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Secrets to IRS Penalty Forgiveness Using Reasonable Cause

Uh-oh! In your mailbox, you found that dreaded envelope—the one from the IRS.

Inside the envelope, you find a notice from the IRS informing you that it assessed additional tax, penalties, and interest on your tax return from two years ago!

After you recover from the shock, you review your tax records for that year and realize to your dismay that the IRS is right: you do owe the additional tax.

The additional tax liability is bad enough, but the added penalties and interest are extra sources of aggravation. Is there any way for you to avoid paying them?

The tax code[1] requires the IRS to charge interest on unpaid taxes and penalties. The IRS can waive interest only if[2]

- it made an administrative error; or
- it caused an unnecessary delay in assessing the tax obligation.

On the other hand, the IRS can waive penalties it assessed against you or your business if there was "reasonable cause"[3] for your actions.

Okay, we know what you're thinking. This should not be too hard. After all, you understand the term "reasonable cause" and often use it in your everyday conversations!

Warning! Contrary to what you might think, the term "reasonable cause" is actually a term of art at the IRS. This seemingly simple phrase has a precise and detailed definition as it relates to penalty abatement.

Moreover, many of the rules and requirements for reasonable cause exceptions to penalties are downright tricky to navigate.

What Is Reasonable Cause?

The IRS permits reasonable cause penalty relief for penalties arising in three broad categories:[4]

1. Filing of returns;
2. Payment of tax; and
3. Accuracy of information.

For each case, the IRS judges the facts and circumstances at hand, and will generally permit penalty relief for reasonable cause if you exercised ordinary business care and prudence in determining your tax obligations but were unable to comply with those obligations.[5]

But reasonable cause does not exist if, after the facts and circumstances that explain your noncompliant behavior cease to exist, you fail to comply with the tax obligation within a reasonable period of time.[6]

The IRS provides several examples of reasonable cause. Here are five:

1. Death or Illness

Your or an immediate family member's death or serious illness, or your unavoidable absence.[7] For example, if your spouse died October 11, the IRS might consider this reasonable cause for not filing your return by the October 15 extension deadline.

But it is also important to consider when you actually did file the return. You have a strong case if you filed the return on November 1. Your case is much, much weaker if you wait until June 15 of the following year to file.

2. Records

Inability to obtain necessary records to comply with your tax obligation.[8] If you were unable to obtain records needed to prepare your tax return, reasonable cause may apply. You need to document why you needed the missing records, and why they were unavailable.

Furthermore, you need to document the steps you took to obtain the needed information. Your diligence in and attention to finding or re-creating the missing information will be a key aspect in the IRS's reasonable cause evaluation.

3. Disaster

Destruction or disruption caused by fire, casualty, natural disaster, or other disturbance.[9] Commonly, either the casualty affects your ability to attend to your tax matter, or the needed records are affected.

You should follow the procedures outlined above to clearly document how the disaster impacted your ability to meet your tax obligation, and the steps you took once the crisis was over.

4. Advice

You relied on erroneous advice.[10] Reliance on advice of a tax advisor generally relates to the reasonable cause exception for the accuracy-related penalty.[11]

In determining whether reliance on professional advice constitutes reasonable cause, the IRS applies a three-prong test.[12] You must meet all three prongs to qualify for penalty abatement:

1. The advisor was a competent professional with sufficient expertise to justify reliance;
2. You provided all necessary and accurate information to the advisor; and
3. You actually relied in good faith on the advisor's judgment.

5. Ignorance

Ignorance of the Law. Generally, ignorance of the law is not reasonable cause for failing to comply with the tax law.[13]

But in some cases, you can establish reasonable cause for penalty relief if you can show ignorance of the law in conjunction with other facts and circumstances.

For example, the IRS may consider the following factors in conjunction with ignorance of the law to establish reasonable cause:[14]

1. your education;
2. whether you have previously been subject to the tax in question;

3. whether you have been penalized before;

4. whether there were recent changes in the tax forms or law that you could not reasonably be expected to know; and

5. the level of complexity of the tax or compliance issue.

Thus, in one U.S. Tax Court case,[15] the IRS denied a dependent deduction and imposed an accuracy-related penalty for a non-custodial father because he did not provide the necessary exemption release from his ex-wife.

Although the U.S. Tax Court did not allow the deduction, it removed the accuracy-related penalty because the father incorrectly thought he could use his state court orders instead. The court ruled that the father's attempt to comply with the documentation requirements warranted reasonable cause for penalty relief.[16]

What Is Not Reasonable Cause?

Some excuses are not accepted as reasonable cause. You should not base your request solely on any of the following four reasons:

1. Mistake

You made a mistake.[17] Mistakes are not consistent with the IRS's ordinary business care and prudence standard.

But the **reason** for the mistake may be a supporting factor if additional facts and circumstances support the determination that you exercised ordinary business care and prudence.

For example, if you can show that at the time you prepared your return you were taking prescribed painkillers following an injury or accident, the IRS might consider this reasonable cause for making a mistake that might otherwise not be excused.

2. Forgot

Forgetfulness.[18] In general, forgetfulness is not reasonable cause.

