



## Before You File Your 2007 Tax Return, Read This

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**“Under the English legal system you are innocent until you are shown to be Irish.”**  
 — Ted Whitehead

### Audit Information and Misinformation

Many taxpayers seem to believe that if the IRS doesn't call them in for an audit within six months after their return is filed, they are home free. WRONG!

- ✦ The IRS has, at *least*, three years from the date your return was filed or due, whichever is *later*, to audit your return.
- ✦ If you omit more than 25% of the *gross* income from your return, the statute of limitations is raised to six years.
- ✦ There is a further exception in the case of fraud. If the IRS can allege and *prove* that fraud was committed — there is *no* statute of limitations.
- ✦ Pre-refund audits are almost never conducted unless the IRS knows or strongly suspects fraud.
- ✦ Receiving your refund check does *not* confer any immunity from audit.
- ✦ Realistically, if your return isn't opened for audit within 20 months, it probably never will be. (This is no IRS guarantee, just practical knowledge.)
- ✦ The individual states frequently have *different* statutes of limitations than the IRS. For example, in California, the regular statute of limitations is four years vs. the IRS' three years.

### Easy Ways to Avoid the First IRS Audit Scan

- ✦ The most common error (believe it or not) is *missing signatures*. Have you and your spouse *both* signed and dated the tax return?
- ✦ Report *all* Form W-2 and Form 1099 income. If you feel that some 1099 reported income is not taxable: (a) *report* the income anyway; (b) on the next line *subtract* the same amount and add “see explanation”; (c) attach a full explanation as a footnote. But don't just ignore the Form 1099....
- ✦ If you receive a Form 1099-R (indicating a retirement plan distribution) and the entire amount was rolled over into another retirement account — report this transaction *even though* there is no taxable income. It clears the IRS computer that has this same information.
- ✦ File on time, including extensions. (Filing later with an approved or automatic extension does *not* increase your chances of an audit.) Filing *after* the final extended due date does.
- ✦ Try to avoid really huge refunds by adjusting your withholding and/or estimated tax payments in advance. **TAXTIP:** If it's too late, consider letting the IRS keep the refund — and immediately reduce your withholding and/or future estimates by the same amount. Couldn't hurt....

## “Pre-refund audits are almost never conducted unless the IRS knows or strongly suspects fraud.”

- ✦ Attach *all* required supporting schedules and forms to your return.
- ✦ Double check that the social security numbers of you, your spouse and dependent children are *all* correct. A common error....
- ✦ Report the name, address, and identification number of child-care providers.
- ✦ Be sure and provide the Social Security number of any person to whom you *paid* alimony.
- ✦ Attach Form 8283 if you gave *total* non-cash (“in kind”) items worth more than \$500 to charity.
- ✦ Report all sales of capital assets and be sure the selling price *agrees* with the amount reported by your broker or other financial institution to the IRS.
- ✦ Don’t ignore the Alternative Minimum Tax (AMT) calculation if you are even possibly liable — and attach Form 6251 (we do in every case).
- ✦ Don’t round off figures to the nearest \$50 or \$100.
- ✦ Be neat and legible. You can really irritate some IRS reviewer by sending a tax return he or she can barely read. It won’t get you a “pass” — but it might get you an audit!
- ✦ Show the IRS how honest you are by reporting small amounts of income the IRS is unlikely to uncover. This particularly applies if you are filing a Schedule C — as well as elsewhere (e.g., jury duty fees).

### Form W-2

It costs the employer *nothing* to check Box 15, Form W-2, if your employee possibly qualifies as a “statutory sales employee.” However, it can be a big help to the employee in claiming unreimbursed business expenses (but if you are reimbursing *all* such expenses, there is no tax advantage to the employee). This classification permits the employee to deduct all *unreimbursed* business expenses on Schedule C, *as if* he/she was a self-employed individual. It saves the employee the 2% (of adjusted gross in-

come) disallowance of those expenses (100% disallowed for the AMT calculations) and the necessity to claim itemized (rather than standard) tax deductions, among other advantages.

### Schedule B — Interest and Dividend Income

Year after year, many taxpayers cause needless problems for themselves, by reporting the correct *amounts* of dividends and interest, but not in a way that matches the IRS computer verification system. In Schedule B, Parts I and II, interest and dividends should be reported in the following manner. If you receive a broker’s statement that lists total dividends and/or total interest — report just the name of the *broker* and only those *totals*. Instead, taxpayers continually list the *individual* stocks, bonds and funds — and the separate income from each. Please do as they ask and save yourself time and potential aggravation....

