

Common sense and reasonable cause for IRS penalties

Find out how taxpayers can argue they had reasonable cause and have the penalties abated.

By Robert W. Wood, J.D.

October 22, 2020

Dear IRS, no penalties please! Taxpayers claim that penalties are not warranted for many reasons, but what works? One of the biggest yet most misunderstood is the defense that a tax position was based on reasonable cause and the taxpayer acted in good faith. Those seem like pretty friendly, easy-to-understand words, but they are actually terms of art. Even if a taxpayer *thinks* he or she complied with them as a matter of common sense, the IRS may not agree. (This article focuses on reasonable cause and does not discuss the IRS's first-time abatement program to have penalties abated.)

Among other things, how the IRS evaluates a defense depends on *which* penalty has been assessed. In addition, on top of reasonable cause, certain penalty defenses involve other concepts, such as an absence of willful neglect. Isn't that proving a negative? Yes, it is.

Who wins in a tax penalty stalemate? This one should not be a surprise. The IRS does, of course. Put differently, taxpayers bear the burden of substantiating their reasonable cause. Taxpayers all must exercise ordinary business care and prudence in reporting their proper tax liability. And remember, all tax returns are signed under penalties of perjury, so keep that in mind too.

The IRS applies a facts-and-circumstances test on a case-by-case basis to determine whether a taxpayer meets the reasonable-cause and good-faith exception. This can lead to inconsistent results, and ones that are subjective. The stakes can be high because the Sec. 6664(c) reasonable-cause exception applies to the Sec. 6662 accuracy-related penalties, which are usually 20% of the amount at stake.

The reasonable-cause exception also applies to penalties for civil fraud under Sec. 6663. How much is the civil fraud penalty? A whopping 75%. So, if a flaky tax deduction amounts to \$10,000 in tax, add another \$7,500 on top if the IRS says it was fraud. Fraud penalties are not asserted frequently, but it is not an exaggeration to say that

they can be big. That makes taxpayers' ability to sidestep them big too, even if they end up having to pay all the tax and the interest.

But wait, there's more. Reasonable-cause exceptions also apply to other penalties the IRS can impose, including the penalties: (1) for failure to file a tax return, and failure to pay, under Sec. 6651, (2) for making an erroneous claim for refund or tax credit, under Sec. 6676; (3) for failure to file Form 1099 or other information reporting returns under Sec. 6721; and (4) a tax return preparer's understatement of a taxpayer's liability under Sec. 6694.

In fact, the Code is chock full of penalty provisions. So, a reasonable shortcut to all the detail is to say that taxpayers *always* want to argue that they acted reasonably and with cause in claiming every single item listed on the tax return in good faith. However, when do taxpayers *not* want to bother arguing reasonable cause?

There could be several situations. The reasonable-cause exception does not apply to an underpayment of tax that is due to transactions lacking economic substance under Sec. 6662(b)(6). The same is true for penalties for a gross-valuation overstatement from claiming charitable contributions deductions for property. All is not lost though — at least not necessarily. There *can* be penalty relief in those two cases, but the rules are different and more complex. Fortunately, though, those two penalties are generally asserted for highly aggressive transactions that do not apply to most people or most situations.

Tax return reporting is key

According to the IRS, the *most* significant factor in determining whether a taxpayer has reasonable cause and acted in good faith is his or her efforts to report the proper tax liability. A taxpayer may be doing his or her best to report the right amount, and that sounds simple. However, unlike the taxpayer defense of "reasonable basis," reasonable cause does not depend on the legal authority behind the position taken on the return.

Rather, it depends on the taxpayer's *actions*. For example, suppose the taxpayer reported the amount from an erroneous Form 1099, but didn't actually *know* that the Form 1099 was wrong. Under audit, it turns out that the Form 1099 reported less than the taxpayer actually received, which could happen to anyone. After all, most people often rely on Form 1099 data, so reasonable cause may apply if the taxpayer just reports the amount on the form because it is reasonable to assume it is correct.

