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Which Tax Mistakes Avoid IRS Penalties?

No one likes to pay penalties, but yet when the IRS sends you a tax bill, they tend to add penalties.

Taxpayers say IRS penalties are unwarranted for many reasons. One of the biggest and most misunderstood is that you had reasonable cause and acted in good faith. Those seem like easy-to-understand words, but even if think you meet them, the IRS may not agree.

But that doesn't mean you always have to pay, as you may be able to push back.

How the IRS evaluates a penalty defense depends on which penalty was assessed, and you bear the burden of providing that you acted reasonably. We all must exercise ordinary business care and prudence in reporting our tax liability, and all tax returns must be signed under penalties of perjury.

If you lose in an audit, you won't be happy about paying extra tax and interest. But you will be even less happy if you have to pay a 20% penalty, too. To make matters worse, you generally can't claim a tax deduction for paying a penalty. Some penalties are even higher, like the civil fraud penalty which is a whopping 75%.

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. In any audit, you hope to prevail and not to end up with a tax bill. If you can't win, you hope to 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 penalties. The tax code is chock full of penalty provisions. 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.

According to the IRS, the most significant factor in determining whether you have reasonable cause and whether you 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, 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.

But 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. 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.

Reliance on advice from a tax professional is a point that many taxpayers invoke to try to avoid penalties.

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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