Expert View

Three Tax Mistakes You Make Every Day

Robert W. Wood, 10.23.09, 5:45 PM ET

Harvey Silverglate's new book *Three Felonies a Day* argues that a combination of vague laws and changing technologies has led the average American to unwittingly break the law daily. That got me to 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 next 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 may be overstated to say that never the twain shall meet. You may 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. That may 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 ones 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 their best client.

* Claim their hobby activity as a gentleman farmer or horse breeder was really engaged in for profit. (If you do engage in a business that the IRS might construe as a hobby, click here for more advice.)

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. II think you'll find your tax life to be easier.

2. Keep good records.

Most of us at one time or another violate this edict. You might think keeping good records is only something that can help you 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 (yes, even retirees playing the slots) need to keep a diary or other contemporaneous 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--losing once at the tables and once to Uncle Sam.

Another example: 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.

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--and 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. (For more on how IRS mail handling problems can turn one of these audits into a mess, click here.)

3. Respect and keep those 1099s.

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

Whether you are payee or payor, you need a system to record and track these information returns. After all, 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), for interest (Form 1099-INT) and so on. There are also a few information returns that you may receive showing how much you paid. For example, if you have a home mortgage and make mortgage payments, you should receive a Form 1098 from your lender reporting how much interest you paid during the year. 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 little forms as they arrive. Confusingly, these days you may 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. Payors are required to mail all 1099s to payees no later than Jan. 31. Then, the payor has another month (until Feb. 28) to send all of its 1099s to the IRS. This one month lag means that if you receive a 1099 you know is wrong, there may be time to correct it before the IRS receives a copy.

If you receive an incorrect 1099 (and this is common), contact the payor who issued the erroneous form as soon as you receive it. Explain the error and ask whether they have already sent a copy of the 1099 to the IRS. The best corrections are done this way, with the payor simply destroying the old form and issuing a new and correct one. It's a good idea to keep a record of such communications, since you may end up ensnarled in a reporting mess later on. If the payor has already sent a copy of the erroneous form to the IRS, you can still ask for a correction. In that event, the payor should issue a "corrected" 1099 (there's a special box for this).

If you are a partner in a partnership, a member of an LLC or a shareholder of an S corporation, you also should receive a Form K-1 for each year, reporting how much gain, loss or income is being attributed to you. Normally, it must be mailed to partners/shareholders no later then March 15, giving them one month to meet their own April 15 deadline. But some entities are notorious for being late in mailing out Forms K-1. You may find yourself unable to file your personal tax return until you receive just one more Form K-1. If it doesn't come, file a request for an extension. It's easy and the IRS will automatically grant it. (For more on what to do if you can't file on time, click here.)

Robert W. Wood is a tax lawyer with a nationwide practice (www.woodporter.com). The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments *(4th Ed. 2009 www.taxinstitute.com), he can be reached at wood@woodporter.com.*

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