IRS Penalties: Running Afoul of the Tax Code

The income tax system of the United States is essentially based on the notion of voluntary compliance.

You are expected to report and remit the income you've earned and the corresponding taxes that are due to the government. If you don't, or if you don't comply on time, you could find yourself facing either civil or criminal penalties.

As white-collar crime has flourished in the recent recession, the government has been aggressively trying to close loopholes and remedy weaknesses to secure more revenue for the Treasury. The IRS initiated a voluntary disclosure program in a crackdown on international tax evasion that offered stiff penalties, but no jail time. It brought in thousands of disclosures.

Today, more than ever, the U.S. government is motivated to curb tax fraud and recover funds. The expanding reach of sophisticated technology and forced cooperation with foreign banks and countries is facilitating the IRS effort to remedy weaknesses and close loopholes in the income tax system.

Civil penalties for noncompliance

The penalties for noncompliance with the tax laws fall under two categories: failure-to-file and failure-to-pay. There are accuracy-related penalties as well, which can be quite substantial – potentially 100 percent of the unpaid tax, in addition to the unpaid liability.

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Personal Attention Will Never Become Obsolete

Criminal penalties could also apply and may result in substantial fines and extended prison sentences for those convicted. You may have to pay a penalty if you do not file your return and pay your tax by the due date. You also might have to pay a penalty if you substantially understate your tax, fail to report a reportable transaction, file an erroneous claim for refund or credit, file a frivolous tax submission or fail to supply your Social Security number or individual taxpayer identification number.

Filing late. If you do not file your return by the due date, including extensions, you may have to pay a failure-to-file penalty. The penalty is usually 5 percent for each month or part of a month that a return is late, but not more than 25 percent. The penalty is based on the tax not paid by the due date without regard to extensions.

Return over 60 days late. If you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of $135 or 100 percent of the unpaid tax.

Exception. You will not have to pay the penalty if you show that you failed to file on time because of reasonable cause and not because of willful neglect.

Paying tax late. In addition to the failure-to-file penalty, you will have to pay a failure-to-pay penalty of 0.5 percent of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid and this penalty is not capped.

This penalty does not apply during the automatic six-month extension of time to file period if you paid at least 90 percent of your actual tax liability on or before the due date of your return and pay the balance when you file the return. Should you not have the funds to pay your taxes, you should go ahead and file an extension of the return showing your tax liability since this may reduce or eliminate the failure-to-file penalty.

The monthly rate of the failure-to-pay penalty is half the usual rate (.25 percent instead of .50 percent) if an installment agreement is in effect for that month. You must have filed your return by the due date (including extensions) to qualify for this reduced penalty.

If a notice of intent to levy is issued, the rate will increase to 1 percent at the start of the first month beginning at least 10 days after the day that the notice is issued. If a notice and demand for immediate payment is issued, the rate will increase to 1 percent at the start of the first month beginning after the day that the notice and demand is issued. This penalty cannot be more than 25 percent of your unpaid tax.

You may not have to pay the penalty if you can show that you had a good reason for not paying your tax on time.

Accuracy-related penalty. You may have to pay an accuracy-related penalty if you underpay your tax if, among others:

1. You showed negligence or disregard of the rules or regulations.
2. You substantially understated your income tax.
3. You claimed tax benefits for a transaction that lacks economic substance.

The penalty is equal to 20 percent of the underpayment. The penalty is 40 percent of any portion of the underpayment that is attributable to an undisclosed noneconomic substance transaction or an undisclosed foreign financial asset transaction.

Negligence or disregard. The term "negligence" includes a failure to make a reasonable attempt to comply with the tax law or to exercise ordinary and reasonable care in preparing a return. Negligence also includes failure to keep adequate books and records. You will not have to pay a negligence penalty if you have a reasonable basis for a position you took. The term "disregard" includes any careless, reckless or intentional disregard.

Adequate disclosure. You can avoid the penalty for disregard of rules or regulations if you adequately disclose on your return a position that has at least a reasonable basis. There are various methods to adequately disclose the relevant facts about your tax treatment of an item, so it is important to consult your tax advisor. You must also have a reasonable basis for treating the item the way you did.

Substantial understatement of income tax. You understate your tax if the tax shown on your return is less than the correct tax. The understatement is substantial if it exceeds the greater of 10 percent of the correct tax or $5,000. However, the amount of the understatement may be reduced to the extent the understatement is based on substantial authority or there was a reasonable basis for the position and adequate disclosure.

If an item on your return is attributable to a tax shelter, there is no reduction for an adequate disclosure.

However, there is a reduction for a position with substantial authority, but only if you reasonably believed that your tax treatment was more likely than not the proper treatment.

Substantial authority. Whether there is or was substantial authority for the tax treatment of an item depends on the facts and circumstances. Some of the items that may be considered are court opinions, Treasury regulations, revenue rulings, revenue procedures, and notices and announcements issued by the IRS.

Reasonable cause. You may not have to pay a penalty if you show a good reason for the way you treated an item. You must also show that you acted in good faith. This does not apply to a transaction that lacks economic substance. If you're billed for penalty charges and feel you have reasonable cause, send your explanation along with the bill to your IRS service center, call the IRS at (800) 829-1040 for assistance or consult your tax advisor.

Filing erroneous claim for refund or credit. You may have to pay a penalty if you file an erroneous claim for refund or credit. The penalty is equal to 20 percent of the disallowed amount of the claim, unless you can show a reasonable basis for the way you treated an item. The penalty will not be figured on any part of the disallowed amount of the claim that relates to the earned income credit or on which the accuracy-related or fraud penalties are charged.

