



## Fact Sheet

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### Avoiding Penalties and the Tax Gap

FS-2008-19, March 2008

WASHINGTON— The Internal Revenue Code imposes many different kinds of penalties, ranging from civil fines to imprisonment for criminal tax evasion.

If you do not file your return and pay your tax by the due date, you may have to pay a penalty. You may also have to pay a penalty if you substantially understate your tax, understate a reportable transaction, file an erroneous claim for refund or credit, or file a frivolous tax submission. If you provide fraudulent information on your return, you may have to pay a civil fraud penalty.

Penalties are generally payable upon notice and demand. Penalties are generally assessed, collected and paid in the same manner as taxes. The notice will contain the name of the penalty, the applicable code section, and how the penalty was computed (or information on how to obtain the computation if not included).

This fact sheet is the 22<sup>nd</sup> in the Tax Gap series. It provides additional guidance to taxpayers regarding civil penalties and the consequences for understating income and overstating expenses.

#### Estimated Tax-Related Penalties

Employees have taxes withheld from their paychecks by their employer. When you have income that is not subject to withholding you may have to make estimated tax payments during the year.

This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount being withheld from your salary, pension, or other income is not enough to pay your tax liability.

Estimated tax payments are used to pay income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough through withholding or estimated tax payments, you may have to pay a penalty. If you do not pay enough by the due date of each payment period you may be charged a penalty even if you are due a refund when you file your tax return.

#### Penalties for filing or paying taxes late

The most common penalties are for filing late or paying taxes late.

**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).

If you file your return more than 60 days after the due date, the minimum penalty is \$100 or, if less, 100 percent of the tax on your return.

**Paying tax late:** You will have to pay a failure-to-pay penalty of  $\frac{1}{2}$  of 1 percent (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. 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 original due date of your return and pay the balance when you file the return.

The failure-to-pay penalty rate increases to a full 1 percent per month for any tax that remains unpaid the day after a demand for immediate payment is issued, or 10 days after notice of intent to levy certain assets is issued.

For taxpayers who filed on time, the failure-to-pay penalty rate is reduced to  $\frac{1}{4}$  of 1 percent (0.25 percent) per month during any month in which the taxpayer has a valid installment agreement in force.

**Combined penalties:** For any month both the penalty for filing late and the penalty for paying late apply, the penalty for filing late is reduced by the penalty for paying late for that month, unless the minimum penalty for filing late is charged.

### **Accuracy Related Penalties**

The two most common accuracy related penalties are the "substantial understatement" penalty and the "negligence or disregard of the rules or regulations" penalty. These penalties are calculated as a flat 20 percent of the net understatement of tax.

#### **Penalty for substantial understatement**

You understate your tax if the tax shown on your return is less than the correct tax. The understatement is substantial if it is more than the larger of 10 percent of the correct tax or \$5,000 for individuals. For corporations, the understatement is considered substantial if the tax shown on your return exceeds the lesser of 10 percent (or if greater, \$10,000) or \$10,000,000.

You may avoid the substantial understatement penalty if you have substantial authority for your tax treatment of the item or through adequate disclosure. To avoid the substantial understatement penalty by adequate disclosure, you must properly disclose the position on the tax return and there must at least be a reasonable basis for the position.

To properly disclose the position, complete and attach IRS Form 8275 to your tax return and disclose all relevant facts. A reasonable basis is one that has approximately 10 percent or greater chance of success if challenged. This means that the position must be more than just arguable. There must be some authority supporting the position.

#### **Penalty for negligence and disregard of the rules and regulations**

"Negligence" includes (but is not limited to) any failure to:

- make a reasonable attempt to comply with the internal revenue laws
- exercise ordinary and reasonable care in preparation of a tax return or
- keep adequate books and records or to substantiate items properly

This penalty may be asserted if you carelessly, recklessly or intentionally disregard IRS rules and regulations - by taking a position on your return with little or no effort to determine whether the position is correct or knowingly taking a position that is incorrect. You will not have to pay a negligence penalty if there was a reasonable cause for a position you took and you acted in good faith.

### **Civil Fraud penalty**

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. 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.

Negligence or ignorance of the law does not constitute fraud.

Typically, IRS examiners who find strong evidence of fraud will refer the case to the Internal Revenue Service Criminal Investigation Division for possible criminal prosecution. Keep in mind that both civil sanctions and criminal prosecution may be imposed.

### **Frivolous Tax Return penalty**

You may have to pay a penalty of \$5,000 if you file a frivolous tax return or other frivolous submissions. If you jointly file a frivolous tax return with your spouse, both you and your spouse each may have to pay a penalty of \$5,000. 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.

You will have to pay the penalty if you filed this kind of return or submission 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 preprinted language above the space provided for your signature.

This penalty is added to any other penalty provided by law.

### **Penalty for bounced checks**

If you write a check to pay your taxes and the check bounces, the IRS may impose a penalty. The penalty is either 2 percent of the amount of the check - unless the check is under \$1,250, in which case the penalty is the amount of the check or \$25, whichever is less.

The bottom line is that you must report all your income, file your return and pay your tax by the due date to avoid interest and penalty charges.

For more information about IRS notices and bills, refer to [Publication 594](#) (PDF), *Understanding the Collection Process*. More information about penalty and interest charges is contained in Chapter 1, *Filing Information*, of [Publication 17](#), *Your Federal Income Tax*.

### **References/Related Topics**

- [Tax Topic 653 - IRS Notices and Bills, Penalties and Interest Charges](#)
- [Filing Late and/or Paying Late: Information You Should Know](#)
- [Haven't Filed a Tax Return? Here's What to do](#)
- [Receiving a Bill From the IRS](#)
- [Electronic Federal Tax Payment System \(EFTPS\)](#)
- [Installment Agreements](#)
- [What is an Offer in Compromise?](#)
- [Temporary Delay](#)
- [The Electronic IRS: File, Pay....and More](#)