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HOW TO AVOID TAX PENALTIES

Penalties for failure to follow the tax law have been increased and made tougher over the past few years.

THE WORST PENALTIES AND HOW TO AVOID THEM

FAILURE TO FILE A TAX RETURN OR TO PAY TAXES: You can get hit with this penalty if you file your tax return and make your payment late. You can easily avoid this penalty by filing an IRS Form 4868 by the due date of your return. This allows you a four-month extension of time to file your return. The extension is automatically given to all taxpayers who file the form.

Caution: Even if you extend your return, you still have to pay the tax by the original due date, not the extended due date. Make an estimate and pay an amount that's as close to the correct amount as possible. If your estimate is incorrect by more than 10%, you will be slapped with the penalty as if you had never obtained an extension. Late filers who already paid enough through taxes withheld from their wages will only be subject to the failure-to-file penalty: 25% of your tax.

Maximum combined failure-to-file and failure-to-pay-tax penalty: 5% per month. However, the 25% maximum penalty is applied to each failure separately. Therefore, if you don't file your tax return and also don't pay your tax, the most you can get hit with is 5% per month, up to 50% of the total tax deficiency.

How to avoid the penalty: Prove that there was a reasonable cause. Acceptable excuses:

* Serious family illness or death.

* Reliance on a third-party preparer who gave you the wrong advice. Note: You are expected to know the due date of your return, regardless of advice from a preparer.

* Fire or other natural disaster that caused records to be lost, misplaced or destroyed.

* Some other crisis that made it impossible for you to comply with IRS rules.

ACCURACY-RELATED PENALTY: The accuracy-related penalty consolidates all of the penalties relating to the accuracy of tax returns. It is equal to 20% of the portion of the underpayment that is attributable to one or more of the following:

1. negligence or disregard of rules and regulations
2. substantial understatement of income tax
3. substantial valuation misstatement

The penalty is applied after the IRS has audited your return and has determined that you have underpaid your tax.

Once the IRS makes a determination of negligence, there is almost no way to avoid this penalty. Defined by the IRS as any disregard of the rules, whether careless, reckless or intentional, negligence includes the failure to reasonably comply with tax laws, to exercise reasonable care in preparing a tax return, to keep adequate books and records, or to substantiate items properly. Most excuses won't work, and it usually can't be negotiated with the IRS.

Double whammy: Interest will usually run on this penalty from the due date of the return, not the time the penalty is assessed. Interest costs can be high because it can take the IRS years to determine if you owe additional tax.

FRAUD PENALTY: If the IRS determines that your underpayment is due to intentional disregard, the fraud penalty will be assessed instead of the negligence penalty. The IRS must meet its burden of proof in establishing fraud by clear and convincing evidence.

Amount of the fraud penalty: 75% of the underpayment due to fraud.

The fraud penalty won't be assessed on top of other penalties. If you are also subject to the failure-to-file and late-payment penalties, the fraud penalty will be assessed instead of the others.

FAILURE TO MAKE ESTIMATED TAX PAYMENTS: Every person is obligated to pay taxes throughout the year. Payments can be made through withholding or through estimated-tax payments. You should have paid 90% of what you expect to owe the IRS by the due date of the return, which is normally April 15th.

Exception: If you have paid taxes in an amount equal to your actual tax bill from the prior year, you will not be subject to a penalty.

Amount of the failure-to-pay-estimated-tax-penalty: The penalty is equal to interest (the applicable federal short-term rate plus three points) that would have accrued during the time of the underpayment. The IRS will divide your income among the four quarters. For each quarter, the IRS compares the estimated payments, applied overpayments and withholding, etc, with your liability. You will be penalized for any quarter for which you owe tax.

How to avoid the penalty: Pay 100% of last year's bill or 90% of this year's bill, ratably throughout the year.

If most of your income is earned at the end of the year, take advantage of that by being prepared to show the IRS that you didn't earn the income steadily throughout the year. Instead, show that you earned it in the last quarter and that's why you paid the bulk of your tax in the last quarter. On the other hand, try to pay only enough estimated taxes to avoid the penalty.

SUBSTANTIAL UNDERPAYMENT PENALTY: This applies if you underpay your taxes by more than 10% of your tax bill or $5,000.00, whichever is greater.

Amount of the substantial-underpayment penalty: 25% of the amount attributable to the underpayment.

To avoid the penalty, either:

> * Prove that you had substantial authority to rely on a particular position that you took on your return. If the understatement is related to a tax shelter, you must be able to prove you believed it was more likely than not that you would win against the IRS. Or...
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> * Prove that you disclosed all the facts and circumstances related to an issue on your tax return.

If you have any questions on penalties, please discuss this with your tax accountant or call Patrick Hurley at (800) 996-1040.