



Tax Tips You Can Use Nov. 2007

“Tax Gap” Part 2

By Kathleen Crawford, EA

The “Tax Gap” is the difference between the tax money that was actually paid and the amount that should have been paid to the federal government. The tax gap has three components: Non-filers or taxpayers who don’t file a tax return for some period; people who file but do not pay the full amount of tax owed; and taxpayers who under-report their income or over-report their expenses. Last month’s article looked at the 15% of the tax gap made up of non-filers and non-payers. This month, the subject is the largest part of the tax gap- the taxpayers who under-report their income or over-report their expenses.

Many people will wonder how a taxpayer can report less income than he receives. Most of the time it is the self employed who under-report. For example, a repairman is paid in cash and ‘forgets’ to put the amount in his records. Or a contractor fails to send out 1099’s to her subcontractors, so a subcontractor decides not report that income. Another type of income under-reporting is personal loan interest. If I loan my friend money and he pays me interest, that interest is income to me just like bank interest. How many people know to report this income? A third type of unreported income is the gain on sale of assets. The profit on the sale of personal items is taxable income, so that coin collection sold on ebay may generate taxable income to be reported.

The IRS has several methods to find these people. The first method affects many taxpayers. The rules for 1099 reporting are being tightened so that more 1099’s will be required. The various “1099” forms are the way that a business can report amounts paid to other individuals and businesses, so that the IRS will know about them. The fines for failing to issue 1099’s are being raised and enforced. In my practice, I have just seen the first penalty letter for late filing of 1099’s.

Another way that unreported income and over reported expenses are found is during an audit. In an audit, the IRS will look at bank deposits for the year. If a taxpayer’s deposits are above the income listed on the tax return, then the taxpayer failed to report income, unless he has an explanation for the difference. The IRS will also look at some aspects of life style. If the taxpayer claims to have made \$2000 last year and has a new \$50000 car in the driveway, there needs to be some explanation.

The IRS is three times more likely to audit a self-employed person than a taxpayer who works for wages because of the possibly of under-reported net income. Audits are not always random. I recently helped a taxpayer with a small audit. She received a letter that her large subcontract expense was being disallowed. The taxpayer had not filed 1099’s for her subcontractors. We submitted the bookkeeping records to show that the expense was legitimate. But before the records were accepted, we had to submit cancelled checks, names, addresses and social security numbers, where available, for each subcontractor. My client’s tax return was accepted, but guess who will get audited next.

The IRS is tightening income reporting rules and increasing audits because Congress wants the Tax Gap narrowed. When tracking income and expenses for your tax return, this is important to keep in mind.

The fine print is that this article is for information only. Please call Kathy or a tax professional for questions about your individual tax situation. The Jacksonville Tax Lady can be reached at 541-899-7926 or at 610 North Fifth Street.

