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Personal Income Tax Guide

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1) Personal Income Tax Guide: Introduction

For many people, getting ready for tax season is about as much fun as planning a trip to the dentist. Just thinking about getting ready for tax time causes most people to get a pit in their stomach, and their blood pressure boiling. Sadly, just like it's too late to worry about cavities once you're sitting in the dentist's chair, it's too late to try and minimize your tax bite a few days before taxes are due. By being proactive and planning ahead, you can ensure that your annual appointment with the IRS is as painless as possible.

In this tutorial, we'll cover everything you need to know to get ahead of the game, including a look at some of the most misunderstood basic concepts, the most overlooked deductions and some steps you can do today to save yourself some money - even if you weren't the most prepared or diligent person last year.

To read more articles about tax preparation, see *Common Tax Questions Answered*, *How To Owe Nothing On Your Federal Tax Return* and *Money Saving Year-End Tax Tips*.

2) Personal Income Tax Guide: Basic Concepts

One of the most important, but misunderstood concepts in tax planning is the mechanics of the United States' progressive tax system. When asked how this system functions, most people would typically explain it as "the more you make, the more you pay in taxes." While this is partially true, this explanation gives the false impression that earning more causes *all your income* to get taxed at a higher rate - which is incorrect.

Under the progressive tax system, a taxpayer's income is actually taxed in progressively higher blocks called "brackets". This model can be thought of filling individual glasses (brackets) from a pitcher of water (income). As the income fills each bracket, only that amount is taxed at that particular rate - once it overflows you need a new glass and a new tax rate.

This is important for a couple of tax planning reasons. First, if you have any control over the timing of your income or expenses towards the end of the year, it may make sense to push the income or expense into one year or another. Naturally, you'd want to push income into the year where you expect to be in a lower income bracket. Likewise, you'd want to push the expense into the year where you expect to be in a higher income tax bracket.

Second, it's important for taxpayers to realize that due to the bracket system, a deduction may not be worth as much as they think. This can occur when a taxpayer only has a small amount of income falling in that top bracket, resulting in most of one or more of their deductions being applied at the next (lower) bracket.

Example 1:

A Suzy Taxpayer (whose top tax bracket is 25%) may think that donating $1,000 to charity will save her $250 ($1,000 x 25%) at tax time. However, since only $500 of her income fell in the 25% income tax bracket, only $500 will experience a savings at that bracket. The rest will experience a tax savings at the next lowest bracket of 10% bracket, making the overall deduction only worth $175 [($500 x .25) + ($500 x 10%)].

Tax Deduction vs. Tax Credits

Another important but commonly confused distinction by most taxpayers, is the difference between a tax deductions and a tax credit. Understanding the difference is crucial, since the tax strategies that you adopt now can favor one over the other and yield substantially different tax savings. (To learn more read, *Give Your Taxes Some*

Credit.)

A tax deduction is an expense that is subtracted from a taxpayer's income, before taxes are calculated on the amount. A tax credit however, is an amount actually subtracted from the taxes that are owed once they've been calculated. Thus, a $1,000 tax credit is often worth more than a $1,000 deduction.

Example 2:

If Bob The Taxpayer is in the 25% marginal income tax bracket, a $1,000 deduction would save a maximum of $250 in taxes from his bottom line ($1,000 less in income that will not be taxed at 25%). However, if he were in the 25% marginal income tax, he would receive a $1,000 tax credit, and he will have $1,000 subtracted directly from the amount that he'll ultimately owe the IRS.

Understanding the Bottom Line

One of the primary goals of getting ready for tax season is to eliminate nasty surprises. For most people, sitting down at your accountant's desk or hitting the "calculate" button on your tax software is like waiting for the doctor to tell you if you're going to live or die. People cross their fingers, close their eyes and say a prayer, usually with no real idea what the outcome is going to be. But, since the IRS expects any balances owed to be paid when you file your return, April 14 is a horrible time to find out you're a few thousand short. Likewise, as hard as it is to believe, it's also a horrible time to find out you're getting a few thousand back - meaning you just gave the government a tax-free loan on that money for the year, instead of having it earning money for you.

There really is no mystery to the bottom line (what you owe or what you are owed) of your tax return. In simple terms, your taxes or refund due is figured by reducing your income by your deductions, calculating the tax liability on that remaining amount, and then comparing that liability against what you've already paid through your payroll deductions throughout the year. If you've paid more than you owe, you get money back. If you've paid less, it's time to get out your checkbook.