Similarly, report every Form 1099 for interest and dividends *exactly* as the names and amounts are indicated on each form. Whatever you do — don’t *lose* any of those forms, or about 18 months later, you will surely receive an IRS computer form letter (CP-2000 or CP-2500 or CP-2501) with a bill for additional taxes, interest and penalties. At which point every taxpayer immediately screams one of the four standard excuses (yawn):

- ✦ “I never ever got the Form 1099 — so it’s not my fault.”
- ✦ “I think I sent it to my CPA — so it’s his fault, because the jerk lost it!”
- ✦ “I never even owned any of that stock — so they’re wrong.”
- ✦ “I never even had an account at that bank — it’s their mistake.”

Then, after much stress, wasted time, soul-searching, record-searching, extra accounting fees, and long conversations — you reluctantly concede that the IRS was correct (usually) and pay the bill for taxes, interest, and penalties. Try to avoid this *needless* trauma with better recordkeeping and *save every Form*

1099. And remember: the “CP” designation in that IRS letter either stands for “Computer Program,” or “Crooked Person,” we’re not sure which.

### Tax Carryforwards

You may have some *major* tax credits or tax deductions from prior years’ carryforwards such as: alternative minimum tax (AMT) carryover, capital loss carryover, charitable contribution carryover, passive loss carryover, investment tax credit or jobs tax credit carryover, net operating loss carryover, investment interest carryover, etc. **TAXTIP:** If you have *changed* tax preparers since last year, you should be particularly alert to the possibility of one or more of these items being missed, since they won’t be part of the new preparer’s computer program.

### Your Filing Status, Page 1, Lines 1-5

You may be *legally* married, but still able to file your return as “Head of household” (or sometimes “Single”), rather than “Married filing separate return.” Since the “Head of household” (HOH) reflects the most favorable tax rate of those alternatives, you should file as such (*even though married*) if you meet *all four* of these conditions:

1. Your spouse was not a member of your household for the *last* six months of the calendar year, *and*
2. You maintain a household for more than half a year as the principal home of your child-stepchild-adopted child, for whom you are generally entitled to a dependency exemption (or your parents that you can claim as dependents even if *not* living with you), *and*
3. You furnish over half the cost of maintaining that household, *and*
4. You file a separate income tax return.

**TAXTIPS:** We frequently find divorced and single individuals who *also* could file as “head of household,” rather than “single,” and save income taxes. You singles should check the exact rules with your own tax preparer, for possible big tax savings! (Also, if you are *legally*



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separated and cannot qualify as HOH — you *can* file as “single,” which usually represents a tax saving).

**Special Tax Options and Opportunities**

Use this list to review with your own tax preparer or yourself. Were you eligible to claim?

- \* Credit for children under age, under the latest rules?
- \* Dependent care-credit?
- \* HOPE Scholarship Credit?
- \* Lifetime Learning Credit?
- \* Education IRA?
- \* Education loan interest deductions?
- \* Earned income credit?
- \* Adoption credit?
- \* Elderly tax credit?
- \* Credit for paying your CPA very generous fees? (Just kidding, but *we* will certainly give you lots of *credit!*)

All of these may be limited or eliminated — depending on your Adjusted Gross Income (AGI), but you don't even know if you are eligible until you check each possibility. **CAUTION:** There are *different* AGI limits for the different tax opportunities listed above.

And also:

- \* If you worked multiple jobs, make sure you claim any excess social security taxes (over the maximum) as additional income tax withheld (and in California also excess SDI).
- \* You may claim a dependency exemption if you supply more than 50% of the support for a U.S. citizen (or U.S. resident; or a resident of Mexico or Canada) provided that person lived in your home as part of your household during the entire year, and whose gross income (excluding nontaxable income) was less than \$3,300. *The person does not have to be related to*

*you*. Thus, a dependency exemption might also be claimed in same-sex living situations, when one partner earns less than \$3,300 (provided the relationship does not violate local law).

- \* *Always* send your return by certified mail, return receipt requested. Then attach the return receipt to your file copy of the tax return. (E-filers can ignore this.)
- \* Place your social security number on *any* checks you send IRS and always keep a copy of your return and a copy of all the cancelled checks with your tax records.
- \* “Cold” review your individual income tax return (Form 1040), maybe a day after you first look it over — before you finally mail the thing away. It does not matter if you prepared the return yourself or if you used a paid tax preparer — there can still be errors....

