

Why Some Taxpayers Benefit from Not Claiming Deductions

By Joseph D. Beams and W. Eugene Seago

Joseph D. Beams and W. Eugene Seago discuss why some taxpayers may benefit from not claiming deductions.

When it comes to reporting taxable income, most people assume that less is better. While this is usually true, there are exceptions. The U.S. tax code (“the Code”) requires the recognition of all income unless specifically excluded by the Code.¹ By contrast, “[d]eductions are a matter of legislative grace.”² They are allowed as specifically permitted by the Code. For trade or business expenses, Code Sec. 162(a) states that “there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” Income is required to be reported and deductions are allowed to be reported. Most taxpayers want to minimize taxable income in order to lower income tax; however, there are a variety of situations where a taxpayer may want to increase taxable income. Should the IRS have the right to require an individual to claim a deduction if it would lower his refund?

Benefits from Not Reporting Allowable Expenses

In most situations, the IRS has no reason to require a taxpayer to report a deduction. A cash-basis, calendar-year taxpayer can choose to pay for some expenses after December 31 in order to shift the deduction into the following year. This is an example of timing a deduction; however, there are also situations

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where a taxpayer benefits by completely omitting certain deductions. The following list identifies situations where individuals may benefit from not claiming allowable deductions:

- The taxpayer benefits from nontax reasons like disaster relief, insurance settlements, bank loans or selling a business.
- The deduction causes a loss of credits and a lower refund.
- The deduction increases the chance that the tax return will get audited.
- The paper work required is not worth the amount of the deduction.
- The taxpayer needs to recognize income to contribute to a Roth IRA for the current year.
- Claiming all allowable expenses each year would cause an activity to be classified as a hobby loss rather than a business loss.
- Itemizing deductions on the federal return causes a greater increase in state income tax.

Nontax Reasons

Taxpayers may have nontax reasons for not reporting deductions and thereby report higher income. Some situations involve third parties that ask for a copy of an individual or business tax return in order to access the income potential of the entity.

The tax return itself may not be a good representation of how the business is performing due to the fact that expenses are not required. Audited financial statements help to alleviate this problem because financial statements prepared under generally accepted accounting principles (GAAP) require reporting all expenses. How-

ever, many small businesses have little bookkeeping other than what is required to prepare the tax return.

Business entities damaged by a hurricane or other disaster may have an incentive not to claim deductions and thus report higher pre-catastrophe income. This is particularly true for small businesses in areas recently hit by hurricanes. Higher pre-catastrophe income can lead to higher federal assistance and insurance settlements from damages due to loss of income.

Individuals applying for a home loan or small business loan normally have to meet certain income requirements to qualify for the loan. If an individual is self-employed and does not have formal financial statements, banks will request a copy of the individual's tax returns for the last several years in order to assess the individual's ability to repay the loan. If the borrower knows beforehand that the tax returns will be used for this purpose, he may be tempted to omit certain deductions to make the entity look more profitable even though it may result in higher taxes.

If an individual is selling a business and does not have audited financial statements, the buyer will often request to see a copy of the businesses' tax returns for the last several years. Again, the third party is using the tax returns to assess the potential earnings of the entity. An individual trying to sell a business may omit expenses in order to show more income and make the business appear more profitable.