Needless to say, it's well worth the time and money to sit down with a calculator or your tax preparer in the last few months of each year to estimate where you'll be at tax time. If you're going to owe, you'll be able to begin adjusting your budget now to try and save a little extra each month to pay your bill. If you're getting money back, you can breathe a sigh of relief and begin making other plans to pay off debts or save for your long-term goals. If this is the second year in a row you'll receive a refund, you'll want to look at adjusting your withholding and stop giving Uncle Sam an interest-free loan. (To learn more see, *How To Owe Nothing On Your Federal Tax Return* and *Tax Credits You Shouldn't Miss*.)

3) Personal Income Tax Guide: Documentation And Records

If "location, location, location" is the most important rule in real estate, then "documentation, documentation, documentation" is by far the most important rule in taxes. Without a system for properly documenting your income and expenses, you're flying blind and without a safety net. To get ready now for tax time, you'll want to review (or create, as the case may be) your tax documentation system.

The Hazards of Poor Documentation
The biggest risk of not keeping accurate and detailed records is that you're likely going to miss opportunities to deduct legitimate expenses. Considering that an average American might make hundreds of deductible purchases each year, there's no way they'll all make it on to your return unless you've documented them somehow. In the end, tracking these expenses in an organized fashion takes far less work than filing an amended tax return when you remember a large expense after you've already filed.

A secondary, but very valid risk, is that you won't be able to back up your expenses if you get audited. Since the basic stance of most IRS auditors is, "if you can't document your expense, then it didn't happen," a failure to keep clear and concrete records can result in significant back-taxes. (For more on this, see *Surviving The IRS Audit*.)

Lastly, poor documentation is likely to increase the amount of time, money and stress that goes into preparing your tax return. In part, this is because most legitimate accountants will not prepare returns with large amounts of undocumented expenses, requiring you to either go digging for receipts or skip the deduction. Even if you do have documentation, but spend a few hours sorting through it in front of your preparer, you're likely going to get charged for their time. If you're preparing your return yourself, poor documentation can leave your dining room table buried under an avalanche of paperwork, making an already confusing process that much harder.

Creating a System That Works
Before you head off the office supply store to buy a filing cabinet and a few hundred folders, consider something simpler. All you really need is a couple standard size cardboard file boxes and a 10-20 full size document envelopes (with metal clasps). You'll label and use these envelopes to sort your receipts into the major deduction categories used on your return, such as:

- *Income* - Use this envelope for all your pay stubs, various 1099s, and statements for your business if you own one.

- *Mortgage/Home* - If you own your home, you'll want to put your mortgage statements and Form-1098 in this envelope. You'll also want to include any paperwork relating to home improvements, remodeling, or home equity lines of credit. If you rent a home and live in a state such as California, which gives a deduction or credit to renters, you'll want to include copies of receipts or your canceled checks if available.

- *Utilities* - If you use a portion of your home as an office of any kind, you may qualify for the home office deduction. For those that qualify, you can deduct a portion of most of your utilities in addition to the square footage deduction.

- *Medical* - With medical costs soaring, you'll want to save every receipt that is even remotely related to any kind of medical care. This envelope would include receipts for co-pays, prescription costs, dental work, mental health counseling, alternative medical treatments, and even over-the-counter medications and remedies. You'll even want to stick in a note recording your mileage each time you visit the doctor.

- *Charitable* - Whenever you lend a helping hand, the IRS helps you right back. But as with every other type of deduction, you've got to be able to prove it. You'll want to keep all your donation receipts, canceled checks, appraisals for large non-cash gifts, and a detailed list of clothes and goods you donate. Be sure to keep your receipts for any food or other goods you buy and donate, as well as mileage you drive doing charity work - both are deductible. (For more on this read, *Deducting Your Donations*.)

- *Unreimbursed Business Expenses* - If you work for someone else, expenses you incur in the line of work that don't get reimbursed may be deductible. This may include expenses such as uniforms, meals, materials and mileage. Be sure to also save the stubs from any reimbursement checks you do receive, just to avoid confusion later.

- *Dependent Care Expenses* - Money spent on care for a child or an elderly parent may earn you a handsome tax credit. Be sure to save all your receipts for these expenses.

