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How “Reasonable Cause” Sidesteps IRS Penalties

By Robert W. Wood

IN BRIEF

- Is it possible to argue your way out of a tax penalty?
- Yes! It’s called the “reasonable-cause exception,” and an understanding of its requirements based on the type of penalty assessed just might save you some money should you meet those requirements.

Dear IRS, no penalties please! Taxpayers claim that penalties are not warranted for many reasons, but what actually works? One of the biggest, yet most misunderstood, is the defense that a tax position was based on reasonable cause.[1] Section 6664(c) of the IRC provides that “no penalty shall be imposed . . . with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.” How the IRS evaluates this defense depends on *which* penalty has been assessed, so you must first know that to determine whether you are, well, reasonable. 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? 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 exception. As you might expect, that can lead to inconsistent, subjective results. The stakes can be high. The reasonable-cause exception applies to accuracy-related penalties under section 6662, which are usually 20 percent of the amount at stake. It even applies to penalties for civil fraud under section 6663. How much is the civil fraud penalty? A whopping 75 percent. Thus, if your flaky tax deduction amounts to $10,000 in tax, you can add another $7,500 if the IRS says it was fraud. Fraud penalties are not asserted frequently, but 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 the interest.

But wait, there's more. The reasonable-cause exception for penalty relief also applies to other penalties the IRS can impose, including penalties for: (1) failure to file a tax return and failure to pay, imposed by section 6651, (2) making an erroneous claim for refund or tax credit under section 6676; (3) failure to file Form 1099 or other information reporting returns under section 6721; and (4) 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. A reasonable shortcut to all the detail is to argue that you *always* behaved reasonably. You also want to be able to say that you always claimed every single item listed on your tax return in good faith. However, where might you *not* want to bother arguing about your reasonable cause?

Well, 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 as described in section 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, 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. Doing your best to report the right amount 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, it 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 simply 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 you picked up that number unintentionally and reported it, compared to an error where the inaccurate Form 1099 indicated $285,000. Still, your behavior may be reasonable, even with a big error.

How about an isolated computation or transposition error you might make on your return? 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 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 advisor. 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 your reliance must be *objectively* reasonable. That means you must provide your tax advisor with all of 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 you being viewed as reasonable if you are relying on a sugar-coated answer.

In addition, your tax advisor must be competent in the subject matter. If you have a complex corporate tax problem and you consult a low-income, individual income tax advisor, it might *not* be reasonable for you to rely on that advisor, no matter how faithfully you follow his or her 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, section 6676 of the code imposes a penalty for an excessive claim for refund or credit, but the penalty can be waived if you demonstrate reasonable cause.

Section 6662 imposes accuracy-related penalties, but to get out of them, your error must have been made with reasonable cause *and* in good faith. Finally, section 6651 imposes the failure to file or pay a 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 seeks 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 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.[2]

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.

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 advisor, and so on. Other factors include the taxpayer’s experience, knowledge, education, and reliance on the advice of a tax advisor.

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. You might assume that such a review would extend back one year, i.e., the tax year involved. However, the IRS tells its agents to look at the three previous tax years. They will look for your payment patterns and compliance history. A taxpayer who repeatedly is assessed the same penalty may not be exercising ordinary business care.

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 occurrence of the tax problem and when you fixed it. The reason for your error should coincide with the timeframe 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 also 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 subject, particularly in the case of oral advice. Oral advice usually isn’t worth the paper it’s (not) printed on. If you point to something the IRS told you in writing, however, the IRS evaluates the information and determines whether 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 you actually relied on its advice.

Taxes are complex, and that itself might provide you with plenty of excuses as to how you could mess up. However, 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. Arguing that you thought tax returns were due May 15, not April 15—even if a tax professional told you that—isn’t likely to save you from penalties.

Arguing that you or your accountant forgot to file also is not likely so demonstrate reasonable cause. The IRS says everyone is responsible for timely filing taxes, and for paying them, 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 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* seek penalty relief due to 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.

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[1] Robert W. Wood practices law with Wood LLP and is the author of *Taxation of Damage Awards and Settlement Payments* and other books available at www.TaxInstitute.com. This discussion is not intended as legal advice.

[2] *See* Treas. Reg. 301.6651-1(c)(1), 301.6724-1(m).