The Layman's Guide to Reasonable Cause With the IRS

by Robert W. Wood

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In this article, Wood explains that the IRS is never your friend when asserting tax penalties, even when you show reasonable cause and good faith.

This discussion is not legal advice.

No one wants to pay penalties on top of a tax liability and interest. And yet the IRS can and does frequently add penalties when it finds something amiss. Just about every taxpayer figures that the penalties are truly adding insult to injury, and that the bitter pill of paying additional taxes and interest wouldn't be quite so bitter if at least you could get those penalties removed. One of the biggest yet most misunderstood justifications for penalty abatement is the defense that a tax position was based on reasonable cause and that the taxpayer acted in good faith.

Many people think they should easily qualify, since those seem like pretty friendly, easy-to-understand words. Actually, they are terms of art, and even if you think you comply with them as a matter of common sense, the IRS may not agree. Among other things, how the IRS evaluates a defense depends on which penalty has been assessed, so you need to know that to see if you were, well, reasonable.

Also, on top of reasonable cause, some penalty defenses involve other concepts, such as an absence of willful neglect. Isn't that proving a negative? You bet. Who wins in a tax penalty stalemate? This one should not surprise you. The IRS does, of course. Put differently, taxpayers bear the burden of substantiating their reasonable cause.

We all must exercise ordinary business care and prudence in reporting our proper tax liability. And remember that all tax returns are signed under penalties of perjury. 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. As you might expect, that can lead to inconsistent results, and ones that are subjective. The stakes can be high too.

The IRC's reasonable cause exception under section 6664(c) applies to accuracy-related penalties under section 6662, which are usually 20 percent of the amount at issue. The reasonable cause exception also applies to penalties for civil fraud under section 6663. How much is the civil fraud penalty? A whopping 75 percent. So, if your flaky tax deduction amounts to $10,000 in tax, you can add another $7,500 on top if the IRS says it was fraud. Fraud penalties are not asserted frequently, but still: It is not an exaggeration to say that penalties can be big.

That makes your ability to sidestep them big too, even if you end up having to pay all the tax and interest. But wait: There's more. Reasonable cause exceptions for penalty relief also apply to other penalties the IRS can impose, including those: (1) for failure to file a tax return and failure to pay under section 6651; (2) for making an erroneous claim for a refund or tax credit under section 6676; (3) for failure to file Form 1099 or other information reporting returns under section 6721; and (4) for the understatement of a taxpayer's liability by a tax return preparer under section 6694.

In fact, the tax code is chock full of penalty provisions. So a reasonable shortcut to all the detail is to say that you always want to argue that you behaved reasonably. You also want to always be able to say that you claimed every single item listed on your tax return in good faith. However, when might you *not* want to bother arguing about your reasonable cause?

Perhaps asking never hurts, but the reasonable cause exception does not apply to an underpayment of tax that is caused by transactions lacking economic substance as described in section 6662(b)(6). The same is true for penalties for a gross valuation overstatement from claiming charitable contribution deductions for property. All is not lost, however, at least not necessarily. There can be penalty relief in those two cases, but the rules are different and more complex. Fortunately, those two penalties are more the province of 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 you have reasonable cause and whether you have acted in good faith is your effort to report the proper tax liability. You are doing your best to report the right amount, and that sounds simple. Notably, though, unlike the taxpayer defense of "reasonable basis," reasonable cause does not depend on the legal authority you have stacked up.

Rather, reasonable cause depends on your actions. For example, suppose that you report the amount from an erroneous Form 1099, but you didn't actually know that the Form 1099 was wrong. You think the Form 1099 has the total you were paid, but under audit, it turns out that the Form 1099 reported less than you actually received. That could happen to anyone. After all, we all often rely on Form 1099 data, so reasonable cause may apply if you just pick up a reported number and reasonably assume it is correct.

What if you were paid $300,000, but the Form 1099 said you received $300? It might be harder to say that you picked up that number unintentionally and reported it, compared with an inaccurate Form 1099 that said $285,000. Still — how you behaved and what you did may be reasonable, even with a big error.

How about an isolated computation or transposition error you might make on your return? We all might do that too, and 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. A mistake or two can often be explained, even if it is clear in the end that you were just plain wrong.

However, if you have a dozen of these on your return, it is not as likely that the IRS will understand and let you off the penalty hook. 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 invoke to try to avoid penalties.

However, the IRS says that your reliance must be objectively reasonable. That means you must provide your tax adviser with all the necessary information to evaluate your tax matter. In other words, cherry-picking what you tell your tax adviser to get the answer you want to hear is not reasonable. That kind of behavior would preclude your being viewed as reasonable if you are relying on a sugar-coated answer.

Your 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 you have a complex corporate tax problem and you go to an income tax adviser for low-income individuals, it might not be reasonable for you to rely on the person, no matter how faithfully you follow 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 caused by willful neglect. Not every penalty provision has the same penalty relief standard. For instance, section 6676 imposes a penalty for an excessive claim for refund or credit, but the penalty can be waived if you have reasonable cause.

Section 6662 imposes accuracy-related penalties, but to get out of them your error must be a result of reasonable cause *and* good faith. You need both factors to sidestep the penalty in that case. Finally, section 6651 imposes the failure-to-file or -pay penalty, and it provides a waiver based on reasonable cause and an absence of willful neglect. In short, if you are trying to get out of a penalty the IRS is trying to impose, it pays to look at the specific penalty in question. You want to show how your facts and your conduct meet all the required tests.

In Writing

Do you make your case orally? Usually not, although you can try that for starters in some cases. Like just about everything else with the IRS, you almost always should lay things 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.[1]

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 giving rise to reasonable cause 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 similarly tells its agents to consider all the facts and circumstances. The IRS should review all available information such as the taxpayer's reason, compliance history, length of time, and circumstances beyond the taxpayer's control. You might assume that this is just about one year — the tax year involved.

However, the IRS tells its agents to look at the three previous tax years too. The IRS is looking for your 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 you may not be exercising ordinary business care when it happens again (and again).

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

The IRS is even willing to say that some mistakes and circumstances are beyond your control. However, the IRS asks whether you 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 for oral advice.

First consider if the advice from the IRS was written or oral. Oral advice usually isn't worth the paper it's not printed on. If you point to something the IRS told you in writing, the IRS evaluates the information and determines if the advice was in response to a specific request and was related to the facts in that request. The IRS also wants to know if you actually relied on the IRS advice.

[1] *See* reg. sections 301.6651-1(c)(1) and 301.6724-1(m).

Taxes are complex, and that itself might provide you with plenty of excuses for how you could mess up. But some things are simple, and some "oops" errors are a lot easier to explain than others. For example, the IRS says you generally do 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. Saying that you thought tax returns were due May 15 and not April 15 — even if a tax professional told you that — isn't likely to save you from penalties.

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

In some cases, you can even seek penalty relief because of a lack of knowledge of the law. Relevant factors include your education, whether you have been subject to the tax before, whether you have been penalized before, the complexity of the tax issue, and recent changes in the tax law or forms. Can you use forgetfulness as a basis for reasonable cause? No, as the IRS says that forgetfulness indicates a *lack* of reasonable cause.

Conclusion

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. ■