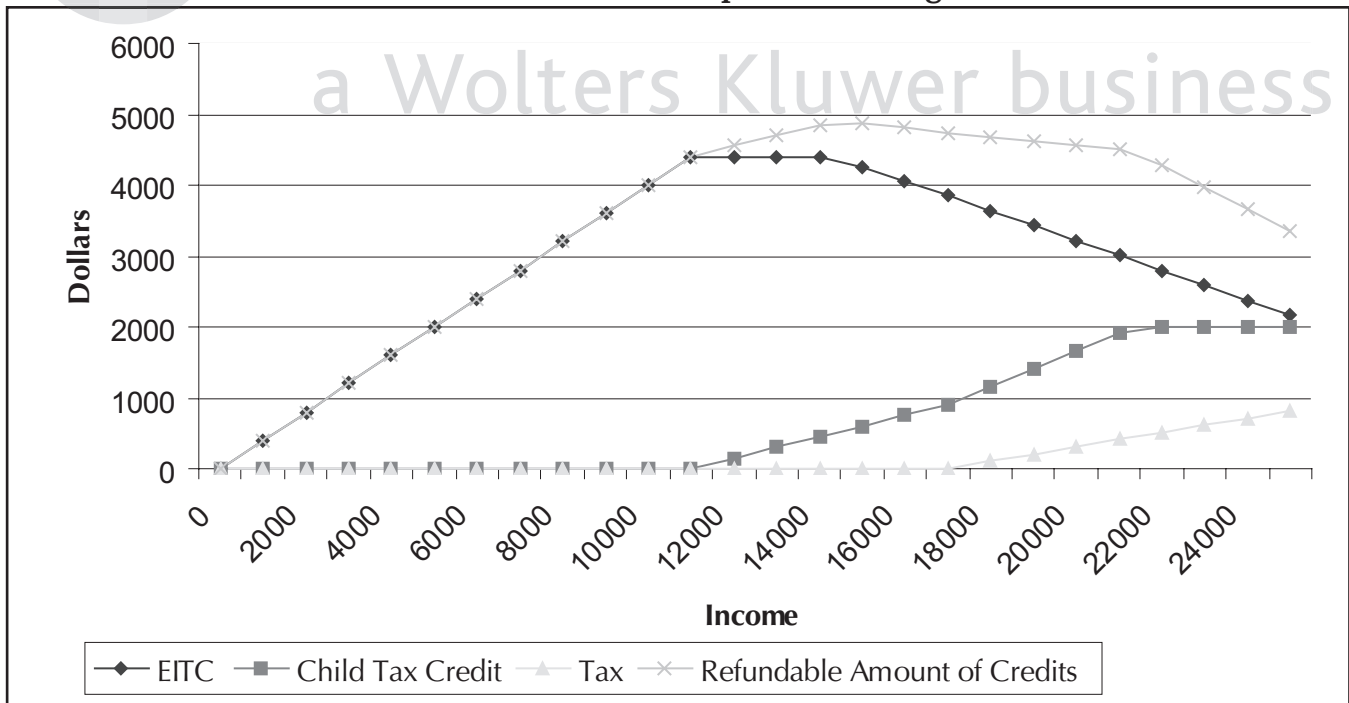
Omitting expenses in financial statements is a violation of GAAP; however, many small businesses do not report GAAP basis financial statements. Instead, their only available financial records are their tax returns. Tax law does not require claiming all deductions for tax purposes. The question then becomes whether the individual is committing fraud by not voluntarily disclosing the additional expenses not reported on the tax returns.

Qualify for Larger Credits and Create Greater Refund

The Earned Income Tax Credit (EITC) and the Child Tax Credit present situations where additional income can lead to a greater credit. The EITC increases up to a certain point of income before it begins to decrease. On an individual tax return, the Child Tax Credit is separated into the nonrefundable portion and the refundable portion, which is listed on the return as the Additional Child Tax Credit. However, under the Code, it is all part of the Child Tax Credit.³

Many credits are nonrefundable, which means that if a taxpayer has no tax, the credit is lost rather than being refunded. The EITC is a refundable credit, so taxpayers can receive a refund of the amount of the credit if they have no tax.⁴ A portion of the Child Tax Credit is also refundable for taxpayers who have little