Frivolous tax submission. You may have to pay a penalty of $5,000 if you file a frivolous tax return. A frivolous tax return is one that does not include enough information to figure the correct tax or that contains information clearly showing that the tax you reported is substantially incorrect or is based on a frivolous position or a desire to delay or interfere with the administration of federal tax laws. This includes altering or striking out the "penalty of perjury" language above the space provided for your signature.

Joint return. The fraud penalty on a joint return does not apply to a spouse unless some part of the underpayment is due to the fraud of that spouse.

Failure to supply Social Security number. If you do not include your Social Security number or the SSN of another person where required on a return, statement or other document, you will be subject to a penalty of $50 for each failure.

You will also be subject to a penalty of $50 if you do not give your SSN to another person when it is required on a return, statement or other document. For example, if you have a bank account that earns interest, you must give your SSN to the bank.

The number must be shown on the Form 1099-INT or other statement the bank sends you. If you do not give the bank your SSN, you will be subject to the $50 penalty. You will not have to pay the penalty if you are able to show that the failure was due to reasonable cause and not willful neglect.

Fraud. The IRS classifies tax fraud into two basic categories:

- ***Legal source tax crimes.*** Legal source crimes involve individuals who legally earn income but evade tax laws by either underreporting income or exaggerating their deductions, thereby reducing their tax liability.
- ***Illegal source financial crimes.*** Illegal source financial crimes include money gained through illegal sources of income that never gets reported to the government. Therefore, the tax on this income is never remitted.

If your failure to file is due to fraud, the penalty is 15 percent for each month or part of a month that your return is late, up to a maximum of 75 percent. If there is any underpayment of tax on your return due to fraud, a penalty of 75 percent of the underpayment due to fraud will be added to your tax.

Criminal penalties

You may be subject to criminal prosecution and imprisoned for up to one to five years, depending on the offense, for income tax fraud including:

1. Tax evasion
2. Willful failure to file a return, keep records, supply information or pay any tax due
3. Fraud and false statements and/or returns
4. Foreign Financial Account Reporting

If you were required to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBARs), but did not do so, criminal and civil penalties can apply. Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account, per violation. Fraud penalties can be as high as 75 percent.

The IRS has announced a program for those with undisclosed income from unreported foreign accounts for the 2003 through 2010 period. Those complying with the terms of the program must pay back taxes and interest, plus an accuracy or delinquency penalty. There is also an additional penalty of 25 percent of the amount in the foreign bank accounts in the year with the highest aggregate account or asset value. However, those who come forward on a timely basis will not face criminal prosecution. In some cases, the 25 percent penalty is reduced to 12.5 percent or 5 percent.

The voluntary disclosure period ends August 31, 2011.

Reporting fraud to the IRS

If you suspect or know of an individual or company that is not complying with the tax laws, you can report this activity by completing Form 3949-A, Information Referral. You can fill out the form online or print it and mail it to: Internal Revenue Service, Fresno, CA 93888.

Or, you can send a letter to the address above, including the following information, if available:

- Name and address of the person you are reporting
- The taxpayer identification number (Social Security number for an individual or employer identification number for a business)
- A brief description of the alleged violation, including how you became aware of or obtained the information
- The years involved
- The estimated dollar amount of any unreported income
- Your name, address and daytime telephone number
- Although you are not required to identify yourself, it is helpful to do so.
- Your identity can be kept confidential.

If you come across tax fraud, you can benefit financially by reporting it to the IRS. You could be entitled to awards up to 30 percent of the amount of back taxes, penalties and interest ultimately collected by the IRS. If you decide to submit information and seek an award for doing so, use IRS Form 211, Application for Award for Original Information.

Patrick Burns, with Taxpayers Against Fraud, says the IRS Whistleblower Program "is not designed to snag the guppies, but to harpoon the whales."

Tax preparers put on notice

More than 700,000 tax return preparers nationwide are now registered with the IRS and letters were sent to 10,000 paid tax preparers nationwide who submit large volumes of returns with frequent errors.

In addition, thousands of these preparers are being visited by IRS revenue agents to discuss their obligations and responsibilities to prepare accurate tax returns. The IRS has said its revenue agents will also visit tax preparers posing as potential clients.

"While the majority of return preparers provide excellent service to their clients, a few unscrupulous tax preparers file false and fraudulent returns to defraud the government and the tax-paying public. Those actions are illegal and can result in substantial civil penalties as well as criminal prosecution for both the return preparers and their customers who knew or should have known better. Taxpayers should choose carefully when hiring a tax preparer," said John A. DiCicco, acting assistant attorney general of the Justice Department's Tax Division.

The IRS has new initiatives to help eliminate fraud and abuse in tax return filing, including: Requiring all paid tax return preparers to register with the IRS and obtain a preparer tax identification number. These preparers will be subject to a limited tax compliance check to ensure they have filed federal personal, employment and business tax returns and that the tax due on those returns has been paid.

Requiring competency tests for all paid tax return preparers except attorneys, CPAs and enrolled agents (EAs) who are active and in good standing with their respective licensing agencies. Requiring ongoing continuing professional education for all paid tax return preparers except attorneys, CPAs and EAs.

Extending the ethical rules set forth by the Treasury Department to include all paid preparers, not just attorneys, CPAs and EAs.