10 Really Dumb Taxpayer Beliefs

10 common tax mistakes and the truth behind each one.

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Belief 1:
If You Don't Ask, I Don't Tell

Taxpayer Belief: If I do not receive a Form 1099-MISC reporting the income I received as an independent contractor, then I don't have to report the income on my tax return.

The Truth: It is not uncommon for companies to either overlook or intentionally fail to send Form 1099 to their independent contractors. The company that fails to report can be penalized $100 for each form they neglect to send. The higher risk, however, is to the independent contractor because failure to report income carries serious penalties and can even be considered tax fraud. 1099 or no, cash received for performance of services is taxable income.

Belief 2:

Time is Not Always Money

Taxpayer Belief: I volunteered 100 hours for charity and my time is worth $50 per hour, so I have a $5,000 tax deduction on my income tax return.

The Truth: Many taxpayers volunteer to work for their favorite charities. These taxpayers often try to conclude that their contribution of time should be deductible just as if it were a contribution of cash. That logic is flawed because the value of the services were never reported as income, so there is no basis in the services that were contributed. The taxpayer is actually better off than if the income and offsetting deduction were reported, because there is no impact on self-employment tax or the limitation on itemized deductions.

Belief 3:
This IS a business

Taxpayer Belief: I don't need to worry about complex tax forms such as AMT or Passive Loss Limitations because I'm not rich.

The Truth: The pitch for many "Biz-Ops" or "Tax Proofing Plans" is that setting up a home-based business will enable the deduction of virtually all expenses of running the home, bringing Federal taxes to near zero. The truth is that expenses are only going to be deductible when a business has a real profit motive, and then only to the extent of the business use allocation. For home office expenses, that limitation includes specific hoops and allocation procedures. For entertainment expenses, there are strict documentation guidelines. There are also hobby loss rules that eliminate deductions for activities that never make a profit.

Belief 4:
No Money, No Problems

Taxpayer Belief: Simply by signing up to a business opportunity, I can deduct otherwise personal expenses.

The Truth: Even ordinary hard-working taxpayers can become subject to these special provisions. A year when income is especially high followed by a year when itemized deductions are especially high can easily trigger AMT. Maintaining rental property can trigger passive loss limitations. There are other special provisions to consider, which makes it important to have professional help or access to good tax guides, professionals (hint, hint) and software.

Belief 5:

I Got This...

Taxpayer Belief: I don't need a computer to do my taxes.

The Truth: The biggest single problem with income tax returns is math errors. The use of inexpensive tax preparation software virtually eliminates this category of error.

Belief 6:
Don’t Worry About Mutual Funds

Taxpayer Belief: It’s too complicated to track changes in the basis of mutual funds.

The Truth: Mutual funds are bought and sold, resulting in capital gain or loss. The gain or loss is not as simple as subtracting the original cost from the sales proceeds. To the extent that dividends and capital gains have been reinvested rather than taken in cash, the basis is more than the original cost. When dollars are moved from one fund to another, there is a taxable event that again changes the basis. Failure to account for all these changes can cause significant overpayment of income tax. If you don’t want to track your basis, consider other types of investment.

Belief 7:
Charitable Contributions

Taxpayer Belief: Any check written to a charity is deductible as a contribution.

The Truth: Many checks written to charities are in payment for products or services. These amounts are not deductible. For example, a taxpayer might pay $50 to a church for his child to participate in a youth soccer program. That payment is no different than paying a private soccer facility for the same service, and is not deductible. Sometimes, payments are only partially deductible. For example, a $200 ticket to a charity dinner could be deductible to the extent that the $200 exceeds the fair value of the dinner. The charity will generally disclose the amount that is considered to be fair value for the service.

Belief 8:
Don't Take Calculated Risks

Taxpayer Belief: I won't take any "gray" deductions because I don't want to be audited.

The Truth: Each expenditure is either deductible or not deductible. Most "gray" expenditures become more black or white with additional research and thought. Taxpayers need to spend the time and effort to properly categorize expenditures and stop leaving deductions on the table. Occasionally, a taxpayer may be unable to reach a clear answer about the deductibility of an item. If the item is unclear, but there is sound logic to support a deduction, then it is usually worth the risk to claim the deduction.

Belief 9:

Car Lease=100% Deduction

Taxpayer Belief: I lease my car because the lease payment is 100% deductible.

The Truth: Many taxpayers assume that every dollar spent on a car lease is deductible as a business expenditure. There are two problems with that notion. First, the deduction is only allowable based on the business use percentage - IT IS STILL NECESSARY TO TRACK MILEAGE. Second, there is a requirement to add an "inclusion" amount to income for leases of all but the most inexpensive vehicles. The intent of the leased vehicle inclusion is to limit the amount of the annual deduction in the same manner that a cap is placed on automobile depreciation for luxury autos (IRS definition of luxury not common sense definition).

Belief 10:

Spend Money, Make Money

Taxpayer Belief: I need to spend more on deductions so I won't have to pay as much tax.

The Truth: It never makes sense to spend a dollar to save 40 cents. It often makes sense to work the timing of an expenditure, or to modify the nature of an expenditure to reflect its business purpose. It doesn't make sense, however, to spend money for the sole purpose of reducing taxes.