Figure 1
Credits for Head of Household Filer with Two Dependents Using Standard Deduction



or no tax.⁵ Figure 1 shows how the EITC and the Child Tax Credit increase as income increases for a head of household filer with two dependent children. A head-of-household filer with two dependent children has a standard deduction of \$7,300 and personal exemptions of \$9,600.⁶ Therefore, there is no tax below \$16,900 (\$7,300 + \$9,600). The refundable portion of the Child Tax Credit begins when income goes over \$11,000 as shown in Figure 1. For a head-of-household filer with two children, the EITC increases rapidly to a maximum credit of \$4,400 when income reaches \$11,000. The credit stays at this maximum amount until earned income reaches \$14,370, at which point it begins to gradually decline as income increases until it is completely phased out when income reaches \$35,263. The total of the refundable and nonrefundable portions of the Child Tax Credit cannot exceed \$1,000 per child.

The top curve on the graph in Figure 1 shows the refundable amount of the credits. This is the total amount of the earned income credit plus the child tax credit less the amount of tax. It coincides with the EITC until income reaches \$11,000, at which point part of the Child Tax Credit becomes refundable. The top curve is the amount that taxpayers receive as a refund in addition to any amounts that they have withheld or otherwise paid in. At an income level

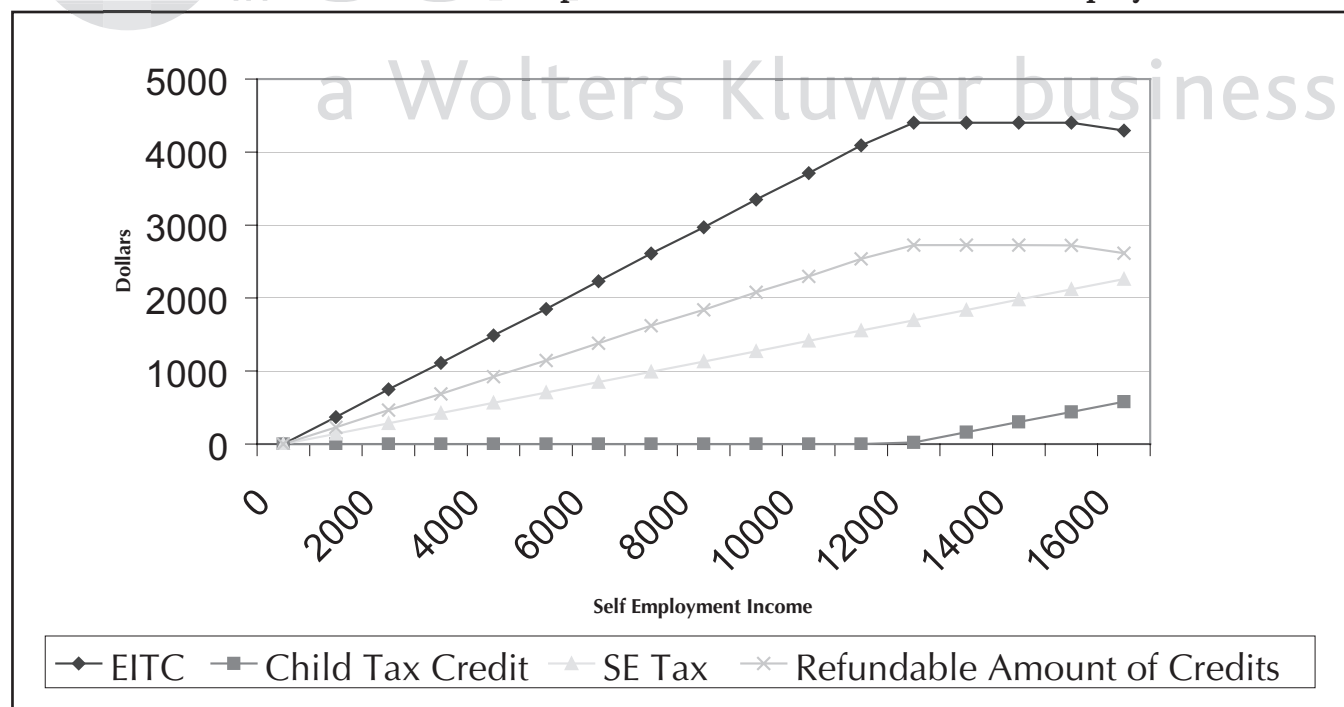
of \$14,000, the EITC is \$4,400, the Child Tax Credit is \$450, there is no income tax, and the refundable amount of the credits is \$4,850 (\$4,400 + \$450).