What if the taxpayer was paid \$300,000, but the Form 1099 said \$300? It might be harder to argue that it was reasonable to pick up that number and report it, compared to an error where the inaccurate Form 1099 said \$285,000. Still, how a taxpayer behaves and what he or she did may be reasonable, even with a big error.

How about an isolated computation or transposition error on the return? Because it is common, that too may be consistent with reasonable cause and a good-faith effort. It is easy enough to transpose numbers or to make other errors. However, if there are a dozen of these on the return, it is not as likely that the IRS will understand and let the taxpayer off the penalty hook.

But a mistake or two can often be explained, even if it is clear in the end that it was just plain wrong. Other factors the IRS considers include the taxpayer's experience, knowledge, education, and reliance on the advice of a tax adviser. When considering the facts and circumstances, the taxpayer's experience, education, and sophistication concerning the tax laws are relevant. Reliance on advice from a tax professional is obviously a point that many taxpayers use to try to avoid penalties.

However, the IRS says that relying on a tax professional must be *objectively* reasonable. Taxpayers must provide their tax adviser with all of the necessary information to evaluate the tax matter at issue. In other words, cherry-picking what the taxpayer tells the tax adviser to get the answer he or she wants to hear is not reasonable.

The tax adviser needs to be competent in the subject matter too. The IRS says the adviser must have knowledge and expertise related to the tax matter. If a taxpayer has a complex corporate tax problem and goes to a low-income individual income tax adviser, it might *not* be reasonable to rely on the person, no matter how faithfully the taxpayer follows his advice.

The IRS tells its auditors that they should determine whether the taxpayer acted with reasonable cause and in good faith based on all the facts and circumstances on a case-by-case basis. The taxpayer must have exercised the care that a reasonably prudent person would have used under the circumstances. The meaning of "reasonable cause" can also depend on the particular penalty.

Some penalty sections also require evidence that the taxpayer acted in good faith or that the taxpayer's failure to comply was *not* due to willful neglect. Not every penalty provision has the same penalty relief standard. For instance, Sec. 6676 imposes a penalty for an excessive claim for refund or credit, but the penalty can be waived if the taxpayer has reasonable cause.

Sec. 6662 imposes accuracy-related penalties, but for the taxpayer to avoid those penalties, the taxpayer's error must be due to reasonable cause *and* good faith. Finally, the Sec. 6651 failure-to-file or failure-to-pay penalty provides a waiver based on reasonable cause *and* an absence of willful neglect. In short, to get out of a penalty the IRS is trying to impose, it pays to look at the specific penalty in question. Taxpayers want to show how their facts and conduct met all the required tests.

In writing

Should taxpayers make their case orally? Usually not, although in some cases taxpayers can begin that way. Like just about everything else when dealing with the IRS, it is always best to lay it out in writing. In fact, in many cases, the tax regulations actually *require* the taxpayer's request for waiver of the penalty to be in writing and even signed under penalties of perjury (Regs. Secs. 301.6651-1(c)(1) and 301.6724-1(m)).

Whether the elements that constitute reasonable cause, willful neglect, or good faith are present is based on all the facts and circumstances. Reasonable cause is established when the taxpayer exercised ordinary business care and prudence. Ordinary business care and prudence is defined as taking that degree of care that a reasonably prudent person would exercise, but nevertheless being unable to comply with the law.

Key factors

The taxpayer's effort to report the proper tax liability is the most important factor in determining reasonable cause. In assessing the taxpayer's effort, the IRS tells its agents to look at all the relevant factors, including the nature of the tax, the complexity of the issue, the competence of the tax adviser, and so on. Other factors include the taxpayer's experience, knowledge, education, and reliance on the advice of a tax adviser.

In determining whether a taxpayer exercised ordinary business care and prudence, the IRS tells its agents to consider all the facts and circumstances, and to review all available information such as the taxpayer's reason, compliance history, length of time, and circumstances beyond the taxpayer's control. However, don't assume that this is just about one year, the tax year involved.