- *Education Expenses* - The IRS provides substantial relief for parents and students tackling the rising costs of higher education, through a number of deductions and tax credits. This envelope is the place for your tuition bills, book receipts and student loan statements.

- *A Car Log* - If you plan on driving a lot of miles for work, medical attention or charity, consider keeping a small spiral notebook with a pen in your glove box. Before you get out of the car at the end of the day, write down the different places you drove, the mileage for each and your purposes for going there. An organized logbook will make it much easier to deduct your mileage than trying to go back over the whole year at tax time.

- *Everything Else* - Use this last folder for all your other receipts, even if you don't think it will be deductible. Even the most organized and knowledgeable taxpayers often discover things they've missed at tax time. From time to time as well, the tax laws will change mid-year, permitting a new kind of deduction not previously accounted for.

Choose a safe location in your home for this box full of goodies. If at all possible, avoid storing it in your garage, since your garage more easily burglarized than your home. After you file your return for the year, take all your envelopes and a copy of your return and wrap it up nicely in a large folder or brown grocery box. Tape it up like a gift and keep it that a separate box right next to your current year's files. As times go on, you can shred everything older than seven years.

Using Personal Finance Software
For anyone expecting to itemize their deductions, especially those with frequent deductible expenditures, personal finance software can go a long way towards keeping you organized. By using programs such as Quicken and Microsoft Money, you can quickly download every transaction from your different bank and credit card accounts, easily sorting them into pre-selected expense categories (like the envelope system above). Then, with the push of a button, these programs will upload all your info into any of the leading tax preparation programs. Even if you're having someone else do your taxes, you can print out an itemized report that'll save your accountant time and you money.

Of course, if you do use personal finance software, be sure to hang on to your paper receipts. While you won't need to go to all the trouble of organizing them (that's what the software is for), you still may need them if you get audited. (For further reading on this subject visit our *Income Tax Special Feature*.)

4) Personal Income Tax Guide: Moves To Make Before December 31

When it comes to the best tax tricks and tips out there, few dates matter more than December 31. That's because, for the most part, the return that you file on April 15 only measures what you did between January 1 and December 31 of the previous year. A couple weeks before you file your return would be too late to be figuring out that you should've contributed more to your favorite charity or accelerated your medical expenses.

Timing Your Year-End Income and Expenses
One of the most basic, but effective, tax strategies is the timing of year-end expenses

and income. By controlling which side of December 31 otherwise normal expenses and income fall on, you can save yourself thousands.

Behind this strategy is the idea that many Americans are in different tax brackets in different years - some years are filled with big paychecks, while others are filled with big write-offs. This means that everything that falls on one side of December 31 might be taxed (or deducted) at a much lower or higher bracket than what falls on the other side of the New Year.

So, if you expect to have two back-to-back years in which you find yourself in very different brackets, you'll want to push all the income you can into the lower tax bracket year. Likewise, you'll want to push all the expenses you can into the higher tax bracket year. Doing so is a completely legal way to minimize the amount of taxes you'll pay on your income and maximize the after-tax value on your tax deductions.

Let's look at an example:

Example 1:
On December 1, Sara is informed that she will be getting a large promotion at work and will be making $30,000 more annually starting January 1. Upon doing the math, Sara realizes that most of this $30,000 raise will fall in the next highest tax bracket (25%) instead of her current tax bracket (15%).

In an effort to maximize her tax savings over the next couple of years, Sara makes a couple of very smart moves. First, she sends out the invoices for a consulting business that she runs on the side sooner than expected. She does this, because any money she receives in the current year will likely be taxed at a lower rate than if she waited to bill her clients in the New Year.

Second, she decides to hold off until after January 1 on some of her big year-end expenses such as her charitable donations and non-emergency medical procedures. By doing so she, she is ensuring that these costs are deducted against income that will be taxed at a 25% rate instead of 15%, saving herself more tax dollars in the process. (For more help on saving, see *Money-Saving Year-*

End Tax Tips.)

Charitable Deductions
According to the Generosity Index, the average American household donated approximately $3,000-4,000 per year to charitable causes over the last decade. Of course, one of the things that makes it easier to show that kind of generosity is that Uncle Sam allows taxpayers who itemize their deductions to subtract their donations from their taxable income. To encourage this generosity, which takes the pressure of the government to support valuable programs, the IRS even allows deductions for things like charitable mileage and the donation of household goods.

