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IRS Penalties Can Be Very Big Even For Innocent Mistakes

You made a mistake on your taxes, will the IRS let it go this time or slap on a penalty? If there is a penalty, can you get out of it by saying that you didn't know and promising to fly right next time?

Some of the answers may depend on what specific provision of the tax law you violated, how it comes to light, and more. Even how the penalty is computed will influence how much penalty leeway you have with the IRS.

Many people assume that the IRS will not impose penalties if you weren't actually trying to cheat on your taxes. After all, taxes are complex, and mistakes happen. But the burden is on you to show that you acted reasonably. Relying on professional tax advice can be one way. If you can't convince the IRS, you will probably end up with penalties.

The size of penalties varies, but they are often around 25% of the tax. But the sizes of penalties vary, and there can be wild swings in IRS penalties. If the IRS believes you were trying to cheat, you could face a civil penalty of 75% or even criminal prosecution.

The tax law draws a distinction between non-willful and willful violations. Willfulness involves a voluntary, intentional violation of a known legal duty. The failure to learn of filing requirements, coupled with efforts to conceal the facts, can spell willfulness.

Repeat violations are looked at too. You might be able to explain one failure to comply with the law. However, repeated failures can morph conduct from inadvertent neglect into reckless or deliberate disregard. But let's assume that you are not trying to cheat or hide anything and that the penalties the IRS is trying to collect are non-willful.

How bad can it be?

A case to be decided by the U.S. Supreme Court provides a good example of just how big penalties—even civil penalties—can be. If you failed to report some foreign bank accounts but were not willful—you just didn't know you had to—which is a reasonable IRS penalty, \$50,000 or \$2.72M? The U.S. Supreme Court has announced that it will rule on exactly this penalty spread for non-willful FBAR violations in *Bittner v. United States*, No. 21-1195. The Court is expected to clarify whether non-willful foreign bank account reporting violations apply per form or per bank account.

In 2021, the Fifth Circuit Court of Appeals ruled that Mr. Bittner, a Romanian-born businessman and investor with foreign bank accounts, was liable for non-willful penalties of \$2.72 million for five years failing to disclose his foreign accounts, not \$50,000, which was how he calculated it. See *United States v. Bittner*, No. 20-40597 (5th Cir. 2021). A Ninth Circuit case, *United States v. Boyd*, No. 19-55585 (9th Cir. 2021), came out the other way, in favor of lower non-willful penalties in a similar case.

So now the Supreme Court will decide. It may not be *Roe v. Wade*, but if you are a taxpayer, you might want to watch how the case comes out. More generally, is it usually possible to argue your way out of a tax penalty? As a general proposition, taxpayers claim that penalties are not warranted for many reasons. One of the biggest is the defense that a tax position was based on “reasonable cause.” How the IRS evaluates this depends on which penalty has been assessed. On top of reasonable cause, certain penalty defenses involve other concepts, such as the absence of willful neglect. Isn’t that proving a negative?

Yes, and the taxpayer must carry this burden too. 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 that they acted with reasonable cause. We all must exercise ordinary business care and prudence in reporting our proper tax liability.

Remember, 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. But with foreign bank account penalties — and many other ones too — it can be particularly difficult to carry the day.

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