**State Income Tax Deduction — Schedule A, Line 5**

There can be up to *nine* different kinds of payments included in this one tax deduction, so it's easy to miss one or more elements:

1. Your state income tax withheld, as shown on your 2007 Form W-2.
2. Any balance you paid on your 2006 state income tax return, on or about April 15, 2007.
3. Any amount paid with an extension request for filing your 2006 return, also around April 15, 2007.
4. Your fourth quarter state estimated tax payment for 2006, if paid around January 15, 2007.
5. Your fourth quarter state estimated tax payment for 2007, if you paid it early, in December 2007.
6. Any state income tax balances for prior years, which were actually paid during 2007.

7. Any state income tax withholding indicated on 2007 retirement plan distributions (Form 1099-R) — or possibly on interest earned or dividends received.
8. Any payments made in 2007 to *other* states, as a non-resident. (This frequently happens when the taxpayer has invested in partnerships with real estate or business income coming from *other* states.)
9. In California, SDI (State Disability Insurance) withheld on your 2007 Form W-2.

Did you claim *all* of these deductions?

**Mutual Funds**

These transactions contain the potential for a number of tax errors:

- \* When reporting the sale of your mutual fund shares, be sure the *cost* you report includes *reinvested dividends and reinvested capital gains* — and not just your initial investment.
- \* When reporting income from U.S. Treasury mutual funds, remember that all (or virtually all) of that income is *state* income tax free.
- \* When reporting income from municipal bond funds, remember that all (or virtually all) of that income is *federal* income tax free — and may or may not be subject to the various states' income taxes.
- \* There are four different methods of figuring the cost of your mutual fund shares sold. Did you use the most favorable method?

**Mortgage Points**

If you refinanced your home mortgage in 2007, keep in mind that any unamortized points from a *previous* financing or refinancing can now be deducted *in full*, on Schedule A (be sure to clearly explain this deduction). We find this to be a common error and one that frequently involves thousands of dollars in deductions!

## “Despite repeated denials by the IRS, there is more than a little evidence that filing your tax return close to the latest legal due date of October 15 — reduces your chances of being audited.”

### IRS Audits and Filing Your Tax Return On Extension

Despite repeated denials by the IRS, there is more than a little evidence that filing your tax return close to the latest legal due date of October 15 — *reduces* your chances of being audited. All this requires is that you send an *automatic* six-month extension of time to file (using Form 4868). No reason is required to obtain this extension of time to *file* (although you should *pay* at *least* 90% of your total tax liability by April 15 of each year). Our own experience with many, many IRS audits tends to bear this out.

The reasoning goes like this. About 94% of all returns are filed by April 15. As returns are filed, the IRS computer steadily scores them and some are selected for inclusion in the IRS audit inventory. However, their entire 1% or so audit selection quota may well be *filled* before the delayed filing of your return, suggested to be near October 15. Your return will certainly avoid the *first* (and maybe *second*) batch of returns so selected. Further, late-filed returns may not even be computer scored, but even if they *are* selected for audit — it's quite possible that time could run out on the IRS before they can actually audit you within the statutory three-year limit. Delays, budget, and scheduling problems usually arise — and *they are always on your side!*

Among others with this opinion, was a professor of statistics at a major university. Using a Cray computer, he analyzed thousands of tax returns and their related audit frequency. His final opinion was that the *later* a tax return is filed (e.g., around October 10-15) the *less* chance of an IRS audit; and that many *late-filed* returns that he analyzed and felt should *absolutely* be audited — usually were *not!*

To sum up, your return might never even end up in that last group selected to be examined — or even if it *does*, they may never get to it in time. So don't be afraid to go on extension. Like my mother's chicken soup — it couldn't hurt....

Finally, since the IRS is now selecting 13,000 individual income tax returns *each October*, for their special statistical detailed audit program — it seems logical that the *later* you file your return (in October, of course) — the better your chances of avoiding being selected for either the regular or special statistical audits.

**LOGIC TEST:** (1) I have never gone on extension and always filed my tax return on time. (2) I have never been audited by the IRS. (3) *Therefore*, going on extension causes you to be audited. True or false?