Of course, as with many deductions, the IRS only allows you to deduct on April 15 what you donated during the previous calendar year (January 1 to December 31). This means that if you are hoping to help yourself by helping others, you've got to make sure donations are completed by midnight on New Year's Eve.

One of the biggest planning opportunities in the area of charitable giving that doesn't matter when it is given is the donation of certain appreciated investments. The IRS allows taxpayers who have investments such as a stock, bond, or mutual fund that has gone up in value, to gift the investment to a charity while taking the write-off for the entire value. This essentially allows the taxpayer to avoid paying tax on their gains, while still taking a write-off for the full amount of the donation. This is far more favorable than making a cash gift in the same amount, while keeping the investment and eventually paying capital gains tax on the growth. (For more information, read *Deducting Your Donations*.)

IRA Withdrawals
There are few IRS penalties as brutal as the one for failing to withdraw the correct required minimum distribution (RMD) from your IRA. The penalty, set at 50% of the under-withdrawn amount, makes your RMD something you cannot afford to be wrong about. Sadly, many people get confused and assume that the withdrawal deadline (December 31) is the same as the contribution deadline (April 15).

While some younger taxpayers might be quick to dismiss this tip as something that applies only to those that have reached age 70.5 (the required age for starting distributions), the RMD rule can also apply to younger individuals who have inherited an IRA from someone else. In either case, be sure to read through IRS Publication 590 or check with your tax advisor to make sure you don't get smacked with this pricey penalty. (To learn more, see *Tax Treatment of Roth IRA Distributions*.)

Section 179 Deductions for Small Business Owners
One of the juiciest, but most overlooked, deductions is the Section 179 deduction for small business owners. This deduction allows small business owners (which include

people running home-based business, consulting practices, etc.) to deduct the entire cost of new machinery and equipment in the year of purchase. With a six-figure limit on the size of this deduction, there is plenty of room for a small business owner to offset a large portion of the net taxable income.

5) Personal Income Tax Guide: Moves To Make Before April 15

The only real significant tax saving move a taxpayer can make after December 31 but prior to filing, is contributing to a traditional individual retirement account (IRA). For many taxpayers who find out they're going to otherwise owe, the April 15 IRA contribution deadline allows them to at least partially offset their taxable income by setting aside money for retirement in a traditional deductible IRA. (For more, see *Tax-Saving Advice For IRA Holders*.)

That's not to say that the only people setting aside money for the future should be people who are trying to dodge a tax bullet. Non-deductible Roth IRAs and Coverdell Education Savings Accounts (ESAs) also have an April 15 funding deadline. Since both of these accounts have unique time limits that affect their eventual taxability, having your contributions count for the prior tax year is still a plus.

Track Down Your Missing Paperwork
Unfortunately, some of the most important information you need to file your tax return comes from beyond your control - the third parties that have the information you need. Whether it is a late or missing W-2, Form 1099-R or K-1, you cannot properly file your taxes without knowing the exact dollar amounts that are on those forms. Since the IRS uses their computer system to automatically match up the information these companies submit with what you report on your tax return, supplying your "best guess" can easily result in an audit. (To find out why you really should avoid an audit, read *Surviving The IRS Audit* and *Avoiding An Audit*.)

Generally, if you haven't received these documents by January 31, you need to take the initiative to track them down before April 15. For starters, try going online - many employers and most financial institutions now provide electronic versions of these documents that you can print or download straight into your tax preparation software.

Don't forget about your "deductible" forms either, such as the Form 1098. These forms, which many taxpayers may not realize they're missing until they're sitting across from their accountant, document how much deductible interest you've paid on things like your mortgage or student loans. (To learn more, see *The Mortgage Interest Deduction*.)

Make a January 15 Quarterly Estimated Payment
Many self-employed taxpayers, as well as certain people meeting other requirements, are required to make quarterly estimated payments to the IRS throughout the year. These payments are meant to take the place of the withholding that would normally be

subtracted from a paycheck if they were an employee of someone else.

Naturally, in the rush of one year's end and another's beginning, it's easy to forget that the estimated payment for October through December is due January 15. Failing to make this payment by that date can result in steep penalties and interest.