If an individual is eligible for the credits and is below the peak point of the top curve, which is the combined credits less the tax owed, an increase in income results in the taxpayer receiving a larger refund. The EITC increases faster than the self-employment tax. Therefore, an individual with schedule C income who is below the income level to receive the maximum earned income credit can choose not to claim all of his deductions in order to obtain a larger refund. In addition to obtaining a larger refund, this individual has paid in more to social security in the form of self-employment tax and may qualify for more benefits when he retires. The Child Tax Credit can also increase when additional income is recognized, although it does not increase fast enough to cover the self-employment tax associated with the additional income, as does the EITC.

Figure 2 shows the EITC, self-employment tax, the Child Tax Credit and the net refundable amount of the credits for a head-of-household filer with two dependents and all earnings from self-employment. At these levels of income, there is no income tax. The top line in the graph is the earned income credit. As before, it increases to a maximum of \$4,400. The third

Figure 2

Head of Household Filer with Two Dependents - All Income From Self Employment



line from the top is the self-employment tax, which increases constantly through this range of income. The bottom line in the graph is the Child Tax Credit. The second line from the top is the net cash refund that the taxpayer would receive above any amounts that the taxpayer pays in. This is the total of the EITC and the Child Tax Credit less the self-employment tax. Therefore, if the taxpayer's income is below the peak point on the curve of the Refundable Amount of the Credit, the taxpayer will receive a greater refund by reporting less deductions and more income.

Assume X has self-employment income and two dependent children. She has gross receipts of \$12,000 and deductible expenses of \$6,000. Table 1 column 1 shows that if she reports all of her deductions she would have income of \$6,000 to report on schedule C. Assuming no other taxable items, X would have no income tax liability and would have self-employment tax of \$848. She would have an EITC of \$2,230 and would be due a net refund of \$1,382. Table 1 column 2 shows that if X chose not to deduct her \$6,000 of deductible expenses, she would report the entire \$12,000 of income on schedule C. Again assuming no other taxable items, X would still have no income tax liability due to her standard deduction and personal exemptions. However, the additional income creates a larger EITC and allows X to qualify for the additional child tax credit. X would have self-employment tax of \$1,696, an EITC of \$4,400 and a Child Tax Credit of \$23. X is now eligible for a refund of \$2,727.

By choosing not to claim the allowable deductions, X has received an additional refund of \$1,345 (\$2,727 – \$1,382) and also increased her self-employment earnings for the year by \$6,000, which may mean greater social security benefits when she begins to draw on them. Choosing not to deduct otherwise deductible expenses can allow low-income taxpayers to increase their tax refund by maximizing the use of the EITC and the Child Tax Credit. In addition to increasing the overall refund, additional amounts are being paid in to social security in the form of self-employment tax.

If the EITC is intended simply as a form of welfare, it should not penalize a taxpayer simply because they report their expenses and do not “play the game” and omit part of their deductions. This creates an inequity in the tax system in favor of those who play the system and those who simply need the support. The EITC was intended to encourage low-income taxpayers to work more and not be as dependent on welfare; however, in this situation it may simply encourage them not to deduct their expenses rather than to work more in order to qualify for the credit.

Reduce Risk of Audit and Simplify Bookkeeping

A taxpayer may choose not to claim a home office deduction or some other business deduction because she fears it will increase her likelihood of getting audited or because the paper work isn't worth the amount of the deduction. The taxpayer has the right to do this.

