Not Mea Culpa

There are times when Taxpayers will attempt to use the "it is not my fault" argument as a defense relating to IRS penalties. Taxpayers might argue that they relied on guidance from a tax professional or from a tax software that turned out to be incorrect. This type of defense or argument, when factually supportable, could be treated as "reasonable cause" to the satisfaction of IRS, for Taxpayer penalty relief. According to IRS, **reasonable cause** is based on all the facts and circumstances of a Taxpayer's situation. IRS will consider reasons which establish that the related Taxpayer used all ordinary care and prudence to meet their Federal tax obligations but were nevertheless unable to do so.

Reasonable Cause

According to the IRS Manual, the important factors in determining reasonable cause are:

- The Taxpayer's effort to report the proper tax liability.
- The Taxpayer's experience, knowledge, education, level of sophistication.
- The Taxpayer's reliance on the advice of a tax advisor.
- The Nature of the tax investment.
- The complexity of the tax issues.
- The competence of the tax advisor.
- The quality of the opinion relied upon must be developed to determine whether the taxpayer was reasonable and acted in good faith.

Taxpayer's Effort to Report the Proper Tax Liability

What is the extent of a Taxpayer's effort to report the proper tax liability? For example, reliance on erroneous information reported, an information return - would indicate reasonable cause and good faith provided that the taxpayer did not know or have reason to know that the information was incorrect. In similar fashion, a computational or transcription error may indicate reasonable cause and good faith. Is there reasonable cause and good faith if a Taxpayer relies on erroneous information inadvertently included in data compiled by various divisions of a multidivisional corporation or in financial books and records prepared by those divisions?

Experience, Knowledge, Sophistication, and Education of Taxpayer

There could be reasonable cause and good faith if there is an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication, and education of a Taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws at the time the return was filed, is relevant in deciding whether the Taxpayer acted with reasonable cause. If the taxpayer is misguided and unsophisticated in tax law, but acts in good faith, a penalty may be considered unwarranted.

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Reliance on Advice

Reliance upon a tax advice provided by a professional tax advisor may serve as the basis for a reasonable cause and good faith exception to the accuracy-related penalty. The taxpayer must supply the advisor with all the necessary information to assess the tax matter. If the advisor suffers from a conflict of interest or lack of expertise that the taxpayer knew or should have known about, the taxpayer might not have acted reasonably in relying on that advisor. The advice also must be based on all pertinent facts, circumstances, and the law as it relates to those facts and circumstances. The advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. The advice must not be based on a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. The advice must not be based on an assumption that the transaction has a business purpose other than tax avoidance.

Don't be a victim of your own making

IRS presents different circumstances that may NOT indicate reasonable cause and good faith:

- Lack of significant business purpose.
- Taxpayer reliance on advice of a tax advisor who the taxpayer knows or should have known lacked sufficient expertise or lacked independence.
- Taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.
- Taxpayer claimed tax benefits are unreasonable in comparison to the Taxpayer's investment in the tax shelter.
- Taxpayer did not disclose a reportable transaction.

Taxpayers ought to rely on credible and legitimate tax advice. Taxpayers have a responsibility to choose the right advisor, analyze the advisor's expertise and the quality of the advice. Reasonable cause is determined by the IRS on a case by case basis and Taxpayers ought to be cognizant of this.