Note: Taxpayers who file their previous year's return by the beginning of February, as well as paying the entire balance due, are exempted from having to make a January 15 estimated payment.

6) Personal Income Tax Guide: 6 Overlooked Deductions And Credits

Due to the overwhelming and ever-changing nature of the U.S. tax code, most taxpayers can't name more than the three or four of the most commonly deductible expenditures. Not only does this lead to missed opportunities on their tax returns, it also results in missed opportunities to direct their spending throughout the year.

Let's take a look at six expenses that can save taxpayers a substantial amount.

The Child Care Tax Credit
People are consistently surprised to learn that preschool and after-school care can actually earn them a sizable tax credit that directly reduces the amount of tax they owe. Of course, like all deductions and credits, there are rules that outline who qualifies and how much of their expenses are eligible.

In this case, the Child Care Tax Credit allows a parent to claim a credit of up to 35% on the first $3,000 in expenses for a child (or the first $6,000 for two or more children), as long as the following conditions were met:

- The child was your dependent and under 13 (or incapable of caring for themselves if older).
- The parent could not work, or look for work, without childcare.
- The daycare provider must meet certain other IRS qualifications. (For more information on this credit, see *Give Your Taxes Some Credit*, *Tax Credits You Shouldn't Miss* and *Taxing Times For Divorced Parents*.)

The Retirement Savings Contribution Credit
The Retirements Savings Contribution Credit rewards a taxpayer's retirement plan contributions by providing a tax credit equal to 10-50% of the amount contributed. In a best-case scenario, this could reduce a taxpayer's amount owed to the IRS by $500 for every $1,000 contributed. Currently, the largest benefits of this credit are offered to lower income tax payers. However, many affluent parents are helping their recently launched adult children to take advantage by gifting the money needed to contribute to a plan, allowing them to claim the full credit.

To receive the Retirement Savings Contribution Credit, a taxpayer must make less than the IRS specified limits, not be claimed as a dependent on anyone else's tax return, and not be a full-time student.

State and Local Income or Sales Tax

If you paid income tax to your state or local government when you filed *last year's* income tax return, that amount is now deductible on *this year's* federal tax return. Many taxpayers often miss out on this deduction because it is so far in the past that they don't remember, or they can find their tax records to deduct the correct amount.

If you find yourself in the position of having paid substantial sales taxes (especially resulting from a large purchase such as a car) in the prior year, these may be deducted instead of your state and local income taxes. One of the best ways to accurately estimate your total sales tax is by looking at all your credit and debt card purchases for the year, subtracting your out-of-state purchases, and multiplying the remaining total by your sales tax rate.

Mortgage Points

Many homebuyers, in order to secure a lower mortgage rate, pay upfront "points" to their lender. These points, which may range from a fraction of one percent to two or more percent, are generally deductible on most taxpayers' return. Unfortunately, many people forget about this substantial sum, only remembering to deduct the actual mortgage interest itself.

The full amount paid as mortgage points is deductible in the year it was paid as long as the mortgage meets certain conditions (such as the home being a buyer's principal residence, the points being within industry standards, having proper documentation, etc). Points not meeting the standard requirements are still deductible, but must be spread out evenly over the life of the loan. (For more on this read, *Mortgage Points - What's The Point?* and *A Tax Primer For Homeowners*.)

Moving Expenses

Moving, even across town, can be a costly endeavor. Thankfully, the IRS allows taxpayers to deduct unlimited move-related costs as long as the move is job-related. Even better, this deduction is one of just a few "above the line" deductions, meaning it can still be deducted even if the taxpayer has no other deductions and opts for the standard deduction.

Of course, such a generous deduction comes with strict rules to minimize abuse by overzealous taxpayers. Requirements for claiming the moving expense deduction include:

- Your new workplace must be at least 50 miles further away from your home than your previous workplace.
- You are employed full-time in the new position, for at least 39 weeks in the 12 months following the move.
- The expenses are not reimbursed by your employer.

One Half of Self-Employment Tax
Being your own boss has a lot of perks, but having to pay double what W-2 employees pay for the FICA payroll tax is not one of them. With few exceptions, both employers and employees have to contribute 7.65% of an employee's wages to the FICA (Social Security and Medicare) system. When you're your own boss, you're on the hook for both sides of this contribution, or 15.3% of your total wages on top of the normal income tax.