But if you were recently diagnosed with Alzheimer's, what appeared to be forgetfulness in missing a tax filing deadline should be described instead as an undiagnosed medical condition that caused the late filing penalty.

3. Relied on Another

You relied on another party to comply on your behalf. You are solely responsible for meeting your tax obligations. You cannot delegate that responsibility.

While it might seem reasonable to rely on a tax professional, the U.S. Supreme Court has ruled otherwise.

In the infamous Boyle decision,[19] the U.S. Supreme Court held that the executor of a decedent's estate lacked reasonable cause for not filing the estate tax return on time, even though he had hired and relied on an experienced probate lawyer to meet his legal and tax obligations.[20]

Lack of Funds

A lack of funds, in and of itself, is not reasonable cause for failure to file or pay on time. But the reasons for the lack of funds may meet reasonable cause criteria for the failure-to-pay penalty.

Thus, in a U.S. District Court case,[21] the court addressed the late filing and late payment of a tax return by a defense contracting company, whose primary customer, the U.S. Navy, had stopped paying on the contract.

The court ruled that lack of funds was reasonable cause for the company's late payment of its taxes, but not reasonable cause for the company's late filing of its tax return.

Additional Requirements for Other Penalties

While a showing of reasonable cause is sufficient to abate the failure to pay and failure to file penalties, other penalties may require a showing of additional factors beyond just reasonable cause.

For example, the IRS frequently adds accuracy-related penalties at the conclusion of an audit.[22] By code, this penalty is 20 percent of any underpayment of federal tax.

If you have an accuracy-related penalty, you must not only demonstrate reasonable cause, but you also must show that you acted in "good faith."[23]

How to Request Reasonable Cause Penalty Relief

You can make a request for reasonable cause penalty relief either by filing a letter or by using Form 843. If you received an IRS notice informing you of a change to an item on your tax return, you should follow the instructions on the notice.

When evaluating a request for reasonable cause penalty relief, a key aspect that the IRS considers is the extent of your effort to pay your tax payment or to fulfill your filing obligation. You should prepare a compelling justification proving that you exercised ordinary business care and prudence, but factors beyond your control prevented you from meeting your tax obligations.

Be sure to correlate the dates and explanations corresponding to the events on which the IRS based the penalties. Describe the steps you took to become compliant once the event that created your reasonable cause was over.

While you can sometimes make your request orally, a written request better enables you to present a persuasive, coherent, well-organized argument. And with the written request, you can attach supporting documents.

Remember to include your name and Social Security number (or employer identification number if a business) on each page of your correspondence to the IRS.

What If the IRS Rejects My Request?

You should consider requesting an appeal if the IRS denies your initial request. There is a saying among tax professionals: “The deals are in appeals.”

One reason to appeal is that the IRS might not have considered all the aspects of your explanation if you have a complex case.

And then you have the IRS’s computerized “Reasonable Cause Assistant,”[24] which looks at each of your arguments in isolation and may automatically reject your request if it finds one of its programmed exceptions in your claim.

When you are in appeals, the specialized appeals officers will take a fresh look at your situation. Their training directs them to look at the big picture and the totality of your circumstances.

Takeaways

The IRS will waive tax penalties if you can demonstrate reasonable cause. The IRS bases reasonable cause on all the facts and circumstances of each situation, and these determinations are subjective.

Here are some key insights from this article:

- The IRS generally grants reasonable cause relief when you use ordinary business care and prudence in determining tax obligations.

- Depending on the nature of the penalty, you may also need evidence that you acted in good faith or that your failure to comply with the law was not due to willful neglect.

- When asserting a reasonable cause defense, you should supply dates and explanations corresponding to the events on which the IRS based the penalties.

- Be prepared to file an appeal if the IRS denies your initial request; your chances of penalty forgiveness increase significantly if your case goes to appeals.

- Time matters: if you missed a filing or payment deadline, you should file or pay at the earliest possible opportunity.

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1 IRC Section 6601.
2 IRC Section 6404(e).
3 IRM 20.1.1.3.2.
4 IRM 20.1.1.1.1.
5 IRM 20.1.1.3.2.
6 Ibid.
7 IRM 20.1.1.3.2.2.1.
8 IRM 20.1.1.3.2.2.3.
9 IRM 20.1.1.3.2.2.2.
10 IRM 20.1.1.3.2.2.5.
11 IRM 20.1.1.3.3.4.3.
12 DJB Holding Corp. v Commr, 803 F.3d 1014 (9th Cir. 2015).
13 IRM 20.1.1.3.2.2.6.
14 Ibid.
15 Armstrong v Commr., 139 T.C. 468 (2012).
16 Ibid.
17 IRM 20.1.1.3.2.2.4.
18 IRM 20.1.1.3.2.2.7.
19 U.S. v Boyle, 469 U.S. 241 (1985).
20 Ibid.
21 Glenwal-Schmidt v. U.S., 78-2 USTC ¶ 9610, 42 AFTR 2d 78-5817, 1978 WL 4527 (D.D.C. July 12, 1978).
22 IRC Section 6662.
23 Reg. Section 1.6664-4.
24 IRM 20.1.1.3.6.