### Another Reason to File for an Extension

This only applies to the many taxpayers with accounts at the various brokerage houses. The law requires that the brokers must send you their year-end information (dividends, interest, securities sales, etc.) by January 31st, reporting the transactions of the previous year. *However*, in almost all cases there is a warning, frequently buried deep within their year-end report. It goes something like this:

*We do not always have the necessary information to provide you with a correct final statement by the IRS deadline of January 31st. Final verification of dividend, interest or other tax information may not be available for all your securities. Some mutual funds and other entities may revise their tax information after we have sent it to you. If we receive notice of corrected earnings after that date, a **corrected Form 1099** may be generated. If you have filed your taxes (Form 1040), you then need to file an amended tax return (Form 1040-X). You may wish to consult a tax advisor about the **timing** of preparing your individual income tax return for the year.*

How many of you read such a notice? Sometimes, there is just a single line such as: “A corrected report may be necessary,” instead of the sample given above. In any event, many, many taxpay-

ers just send the original report to their tax preparer — and wait for their return to be promptly prepared. This is particularly true of the large group of taxpayers that state: “I never went on extension in my life, I'm not going to start now, if I ever went on extension the IRS would audit me for sure — and I would *die!*” And we have a number of those taxpayers in our own practice....

So, the result is frequently that we later prepare *revised and amended* tax returns after the corrected reports are received from the brokers. And a second set of fees is, of course, charged the client — plus the accompanying aggravation. Finally, there is the truism that, if possible, you *never* want to file an amended tax return, since it gives the IRS a second look at your *entire* tax return — and not just the changed information. But the compulsive ones who *never* want to go on extension (or they will *die*) — ignore all this and want their tax return prepared and filed immediately.

What's the intelligent solution? If you receive such a warning notice (look for it!) of course the answer is to file for a six-month extension to October 15th and wait for corrected forms from your brokers. Keep in mind, there is no deadline for them sending you any *corrected* information, and it can be some months later. By July or so, if no such correction is received, you can then proceed to have your tax return prepared. **CAUTION:** As we have often warned, an extension only gives you time to *file* your return and not to *pay* any taxes owing. Any such balance, as best calculated, should be paid *with* the automatic extension that is filed on or before April 15, to avoid both penalties and interest.

### If You Cannot Pay Your Taxes on Time

If you cannot pay the full amount of the taxes you owe by the April 15 deadline, you should still pay as much as you can by that date, to reduce penalties and interest. There are still alternative payment options to consider.

## “Non-deductible expenses [include]... license fees for dogs or marriage (sometimes interchangeable).”

**Pay by Credit Card.** You can charge your taxes on your American Express, MasterCard, Visa or Discover cards. To pay by credit card, contact one of the card companies at their telephone numbers provided. The service providers charge a “convenience fee” based on the amount you are paying (do not add the convenience fee to your tax payment).

**Special Extension of Time to Pay.** Based on circumstances, a taxpayer could qualify for a special extension of time to pay. The IRS is willing to allow such extensions in order to assist in tax debt repayment. A taxpayer can request an extension of from 30-120 days depending on the specific situation. Taxpayers qualifying for this kind of extension will generally pay less in penalties and interest than if the debt were repaid through an installment agreement.

**Installment Agreement.** The IRS may allow you to pay any remaining balance in monthly installments through an installment agreement. You can now apply for this IRS agreement using their “Online Payment Agreement” application accessed through **IRS.gov**. This Web-based application allows eligible taxpayers or their authorized representative to self-qualify, apply for, and receive immediate notification of approval.

**Form 9465.** Another alternative is to attach Form 9465, “Installment Agreement Request,” to the front of your tax return. The IRS charges a \$105 fee for setting up an installment agreement. (If your income is below a certain level [see Form 13844] you may qualify for a \$43 fee.)

**Interest and Penalties.** You will also be required to pay interest plus a late payment penalty on the unpaid taxes for each month or part of a month, after the due date that the tax is not paid. If you do not file your return by the due date — including extensions — you may have to pay an additional “failure-to-file” penalty.

**Offer in Compromise.** Even if you absolutely cannot pay your taxes and there is no hope you can pay your debt, you

should file anyway. At the same time submit an “offer in compromise,” that asks the IRS to accept less (sometimes far less) than you owe. You must be able to demonstrate that you absolutely cannot pay what you owe. Frankly, getting the IRS to agree to most of these offers is both very difficult and takes a long time, but what choice do you have? Even filing bankruptcy does *not* discharge federal income taxes owing for the past three years!

**Not Filing Your Tax Return at All.** The dumbest and most costly thing you can do. You should file your tax return on time (including extensions), even if you can’t pay a penny! Not filing at all will eventually cost you staggering sums in penalties and interest, plus the grim IRS tax collectors on your back forever. The IRS estimates that non-filers of individual income tax returns cost the US (and the rest of us taxpayers) about \$25 billion a year.