Keeping track of small items that are purchased may be too time consuming to be worth the trouble. An individual with a full-time job who derives most of his income from salary may do occasional consulting on the side. He may choose not to keep track of or deduct mileage or any receipts for the side work because it complicates an otherwise simple business.

Contribute to a Roth IRA

Some taxpayers may want to report taxable income so they can contribute to a retirement plan. A Roth IRA allows earnings to grow tax-free and neither the principle nor the appreciation in value is taxed when

Table 1
Potential Benefit from Not Claiming Deductions¹
(Head of Household Filer with Two Dependents)

	Claiming All Allowable Expenses	Not Claiming Allowable Expenses
Gross Receipts from Business Income	\$12,000.00	\$12,000.00
Business Deductions Taken	6,000.00	0.00
Net Schedule C Income	6,000.00	12,000.00
Deductible 1/2 of Self-Employment Tax	424.00	848.00
Adjusted Gross Income	5,576.00	11,152.00
Standard Deduction	7,300.00	7,300.00
Personal Exemptions	9,600.00	9,600.00
Taxable Income	0.00	0.00
Income Tax	0.00	0.00
Self-Employment Tax	848.00	1,696.00
Earned Income Credit	2,230.00	4,400.00
Child Tax Credit	0.00	23.00
Net Refund	1,382.00	2,727.00
Tax Benefit of Not Reporting Expenses		1,345.00

¹ Based on 2005 standard deduction, personal exemptions and tax tables.

taken out at retirement. An individual's contribution is limited to the lesser of the amount of earned income or \$4,000 per year.⁷ It is such an attractive plan that many individuals would like to start taking advantage of it as early as possible. If an individual has no income in a year, he misses out on that year's contribution and cannot make it up by making an \$8,000 contribution the next year.

An individual with a small side business that is breaking even or showing losses may prefer not to report all of the deductions and thereby show at least \$4,000 of income so that she can contribute to a Roth IRA for the year. The income tax may be eliminated by the standard deduction; however, by claiming less expenses, she would have to pay self-employment tax. By showing a small amount of income (\$4,000), the taxpayer could make a (\$4,000) contribution to a Roth IRA.

Prevent the Reclassification of a Loss Activity As a Hobby

Many individuals with full-time jobs conduct other activities like pottery, racing cars or painting. If there is a reasonable likelihood of making money on the activity, it may qualify as a business even if it currently shows losses. If an activity is classified as a business and it has losses, the losses from the activity can be used to offset income from other activities. However, if the activity is classified as a hobby, deductions are only allowed to the extent of income; thus, a loss on the activity cannot be reported. Additionally, the deductions for hobbies are only allowed as miscellaneous itemized deductions, which are only deductible to the extent that they exceed two percent of AGI.⁸ For a taxpayer who would not otherwise itemize, these deductions are even less useful.

If an activity repeatedly has losses, it will likely be classified as a hobby even though the taxpayer feels there is a realistic chance of "making it big" one day. If an activity shows income in at least three out of five years, the burden of proof is shifted to the IRS to prove that the activity is not a business.⁹ To prevent this presumption of a loss activity being classified as a hobby, a taxpayer may choose to only recognize part of the deductions in some years, thereby

reporting a smaller loss or income in those years.¹⁰ By keeping the activity classified as a business rather than a hobby, the deductions will not have to be claimed as miscellaneous itemized deductions and any losses will be deductible against other income.

To Reduce State Income Tax

Some states require that state income tax deducted in calculating federal taxable income be added back in calculating state taxable income. For higher income taxpayers, state income taxes alone may be enough to allow the taxpayer to itemize deductions. However, if the bulk of the itemized deductions are state income tax and the itemized deductions are only slightly higher than the standard deduction, itemizing may cause a greater increase in state income tax than the taxpayer is saving in federal income tax.