To ease this burden, the IRS allows self-employed individuals to deduct one half of the total self-employment tax owed for the year. Like the moving expense, this is an "above the line" deduction that can be claimed even if the taxpayer has no other itemized deductions. (Keep reading on this subject in *An Overview Of Itemized Deductions* and *Next Season, File Taxes On Your Own*.)

7) Personal Income Tax Guide: Common Filing Mistakes

No matter how much tax planning you do, if you screw up the actual process of filing your taxes, the ensuing penalties and time spent cleaning up the mess can quickly wipe out any benefits you've gained. So, whether it's your deadline, your documentation, your signatures, or your e-file status, it pays to double-check everything. If there is one area of your personal finances you don't want to be lax on the details, it is with the IRS. The last thing you ever want to do is give them a reason to look twice at your return, no matter how honest you are.

Filing Deadlines and Extensions
No one aspect of filing taxes yields more horror stories, wives tales and misinformation than tax filing deadlines. Perhaps that's because there are as many rules about when your taxes are due as there are for some of the most complicated deductions.

The classic date that most people associate with taxes being due is April 15. But even this yields confusion when it comes to what must actually be done by that date and what happens if that date falls on a weekend. So, let's break it down into simple terms.

As a general rule, everything must be postmarked and in the mail (not necessarily received by the IRS) by 11:59 PM on April 15. If however, April 15 falls on a Sunday, the deadline is pushed to Monday. There is no special treatment for a deadline that falls on a Saturday.

Included in this April 15 deadline is the requirement to pay any balance that you might owe. In other words, filing your taxes on time but failing to pay the amount due will result in a fine and additional interest payable to the IRS. An estimate of the amount due must still be paid by April 15, even if you file for an extension on completing the return itself. (To learn about extensions, see *Get A Six-Month Tax Extension*.)

When it comes to extensions, the IRS and most states grant one automatic extension to anyone who asks, regardless of the reason. With regards to your Federal return, filing an application for automatic extension (via Form 4868) by April 15 gives you an additional six months (until October 15) to get your paperwork in order. This six-month extension replaces the previous IRS policy of granting an automatic four-month extension with the ability to request an additional two months after that expires.

The Most Common Tax Filing Mistakes

Aside from failing to file their return on time, there are numerous common mistakes that cause both the IRS and taxpayers to roll their eyes. Here's a list of some of the most common mistakes that end up costing more than a few taxpayers a lot of money and tears:

- *Forgetting the stamp* - Yes, as hard as it is to imagine, thousands of taxpayers every year forget to put a stamp on their envelopes. Additionally, just as many people put an insufficient amount of postage on the envelope. Thankfully, the IRS does not send people to jail for their return being a few days (or even a few months late). There may be a penalty, but it's usually a relatively small amount for most taxpayers who submit their return within a few days after their deadline.

- Forgetting to sign - In the eyes of the IRS, an unsigned tax return might as well have not been sent at all. In fact, they will not begin processing it until it is signed and dated correctly. Unfortunately, it takes most taxpayers substantially longer to discover this error than it does to realize they forgot the stamp. It often takes the IRS a month or more to notify a taxpayer of their unsigned return. Of course, when you discover that your return is unsigned, don't hesitate to submit a properly signed return since interest and penalties start accruing from April 15 on, regardless of the reason your return has not been processed.

- Forgetting Social Security numbers (SINs) - While most taxpayers don't forget to include their own Social Security numbers on their return, many often forget to include those of their children or adult dependents. Of course, the IRS will not permit you to take certain deductions or claim dependency exemptions without a valid taxpayer identification number (TIN), which naturally throws off the rest of a taxpayer's calculations. Be sure to check all your other supporting forms and schedules in addition to your Form 1040, for places requiring the entry of your dependents' identifying information. (Sometimes you'll want to leave off the dependents on your form. To learn more, read *Happily Married? File Separately!*)

- Using the wrong annual limits, tax tables, etc. - There's no doubt that taxpayers turn to the internet in droves at tax time. Whether it is looking up their tax brackets or trying to find out their limits on certain deductions, the search engines are the go-to source for many. Unfortunately, especially for taxpayers rushing to complete their taxes, this can lead to substantial errors. Common mistakes such as looking at the current year's tax tables (instead of the previous year's) result in sizable miscalculations and subsequent penalties. Be sure to always double-check which year's forms and information you're using. And remember to always use the IRS's website as your first and main source of information. (For more information, check out *Changes in Tax Legislation And Regulation*.)

