claimed costly clothes and cars as business expenses and funneled company money into personal accounts."

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