3 tax mistakes made every day

You probably don't mean to violate the law or invite hassles with the IRS, but ignoring simple, common-sense guidelines could get you into trouble.

[Related content: taxes, tax audit, IRS, tax laws, deductions]

By Robert W. Wood, Forbes.com

Harvey Silverglate's recent book, "Three Felonies a Day," argues that a combination of vague laws and changing technologies has led the average American unwittingly to break the law daily.

That got me thinking of an analog in the tax world: Most of us, I fear, mess up tax issues every day. No, these mistakes aren't felonies. But you don't want to end up on April 15 having logged 365 days of tax mistakes.

Here are three tax rules many of us break almost daily. Respect them, and you'll reduce the chance of coming to grief with the Internal Revenue Service.

1. Keep business and personal affairs separate

It might be overstated to say that never the twain shall meet. You might often do things with a dual motive -- say, having a pleasant lunch with a business colleague, going on vacation with your best client or buying a vacation home that you also intend as an investment.

However, you'll be better off if you can separate your tax life into business and personal categories. That might sound radical, but it's really just following the tax code. As I look back over a 30-year career as a tax lawyer, I can think of many big, messy and expensive tax disputes that came down to a violation of this fundamental divide. The person who forgets this rule and tries to morph personal matters into business is asking for trouble. I'm thinking of people who:

- Try to deduct the cost of their divorce because their business is at risk.
- Try to deduct a miserable vacation with a client.
- Claim that a hobby is a business.

Sure, there are many provisions in the tax law that explicitly recognize the dual purposes many of us have in pursuing activities and purchases. Still, try to avoid such dual-purpose goals, and do your best to categorize things appropriately. I think you'll make your tax life easier.

2. Keep good records

Most of us at one time or another violate this edict. You might think keeping good records is something that can help you only if you actually end up in a tax controversy. Yet believe it or not, there is something about keeping good records that can keep you out of tax trouble in the first place. Maybe it's karma.

Moreover, this rule isn't just for people who run businesses. For example, recreational gamblers, even retirees playing the slots, need to keep a diary or other record of how much they bet and lose on each visit. That's because your occasional big win will be reported to the IRS by the casino. You can use gambling losses to offset your winnings. But if you don't keep good records, you could end up a two-time loser -- once at the tables and once to Uncle Sam.

Another example is charitable donations. Put a $20 check instead of a $20 bill in the collection plate. The law requires you to have paper proof of every donation you deduct. (For more, read "Give and grow rich with charitable deductions.")

Does the IRS really care about this sort of record keeping? Yes. Most of the audits conducted on ordinary, law-abiding folks -- meaning wage earners without undisclosed offshore accounts -- are so-called correspondence audits. In such audits -- you might be picked for one if you deduct a lot of contributions -- taxpayers are told their deductions will be disallowed unless they promptly mail back records substantiating them. (Also see "Tax records you can toss.")

3. Respect and keep those 1099s

This might sound like an April 15-only item. In fact, how you handle third-party "information returns," such as 1099s, year-round will influence how easy or hard a time you have when you file your return and interact with the IRS thereafter.

Whether you are a payee or a payer, you need a system to record and track information returns. That's exactly what the IRS does. A lot of what goes on at the IRS is computer matching -- the endless correlation of taxpayer identification numbers and payments. Even a small mismatch between what's on these forms and what you report on your tax return will be caught and could result in months of hassles with the IRS. Much of what the IRS does, when it comes to monitoring taxpayers, is information return matching.

There are different forms for miscellaneous income -- Form 1099-MISC (.pdf file) -- for interest -- Form 1099-INT (.pdf file) -- and so on. There are also a few information returns you might receive showing how much you paid. For example, if you have a home mortgage and make mortgage payments, you should receive a Form 1098 (.pdf file) from your lender reporting how much interest you paid during the year. (See "Home: The mother of all tax shelters.") When you deduct interest on your tax return, the IRS will match your return to this form to make sure you haven't overstated your deduction. Another common information form is a Form W-2, issued to employees reporting wages.

Pay attention to these forms as they arrive. Confusingly, these days you might get a statement from your bank that looks like your regular statement but says somewhere it is a 1099. When you get your 1099s, don't just stick them in a drawer. Look at them. Payers are required to mail all 1099s to payees no later than Jan. 31. Then the payer has until Feb. 28 to send all 1099s to the IRS. This one-month lag means that if you receive a 1099 you know is wrong, there might be time to correct it before the IRS receives a copy.

If you receive an incorrect 1099 -- this is common -- contact the payer as soon as you receive the errant form. Explain the error and ask whether the payer has already sent a copy of the 1099 to the IRS. The best corrections are done this way, with the payer simply destroying the old form and issuing a correct one.

It's a good idea to keep a record of such communications, since you might end up ensnarled in a reporting mess later on. If the payer has already sent a copy of the erroneous form to the IRS, you can still ask for a correction. In that event, the payer should issue a corrected 1099 (there's a box on the form to check for this).

If you are a partner in a partnership, a member of a limited liability corporation or a shareholder of an S corporation, you also should receive a Schedule K-1 (.pdf file) for each year, reporting how much gain, loss or income is being attributed to you. Normally, it must be mailed to partners or shareholders no later than March 15, giving them one month to meet their own April 15 deadline.

But some entities are notorious for mailing out K-1 forms late. You might find yourself unable to file your personal tax return until you receive just one more K-1. If it doesn't come, file a request for an extension. It's easy, and the IRS will grant it automatically.

Published Jan. 7, 2010