- Forgetting to include your documentation - While the IRS doesn't require taxpayers to send in their receipts (though it's not a bad idea for unusual or large expenses), it generally does require them to submit their W-2s, 1098s, 1099s, etc. Since the person or company that issued you this form also sent a copy to the IRS, failing to include your copy (much less failing to report it) can bring unwanted attention to your return. A great general rule is, "when in doubt, include it!"

Using a Professional Preparer or Tax-Preparation Software

When you stop to consider America's massive chains of home improvement stores or those amazing late-night infomercial products that promise to cut out the middleman, it's easy to conclude that America is a land of "do-it-yourselfer's". When it comes to filing your tax return however, this bravado can easily lead to big-time headaches and even bigger mistakes. For many, the wisest choice is to pay an expert a relatively small amount in order to save a lot. (To read more on when it is wise to skip the DIY projects, see *Full-Service Brokerage Or DIY?* and *Seven Tips For The Do-It-Yourself Debt Manager*.)

While there'll always be those tax preparers that overcharge and underserve, the vast majority of tax professionals earn every penny of their fees. If you're not the kind of person that has a love for numbers and solving puzzles, there's a good chance it's in your best interest to turn over your return to someone who finds this kind of work enjoyable. Chances are, the cost ($100-200 for a basic return, $500 or more for complex returns) will be quickly offset by the fact that you've got more financially productive things to do with your time than stare at confusing IRS forms. Add in the fact that tax preparation costs are deductible for many taxpayers, paying for professional help becomes a slam-dunk for many.

For those taxpayers that really do enjoy doing their own taxes, tax preparation software is a must. With even the most complex retail tax prep programs costing only $50-150 dollars, these programs are worth their weight in gold. Chances are that the leading software programs will shave off significant amounts of time, find overlooked deductions, and help you avoid the most common errors. Perhaps best of all, the programs come with easy-to-use e-file features.

If you're considering using one of these programs, be sure to compare each version's features before you buy. While most companies offer "Deluxe" versions with all the bells and whistles, the standard versions can usually do everything the average taxpayer needs, for half the price. Also be sure to check for free online versions of the most popular programs, which are often available to lower income taxpayers and military personnel.

8) Personal Income Tax Guide: Avoiding Nasty Surprises

The last thing any taxpayer wants to find in their mailbox is a letter from the IRS, unless of course it holds their refund check. That's why, for many taxpayers, filing their return involves a prayer, a rabbit's foot, or an attempt to store up some good karma.

Luckily, avoiding nasty IRS surprises doesn't have to be a meta-physical experience. In most cases, it simply requires a "heads up" attitude where taxpayers know the details of their situation (be it good or bad) and take a proactive approach to solving them. (For more information on this, see *Cut Your Tax Bill*.)

Get Started As Early As Possible
When it comes to taxes, perhaps the single best piece of advice out there may be, "don't wait until the last minute". April 14 is the wrong time to realize that you don't understand the rules for the mortgage deduction or that your local computer store is sold out of tax preparation software. Likewise, the only thing you may hear from your CPA is laughter if you call on April 1 hoping to book your tax appointment. (To read more about deductions and when to file, see *Deducting Your Donations* and *Don't Put Off Your Year-End Plan*.)

By starting early, you'll not only ensure that your tax preparation and filing experience are low-stress, but you'll also give the IRS ample time before April 15 to send back a return with a major error. If you're entitled to some money back, you'll also be much more likely to receive a quick refund if you file before the April 15 rush. As a general rule, many experts recommend trying to file your return by the end of February. (For more on what to do to be prepared early, read *Money Saving Year End Tax Tips*.)

Estimating and Avoiding Penalties
While the stiffest of IRS penalties, a jail cell, is reserved for people who intentionally try and defraud the system, that doesn't mean that the IRS is overly lenient on people who make innocent mistakes. In fact, the IRS is more than happy to assess double-digit interest rates on unpaid balances and substantially late filers.

To add insult to injury, the IRS has one of longest reaches of any creditor, with a unique ability to garnish wages and seize assets to pay off your debt to them.

