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The dirty dozen tax scams

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Tax day, April 15, is almost upon us, and our friends at the Internal Revenue Service have a relatively new tradition of providing an annual list of 12 "tax scams" that taxpayers should avoid.

It's an odd collection, comprised of both recommendations that taxpayers protect themselves from fraud, as well as admonitions that taxpayers should be fully obedient to all IRS demands.

Unsurprisingly, the list contains no warnings about the needless complexity and punitive nature of the tax code. Nor does the IRS say anything about how taxpayers lose the presumption of innocence if there's any sort of conflict with the tax agency. Perhaps most important, there's no acknowledgement from the IRS that many of the dirty dozen scams only exist because of bad tax policy.

Of course, government bureaucracies aren't in the business of admitting their own flaws, or pointing out the bad choices of their political masters. But it's worth keeping these issues in mind as we review the "dirty dozen" and perhaps learn some unintended lessons.

Here's the IRS list, with each scam followed by some analysis and commentary.

Scam #1

Phone Scams: Aggressive and threatening phone calls by criminals impersonating IRS agents remain an ongoing threat to taxpayers. The IRS has seen a surge of these phone scams in recent months as scam artists threaten police arrest, deportation, license revocation and other things. The IRS reminds taxpayers to guard against all sorts of con games that arise during any filing season.

It's helpful that the IRS is warning taxpayers not to believe callers claiming to be agents. But perhaps it's worth pausing a moment and asking why taxpayers are vulnerable to such scams. Is it because the IRS has a much-deserved reputation for harsh treatment and that people are terrified — and therefore susceptible — when getting calls from criminals posing as IRS officials?

If America had a relatively benign tax system, such as Hong Kong's flat tax, it's highly unlikely that taxpayers would suffer from the toxic combination of fright and gullibility that enables criminal behavior.

Scam #2

Phishing: Taxpayers need to be on guard against fake emails or websites looking to steal personal information. The IRS will not send you an email about a bill or refund out of the blue. Don't click on one claiming to be from the IRS that takes you by surprise. Taxpayers should be wary of clicking on strange emails and websites. They may be scams to steal your personal information.

To be sure, it's a good thing that the IRS is warning people about the dangers associated with unsolicited scams. But we need to ask once again why taxpayers are vulnerable to bogus emails. Is it perhaps because the IRS has such immense power that many people are bullied into unthinkingly acquiescing when a situation calls for prudent skepticism?

Under a simple and fair flat tax, by contrast, it's hard to imagine this kind of scam being successful. After all, the IRS would only need to know the size of your household and a few numbers off your W-2 form.

Scam #3

Identity Theft: Taxpayers need to watch out for identity theft especially around tax time. The IRS continues to aggressively pursue the criminals that file fraudulent returns using someone else's Social Security number. The IRS is making progress on this front but taxpayers still need to be extremely careful and do everything they can to avoid becoming a victim.

This isn't a problem limited to the IRS and the tax code. There are lots of bad people seeking to steal money via identity theft. So it's unclear what the IRS is trying to achieve, other than trying to appear as if it's concerned with our well-being.

Many taxpayers might not be that upset to have their identities stolen if it meant that the thief also inherited their obligations to the IRS. Sadly, that's not the way it works.

Scam #4

Return Preparer Fraud: Taxpayers need to be on the lookout for unscrupulous return preparers. The vast majority of tax professionals provide honest, high-quality service. But there are some dishonest preparers who set up shop each filing season to perpetrate refund fraud, identity theft and other scams that hurt taxpayers. Return preparers are a vital part of the U.S. tax system. About 60 percent of taxpayers use tax professionals to prepare their returns.

Yet again, we have an example of the IRS putting itself in the role of concerned parent, warning us children to be wary of sketchy and dishonest people. That's a semi-admirable stance for the

IRS, though the real problem is that the tax code has become so mind-numbingly complex that more than 60 percent of taxpayers feel compelled to get professional assistance.

If we had a simple and fair tax system, much of this would be unnecessary. With a flat tax, for instance, filing a tax return could be a homework assignment for a kid in elementary school. As such, the risk of identity theft by a dodgy tax return preparer disappears.