Table 2 shows an example of a married couple with AGI of \$70,000. They have \$10,100 of itemized deductions, \$8,500 of which is from income taxes paid to their state. Their state requires that they itemize for state income taxes if they itemize for federal taxes. They live in a state that has a \$5,000 standard deduction and an \$800 personal exemption and a five-percent state tax rate. The table shows that if the

Table 2
Tax Benefit from Not Claiming Itemized Deductions¹

	Married Filing Joint Claiming All Itemized Deductions	Married Filing Joint Standard Deduction
Federal Income Tax		
Adjusted Gross Income	\$70,000	\$70,000
Standard Deduction		(10,000)
Itemized Deductions		
State Income Taxes Paid	(8,500)	
Other Itemized Deductions	(1,600)	
Personal Exemptions	(6,400)	(6,400)
Taxable Income	53,500	53,600
Federal Income Tax	7,295	7,310
State Taxes		
Federal AGI	\$70,000	\$70,000
Standard Deduction		(5,000)
Itemized Deductions		
State Income Taxes Paid	0	
Other Itemized Deductions	(1,600)	
Personal Exemptions	(1,600)	(1,600)
Taxable Income	66,800	63,400
State Income Tax	3,340	3,170
Total Income Tax (Federal + State)	10,635	10,480
Net Tax Savings		155

¹ Based on 2005 standard deduction, personal exemptions and tax tables.

taxpayers chose to itemize deductions, they would save \$15 on their federal taxes because their itemized deductions of \$10,100 are more than the standard deduction of \$10,000 for married taxpayers filing a joint return. However, they would have to pay an additional \$170 in state income taxes. These taxpayers may therefore choose to take the standard deduction on their federal income tax return and forgo their itemized deductions because the net effect of their federal and state taxes will be \$155 less.

Conclusion

Taxpayers are required to report income but are allowed (not required) to report deductions. Allowing deductions rather than requiring deductions can create a counterintuitive result in certain instances. There are several situations in which taxpayers are better off not reporting allowable deductions and thereby artificially increasing income.

It would be very difficult at best to require individuals to claim all allowable deductions. This would make it illegal to omit a deduction because a taxpayer felt it required too much paper work or because he thought it could increase the likelihood of getting audited.

It does not seem feasible for Congress to mandate that taxpayers report all allowable deductions. It

does not create a social problem for a taxpayer to choose not to claim deductions to reduce paperwork or to reduce the chance of getting audited. Some of the issues created by not claiming deductions are already handled by ordinary market mechanisms. If an individual is applying for a loan, banks are wary of self-employment income because of the ability of individuals to manipulate such income. Likewise, individuals buying a business should be aware of the fact that a tax return may not be a fair representation of the profitability of a business.

There are social issues with regard to not claiming deductions in order to receive a larger credit. The EITC is intended to encourage low-income taxpayers to work more and be less dependent on welfare. However, allowing taxpayers to increase their refund by not claiming deductions does not meet the intention of the credit. By allowing some taxpayers to increase their refund while others who are equally in need of the credit to miss out because they report all allowable deductions creates an inequity among taxpayers. Congress could help alleviate the tax incentive for faking income by not permitting self-employment income to qualify for certain credits. Other more equitable means could then be used to provide this support for the needy taxpayers. This would make it much more difficult, although not impossible, to fake income for the purpose of qualifying for a credit.

ENDNOTES

¹ Code Sec. 61(a).

² *New Colonial Ice Co. v. Helvering*, SCt, 4 USTC ¶1292, 292 US 435, at 440.

³ Code Sec. 24.

⁴ Code Sec. 32.

⁵ Code Sec. 24(d).

⁶ Based on 2005 personal exemption of \$3,200 and 2005 standard deduction for a head of household filer.

⁷ Code Sec. 408A, see Code Sec. 219(b) for

limitations.

⁸ Code Sec. 67.

⁹ Code Sec. 183(d).

¹⁰ *Thoughts From a Tax Cheat*, TAX NOTES, Aug. 19, 2002.

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