Because of this, taxpayers should do everything they can to avoid penalty situations. If a penalty is unavoidable, then a taxpayer should get a firm handle on how much they owe and how the balance will grow, so that they're not caught off-guard down the road.

Here's a breakdown of the major penalty categories and their calculations:

- *Failure to File* - This is the most easily avoided penalty, since a taxpayer can still file their return even if they are unable to pay an amount due. The penalty for this infraction is 5% of the amount due on the return, per month, up to a maximum of 25%.

- *Failure to Pay* - While most people might assume that the IRS sticks taxpayers with severe penalties for failing to pay on an amount owed, it is actually one of the most lenient penalties. It turns out that the IRS is far more understanding of people's hardships than it is given credit for. The penalty is a reasonable 0.5% per month up to 25% of the amount due. Again, it's worth pointing out that the IRS penalizes more for failing to file a return than for filing a return but not being able to pay the balance!

- *Accuracy Penalty* - Most often, when the IRS finds an error on your return or uncovers a mistake in an audit, they give the taxpayer the benefit of the doubt as to their intent. That doesn't mean though, that there's not a penalty for doing your math incorrectly. Unlike the "Failure to File" or "Failure to Pay" penalties that can accumulate over a couple of months, the "Accuracy" penalty is an immediate 20% of the under-calculated amount. Naturally, the easiest way to avoid this penalty is to double-check your math at least twice. (In the event of an audit, see *Avoiding An Audit* and *Surviving the IRS Audit*.)

- *Fraudulent Return* - When the IRS feels like a taxpayer has gone above and beyond in their efforts to minimize their tax burden by using such questionable techniques as deliberately hiding income or knowingly inflating deductions, they slap them with the stiffest penalty possible. The penalty for fraud is an immediate 75% of the amount of the under-calculation due to the fraud. Additionally, the IRS can and does pursue jail time for tax cheats. Needless to say, the worst tax strategy is dishonesty, since the downside often involves sharing a jail cell.

If You Owe More Than You Can Pay
As mentioned before, the IRS is surprisingly understanding of taxpayers who find themselves in a financial bind. It's actually in their best interest to minimize their collection costs by setting up some kind of payment plan that encourages you to pay what you can instead of burying your head in the sand and forcing them to start a collection action.

While the Offer In Compromise program (where IRS debts are settled for pennies on the dollar) appears to be winding down due to overuse by taxpayers, the IRS is more anxious than ever to set up "installment" payment plans for balances owed. These plans can provide taxpayers with a manageable monthly payment and cease IRS collection actions.

Of course, setting up an IRS installment plan is not automatic. For balances under $25,000, taxpayers can go online and set up an Online Payment Agreement. Taxpayers owing more than $25,000 must complete and mail both Form 9465 and Form 433F to be considered for an installment plan.

Last but not least, taxpayers who owe a balance but have yet to enter into an agreement, should be on the look out for tax amnesty opportunities. These programs, which are usually offered by individual states, allow taxpayers to pay off their debts with much of their penalties and interest waived. But don't hold your breath for these programs in lieu of other repayment options, since years may pass between when a state or local agency offers amnesty to delinquent taxpayers. (For further reading on taxes visit our *Income Tax Special Feature*.)

9) Personal Income Tax Guide: Conclusion

For all the complexity of our income tax system, the process of determining what you owe is fairly straightforward. It's just not something that most people deal with more than once per year, so it can feel quite confusing and intimidating.

The key, as mentioned many times throughout this tutorial, is to stay ahead of the curve.

- By starting to think about minimizing your tax burden each fall, you'll be able to take the steps you need before windows of opportunity close.
- By beginning to think about the actual filing process in January or February, you'll ensure there's plenty of time to get your documentation lined up and your taxes prepared. (Keep reading about this in *Money Saving Year End Tax Tips*.)
- By being head's up about potential balances you're going to owe, you'll even allow yourself a few extra months to accumulate the money and stay in good graces with the IRS and your state's revenue department - and hopefully avoid an audit. (Keep reading about this in *Avoiding An Audit* and *Surviving the IRS Audit*.)
- By being prepared and recognizing your limits, you'll have time to seek out professional help.

An experienced tax preparer or a good piece of preparation software, put to use well ahead of April 15, will ensure that you don't spend May, June and July living in fear of a penalty notice from the IRS.