Scam #5

Offshore Tax Avoidance: The recent string of successful enforcement actions against offshore tax cheats and the financial organizations that help them shows that it's a bad bet to hide money and income offshore. Taxpayers are best served by coming in voluntarily and getting their taxes and filing requirements in order. The IRS offers the Offshore Voluntary Disclosure Program (OVDP) to help people get their taxes in order.

Finally, we get to an example of the IRS threatening taxpayers rather than pretending to be our friend. The tax agency seems to imply that it's illegal to have a foreign account. It's only if you read the fine print that the IRS acknowledges that such accounts are legal and that "there are legitimate reasons for maintaining financial accounts abroad." So the real purpose of listing this as a scam is to browbeat people into reporting such accounts and paying taxes.

Of course, if we had a good tax system with no double taxation of income that is saved and invested, as well as no extraterritorial taxation on income that is earned – and already subject to tax – overseas, then this entire issue would vanish.

Scam #6

Inflated Refund Claims: Taxpayers need to be on the lookout for anyone promising inflated refunds. Be wary of anyone who asks them to sign a blank return, promises a big refund before looking at their records, or charges fees based on a percentage of the refund. Scam artists use flyers, advertisements, phony store fronts and word of mouth via community groups and churches in seeking victims.

Here's another case of the IRS acting as our concerned parent as the bureaucrats warn us about dodgy tax return preparers. But maybe we wouldn't have such a big problem if the IRS didn't have such a horrible track record of paying out money to people who make false claims. The fraud rate for the earned income credit (an income redistribution program operated by the IRS) is very high, leading to billions of dollars of improper handouts each year, so maybe the IRS should stop throwing stones in its glass house.

The real solution to this scam is tax reform so that the tax code is simple and there are no embedded spending programs like the EITC to attract fraudsters.

Scam #7

Fake Charities: Taxpayers should be on guard against groups masquerading as charitable organizations to attract donations from unsuspecting contributors. Contributors should take a few extra minutes to ensure their hard-earned money goes to legitimate and currently eligible charities. IRS.gov has the tools taxpayers need to check out the status of charitable organizations. Be wary of charities with names that are similar to nationally known organizations.

How thoughtful of the IRS to put us on guard against con artists representing make-believe charities. Though it's rather ironic to have the bureaucracy warn about fake charities when the IRS was misusing its power for reasons of political bias prior to the 2012 elections, and delaying proper tax status to legitimate nonprofit organizations.

This is another tax problem that disappears with the right kind of reform. Under a flat tax, there's no longer any charitable deduction, so there's no risk of adding injury to injury by giving money to a non-credentialed charity and getting in trouble with the IRS.

Scam #8

Hiding Income with Fake Documents: Hiding taxable income by filing false Form 1099s or other fake documents is a scam for which taxpayers should always avoid and protect themselves. The mere suggestion of falsifying documents to reduce tax bills or inflate tax refunds is a huge red flag when using a paid tax return preparer. Taxpayers are legally responsible for what is on their returns regardless of who prepares the returns.

Here's our second example of the IRS playing the role of threatening parent rather than a concerned one. We're being warned not to overstate deductions or understate income. This is another case where the IRS is being hypocritical since it enforces policies such as depreciation that compel businesses to overstate their income. And there are numerous provisions in the tax code — such as the capital gains tax, the double tax on dividends, the second layer of tax on savings, and the death tax — that result in a single dollar of income being taxed more than one time.

So how about a deal? We'll pay the right tax on the right level of income if the IRS agrees to taking just one bite of the apple. But don't hold your breath waiting for the politicians to make such reforms.

Scam #9

Abusive Tax Shelters: Taxpayers should avoid using abusive tax structures to avoid paying taxes. The IRS is committed to stopping complex tax avoidance schemes and the people who create and sell them. The vast majority of taxpayers pay their fair share, and everyone should be on the lookout for people peddling tax shelters that sound too good to be true. When in doubt, taxpayers should seek an independent opinion regarding complex products they are offered.

For our third example of the IRS in the role of threatening parent, the bureaucracy engages in some very disingenuous word games. It basically implies that "tax avoidance" is against the law, but that's false. Courts have repeatedly ruled that we have the right to take advantage of any and all provisions that enable us to legally minimize the amount of our income that is diverted to Washington. By the way, that includes any household that takes a home mortgage interest deduction or claims personal exemptions.