**Nonsense Claims.** Some stupid people don’t file because they variously claim that: (1) there is no law requiring them to pay federal income tax; (2) filing a tax return is completely voluntary; (3) wages somehow are not taxable; (4) and for any other ridiculous reasons found in books (\$50 up) written by various so-called tax protestors. *The Tax Courts have routinely rejected all these and similar specious arguments!* A new 2007 law authorized the IRS to impose penalties of up to \$5,000 (up from \$500) for even *filing* such “frivolous” tax returns.

**More Information.** Go to **IRS.gov** and choose “1040 Central” or refer to Form 1040 instructions, or IRS Publication 17, “Your Federal Income Tax.” (Call 1-800-829-3676 for a free copy of any IRS publication.)

**Filing For an Extension.** See previous.

### Charitable Contributions

The law was drastically changed for your 2007 tax return and ever after! About the only ones paying close attention to this big change seem to be CPAs

and tax attorneys. The rest of you will really feel it about two years from now — if the IRS audits you. But then, it will be too late — unless you read this section and make sure your 2007 charitable contribution deductions follow the new laws (effective January 1, 2007). Here they are:

- ✦ To deduct a charitable *cash* donation, you must have a bank or credit card record — or a written communication from the charity detailing the amount and date of the contribution. (Cancelled checks, of course, are probably the single best record.) **THIS RULE APPLIES TO ALL CONTRIBUTIONS FROM \$1.00 AND UP — NO EXCEPTIONS!** Your own detailed computer (or hand) record of all such donations is *worthless* in the eyes of the IRS — as are diaries, notes, and similar personal records.
- ✦ Consider the common practice of dropping a \$5 or \$10 bill (or more) into your weekly church offering plate. No receipt — no tax deduction! In this case, about the only solution is to write a check in advance of your churchgoing, and stop using cash. Unless the church or other religious organization is prepared to issue receipts on the spot (highly unlikely). Same problem with the great Salvation Army — those dedicated and wonderful folks freezing their buns off and ringing those bells, sometimes during a blizzard. You generously drop a \$20 bill into their red kettle — no receipt — no deduction. Bummer!
- ✦ Charitable contributions are deductible only if you itemize deductions on your Form 1040.
- ✦ Contributions must be made to a “qualified organization.”
- ✦ Used clothing and household items of all kinds (e.g., furniture, linens, appliances) must be in “good” or better condition.
- ✦ Vehicle donations are subject to special and stricter rules.

- ✦ To deduct donations of items valued at \$250 or more, you must have written acknowledgment from the qualified organization as well as the other documentation.
- ✦ To deduct donations of items valued at \$500 or more, you must complete a Form 8283, Noncash Charitable Contributions, and attach the form to your tax return.

If you want still more information, it's IRS Publication 526, Charitable Contributions, available on the web at **IRS.gov** or by calling 1-800-TAX-FORM (800-829-3676).

### Nondeductible Expenses

A sure way to get your tax return pulled for special scrutiny and special handling is to try to claim *non*-deductible expenses. In our experience, the one we still find listed over and over in our "tax organizers" is credit card interest. On an individual, non-business tax return (Form 1040) — *this is never deductible*.

The same is true of interest paid on auto loans by all *employees* (regardless

of business use), excise taxes on utility bills and similar, gasoline tax, inspection fees, alarm fees, license fees for dogs or marriage (sometimes interchangeable), assessments for improvements to your property and the like. Of course some of these may be deductible by a *business*, but none of them qualify on your individual, non-business personal tax return (Form 1040).

### Nontaxable Income


Conversely, don't report *non*-taxable income and overpay your taxes — or the IRS may never (heh, heh, heh) correct this error. Examples are:

- ✦ Money or property inherited or received as a gift (any taxes due were paid *before* you received the assets).
- ✦ Child support or welfare benefits (some people think the two are the same).
- ✦ *Dividends* on life insurance policies (different from *interest* earned on certain policy accumulations, which is taxable).

- ✦ Life insurance proceeds, disability payments (unless the premiums were paid by your employer), workers' compensation benefits, fire and casualty insurance proceeds, regular damages for injury or sickness, etc. (However, *punitive* damages for injury or sickness and *all* damages for emotional distress are taxable.)
- ✦ Certain amounts received as scholarship grants.

Generally (subject to some technical rules) none of the preceding should ever be reported as income on your tax return.

### Conclusion

Now that you have followed all these suggestions and ideas, if you are *still* nervous about your tax return being audited — maybe you should wait and file around October 15, as we explained! 

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