

“Reasonable cause” avoids IRS penalties

By Robert W. Wood

If you make a mistake on your taxes, you may have to pay some additional taxes and even some interest, but how about penalties? No one likes to pay penalties, and yet when the IRS sends you a tax bill, they tend to add penalties to just about everything. However, that does not always mean you have to pay them as you may be able to push back.

Taxpayers claim that IRS penalties are not warranted for many reasons. One of the biggest and most misunderstood is the defense that a tax position was based on “reasonable cause” and that you acted in good faith. Those seem like friendly, easy-to-understand words, but they are terms of art. Even if you *think* you comply with them as a matter of common sense, the IRS may not agree.

We’ll focus on reasonable cause, although there are other avenues that also might get you out of IRS penalties. Among other things, how the IRS evaluates a penalty defense depends on which particular IRS penalty has been assessed. 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, but when it comes to penalties, the IRS is holding most of the cards. It can feel a little like you are going to them with hat in hand. Who wins in a tax penalty stalemate? This one should not be a surprise. The IRS does. 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 must be 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 reasonable-cause exception (in Section 6664(c) of the tax code) applies to accuracy-related penalties, which are usually 20% of the amount at stake.

If you lose in an audit, you won’t be happy about paying the tax and the interest. But you will be even more unhappy if you have to pay a 20% penalty on top. And to make matters worse, you generally can’t claim a tax deduction for paying a penalty. The reasonable-cause exception also applies to penalties for civil fraud under. The civil fraud penalty (under Section 6663 of the code) is a whopping 75%.

So, if a questionable tax deduction ends up getting you a bill from the IRS for another \$10,000 in tax, you can add another \$7,500 on top of it if the IRS says it was fraud. Fortunately, fraud penalties are not asserted frequently, in part because the IRS must show fraud to collect them. That is a change to the burden always being on the taxpayer. Even so, the fear of that 75% penalty can change negotiation dynamics significantly.

It can make a taxpayer’s ability to sidestep big penalties important, even if you up having to pay all the tax and the interest. You hope you will prevail on your tax position and not end up with a tax bill. If you can’t prevail, you hope you can compromise on a favorable basis. Compromises can often

be achieved at IRS Appeals, one level up from an audit. But even if your tax case goes badly, you hope you will not end up having to pay any penalties.

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

As you can tell, the tax 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 in good faith in claiming every single item listed on the tax return in good faith. However, when might you *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 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, though, those two penalties are generally asserted for highly aggressive transactions that do not apply to most people or most situations.

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 know that the Form 1099 was wrong. You *think* the Form 1099 reports 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? In this case, 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.

Bottom line, try to be reasonable in any tax position you take. And whether you are taking tax reporting positions and need guidance about them before signing your return, or trying to push back in an audit and trying to avoid penalties applied later, get some outside help if you need it.

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