The IRS tells its agents to look at the three *previous* tax years too. They look for payment patterns and compliance history. A taxpayer who repeatedly is assessed the same penalty may not be exercising ordinary business care. After all, if the same penalty was previously assessed or forgiven by the IRS, this is an indication that that person may not be exercising ordinary business care when it happens again (and again).

In contrast, if this is the first incident of noncompliance, the IRS will consider that, along with the other reasons and circumstances the taxpayer provides. The IRS is supposed to consider all the facts and circumstances, including the length of time between when the tax problem occurred and when it was fixed it. The reason for the error should coincide with the dates and events that relate to the penalty.

The IRS is even willing to say that some mistakes and circumstances are beyond a taxpayer's control. However, the IRS also asks whether the person could have foreseen or anticipated the event that caused the problem in the first place.

How about relying on tax advice from the IRS? Isn't that *always* reasonable? Not necessarily. This can be a surprisingly touchy one, particularly in the case of oral advice. First, consider if it was written or oral advice from the IRS. Oral advice usually isn't worth the paper it's not printed on. If a person points to something the IRS told him or her in writing, the IRS evaluates the information and determines if the advice was in response to a specific request and related to the facts contained in that request. The IRS also wants to know if the person actually relied on the IRS advice.

Taxes are complex, and that itself might provide plenty of excuses for how taxpayers could mess up. But some things are simple, and some errors are a lot easier to explain than others. For example, the IRS says a taxpayer generally does *not* have a basis for reasonable cause if the penalty relates to the late filing of a tax return or payment of a tax obligation. Taxpayers' saying that they thought tax returns were due May 15 not April 15 — even if a tax professional told them that — isn't likely to save them from penalties.

Saying that their accountant had their return, they told the accountant to file it, and the accountant forgot? The IRS says everyone is responsible for timely filing taxes and for paying them, and those duties cannot be delegated. So even if taxpayers rely on accountants, bookkeepers, or attorneys, they cannot delegate responsibility to timely file tax returns and timely pay their tax obligations. On the other hand, things like the unavailability of records or a law change that they could not reasonably have been expected to know might be forgiven.

In some cases, taxpayers can even seek penalty relief due to a lack of knowledge of the law. Relevant factors include education, whether the taxpayer has been subject to the tax before, whether the taxpayer has been penalized before, the complexity of the tax issue, and recent changes in the tax law or forms. How about forgetfulness as a basis for reasonable cause? The IRS says forgetfulness indicates a *lack* of reasonable cause.

Taxpayers shouldn't assume they've lost

As this breezy survey suggests, avoiding penalties with the IRS is a vast subject, and we have only scratched the surface. If you are being penalized, consider the topic with common sense, and look into the large body of tax law from the IRS and tax cases that might help you. And if the dollars are significant, get some professional advice.

The AICPA Tax Section has an [IRS Penalty Abatement Template](https://www.aicpa.org/signin.html?returnTo=/content/dam/aicpa/interestareas/tax/resources/irsprocedureadministration/downloadabledocuments/irs-letter-to-request-first-time-penalty-abatement.docx%3FcontentType%3Dsecured) (<https://www.aicpa.org/signin.html?returnTo=/content/dam/aicpa/interestareas/tax/resources/irsprocedureadministration/downloadabledocuments/irs-letter-to-request-first-time-penalty-abatement.docx%3FcontentType%3Dsecured>), available for its members to use to support a reasonable cause penalty abatement.

— **Robert W. Wood, J.D.**, practices law and is the managing partner with Wood LLP (WoodLLP.com) in San Francisco. He is the author of *Taxation of Damage Awards and Settlement Payments* and other books available at TaxInstitute.com. This discussion is not intended as legal advice. To comment on this article or to suggest an idea for another article, contact Sally Schreiber, a Tax Adviser senior editor, at Sally.Schreiber@aicpa-cima.com (<mailto:Sally.Schreiber@aicpa-cima.com>).



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