To be sure, it would be nice if the tax code was so simple and fair that there weren't so many Byzantine nooks and crannies that mostly serve to enrich politicians, tax lawyers and accountants. So when I see the IRS advocating for a flat tax, then I'll believe they're looking out for our best interests.

Scam #10

Falsifying Income to Claim Credits: Taxpayers should avoid inventing income to erroneously claim tax credits. Taxpayers are sometimes talked into doing this by scam artists. Taxpayers are best served by filing the most accurate return possible because they are legally responsible for what is on their return.

In scam #6, the IRS benevolently warned us about sketchy tax return preparers who promise inflated refunds. This is sort of the same issue, only this time the IRS is playing the role of threatening parent. As previously noted, the EITC has a notoriously high fraud rate because of IRS laxity and incompetence, so it's hard to take seriously the bureaucracy's warnings about making improper claims.

To be sure, it would be nice if the IRS wasn't in the business of operating an income redistribution program. Ultimately, all means-tested programs should be devolved to the state and local level.

Scam #11

Excessive Claims for Fuel Tax Credits: Taxpayers need to avoid improper claims for fuel tax credits. The fuel tax credit is generally limited to off-highway business use, including use in farming. Consequently, the credit is not available to most taxpayers. But yet, the IRS routinely finds unscrupulous preparers who have enticed sizable groups of taxpayers to erroneously claim the credit to inflate their refunds.

In this case, the IRS is threatening taxpayers to deter them from making false claims for fuel credits, which wouldn't seem to be a major issue. But because the IRS will send a check to people who fill out the form, there's a big incentive for people to get a share of the loot. It's even been an area where organized crime has profited by scamming the government.

Which raises the question of why politicians created such a system. Why not simply have the tax apply equally to all users and get rid of the special ability to claim a refund for certain users? But that's what politicians do, swapping loopholes for campaign cash, which is a big reason why the tax code has morphed into a 76,000-page monstrosity.

Scam #12

Frivolous Tax Arguments: Taxpayers should avoid using frivolous tax arguments to avoid paying their taxes. Promoters of frivolous schemes encourage taxpayers to make unreasonable and outlandish claims to avoid paying the taxes they owe. These arguments are wrong and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or disregard their responsibility to pay taxes. The penalty for filing a frivolous tax return is $5,000.

The IRS gets rather irked when taxpayers claim that the 16th Amendment (allowing income taxation) wasn't properly ratified, or make some other claim that the income tax as currently structured is illegal. And people who make these claims tend to get in serious legal trouble, so it makes sense to heed the implied threat from the IRS.

But maybe the tax system wouldn't engender so much hostility and disrespect if it was simple, transparent, fair, and conducive to growth.

And that may be the big-picture lesson to learn as we conclude our analysis.

When the income tax was first imposed back in 1913, the top tax rate was only 7 percent, the tax form was only two pages, and the tax code was easily understandable.

But now that 100 years have gone by, the tax system has become a mess, like a ship encrusted with so many barnacles that it can no longer function.

Yet the spending appetites of the political class are so insatiable that the IRS is instructed to squeeze ever-larger amounts of money, particularly from the so-called rich. This results in punitive tax rates, which economists universally acknowledge then create big incentives to hide, shelter and under-report income.

Perversely, politicians and tax enforcers then respond with more onerous enforcement techniques and silly gimmicks such as annual "dirty dozen" lists.

But let's also notice that some scams aren't on the IRS's list.

For example, if you don't pay enough tax as part of withholding, the IRS will charge you interest and maybe penalties. But if you over-pay and are due a refund, the IRS treats your money as an interest-free loan.

Or, get this: The IRS will penalize you, and often leap to the most negative interpretation, if your records are incomplete. Yet the IRS has responded to scandals and investigations by claiming to have lost key data.

Another example is the arbitrary enforcement — or non-enforcement — of Obamacare tax penalties, leading to a system where political factors corrupt the rule of law.

And don't forget the fact that the IRS requires investors to pay (a second layer of) tax on capital gains, even if an asset has fallen in value after adjusting for inflation.

In other words, the bottom line is that the biggest scam is the entire internal revenue code. The winners are the lobbyists, politicians, bureaucrats and insiders. The losers are America's workers, investors, and consumers.

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