



ILLINOIS STATE BAR ASSOCIATION

TAX TRENDS

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Abatement of penalties for reasonable cause: Best practices

By David P. Dorner

Every state imposes penalties for the failure to file tax or information returns or to pay taxes within the time prescribed by statute. In most instances, however, a state will abate imposed penalties if the taxpayer can demonstrate reasonable cause for the noncompliance.¹ With many states facing historical fiscal deficits and the need for additional revenues, the issue of tax penalties and the abatement of such penalties for reasonable cause have become increasingly relevant.

What is Reasonable Cause? The term *reasonable cause* is commonly defined as the exercise of "ordinary [business] care and prudence" in the reporting of one's tax obligations.² Ordinary care and prudence generally means the amount of care that a reasonably logical person would take under similar circumstances, given the knowledge, experience and sophistication of the taxpayer.³ In addition to reasonable cause, states may also require the taxpayer to show the exercise of "good faith" or the absence of "willful neglect."⁴ The term *good faith* commonly refers to an honest belief void of any knowledge that would put a taxpayer on notice to inquire further as to his or her tax responsibilities, coupled with the absence of any intention to commit fraud.⁵ *Willful neglect* has been defined as a conscious or intentional failure or a reckless indifference to conform to the tax laws at issue.⁶

How to Best Present Your Request for Penalty Abatement. The devil is truly in the details when it comes to a successful request for abatement of penalties for reasonable cause, in that the small things that are often

overlooked can be equally as important as the underlying facts and legal basis for the abatement request. For instance, a taxpayer may have a valid legal basis for penalty abatement for reasonable cause, but if the request is not "properly" presented and organized, the merits of the request could get lost in the departmental process and at least initially denied by the taxing authority. Accordingly, adhering to certain "best practices," such as those described below, are just as important as the underlying facts and circumstances supporting a reasonable cause request because they increase the likelihood of due consideration:

Timeliness. The request for reasonable cause penalty abatement should be made as soon as possible under that state's rules and procedures and, whenever possible, the request should be made before the taxing authority assesses the tax penalty. As a rule of thumb, it is generally easier to ask that a penalty not be assessed than to ask for the abatement of an assessed penalty. Some states presume reasonable cause or, even better, will not assess penalties if the taxpayer self-assesses and corrects the noncompliance in a timely manner.⁷

Request Must Be in Writing. All requests for

reasonable cause penalty abatement should be made in writing and addressed to the appropriate person or department that will decide the outcome of the request. Providing the request orally to the auditor at the end of the audit or during the closing conference, or providing the auditor with your written request is usually not advisable (or necessarily in compliance with statutory or regulatory provisions),⁸ given that the auditor may not relay the request and, even if the request is passed onto the appropriate person or department, it may not be presented in the light most favorable to the taxpayer.

Documents, Documents and Documents. A very important and sometimes overlooked element of a successful request for reasonable cause penalty abatement is the citation to and inclusion of documents evidencing the facts and foundation for the penalty abatement request. To the extent possible, every request for penalty abatement should include supporting documents. Evidentiary documents—those documents that could be admitted into evidence at trial with a proper foundation—are by and large the only documentary evidence that the taxing body will review when considering a penalty abatement request and, therefore, can carry a lot of weight with the person reviewing the request. Documents also add credibility to the abatement request and are often the hallmark of a thoughtfully researched and fully developed work product.

Address All Statutory and Regulatory Requirements. The abatement request should address in an easy to follow format (i.e., mir-

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ror) the expressed statutory and regulatory requirements for the abatement of penalties for reasonable cause. Many states (including Illinois) lay out what a taxpayer must prove in order for the taxing authority to grant a request for abatement for reasonable cause.⁹ Additionally, states often provide examples of what constitutes reasonable cause. Accordingly, when possible, it is generally advisable to parallel your request with the factors identified by the state as reasonable cause and to correspond your facts with at least one of the examples provided by statute or other tax-related authorities.

Make the State's Job as Easy as Possible. State revenue departments receive numerous requests for the abatement penalties for reasonable cause (as well as other taxpayer inquiries and cases) and can therefore understandably be quick to deny a request for penalty abatement if the request is not fully developed, well-organized and coherently presented with supporting documents. At the same time, the request should be made in the least amount of pages possible, otherwise you may lose your reader. As a result, taxpayers and tax practitioners should prepare their requests with the idea of making it easy for the person at the revenue department to grant the abatement of penalties. If the person at the revenue department needs or has to ask for additional facts, documents or clarification, or will need substantial time to read, organize or understand your request, then you may have diminished your chances for penalty abatement.

The following is a list of facts and circumstances that commonly serve as one element, or, in some instances, the basis for the abatement of penalties for reasonable cause:

- Compliance history.¹⁰
- Exercise of good faith.¹¹
- Nonrecurring or isolated error.¹²
- Materiality of the error.¹³
- Establishment of prudent business practices.¹⁴
- Prompt payment of deficient taxes upon notice or discovery.¹⁵
- The legal merit of the noncompliance.¹⁶
- Complexity of the relevant tax law or a new tax law.¹⁷
- Reliance on a tax advisor.¹⁸

Arguments that should generally not be made and which almost always do not evidence reasonable cause:

- Ignorance of the law.¹⁹
- Mistake or forgetfulness.²⁰
- Employee negligence or error.²¹
- Time constraints.²²

A significant amount of time and resources can be spent researching and preparing a request for penalty abatement but the additional time and effort is almost always worth the result of not paying penalties. Additionally, although there are commonalities between states (and the IRS) in the area of the abatement of penalties for reasonable cause, state law and procedures can vary as to what constitutes reasonable cause or how a request for penalty abatement should be presented to the taxing authority for consideration. Thus, it is always advisable to spend time researching that state's penalty provisions and procedures for requesting penalty abatement. ■

Mr. Dorner's primary practice area is tax controversy, including federal and state audits, appeals, administrative hearings, conciliation and mediation conferences and judicial litigation at all levels throughout the United States. Prior to joining Vedder Price, Mr. Dorner served as Deputy General Counsel for the Illinois Department of Revenue.

FEDERAL TAX NOTICE: By reason of IRS Circular 230, Treasury Regulations require us to inform you that any federal tax advice contained herein is not intended or written to be used, and cannot be used by any person or entity, for the purpose of avoiding penalties that may be imposed by the Internal Revenue Service.

1. Although this article was prepared from a general perspective and with the intent of serving as an outline for preparing a federal, state or local penalty abatement request for reasonable cause, where possible, the citations herein have been purposely limited to Illinois law and published secondary guidance.

2. See, e.g., 86 Ill. Admin. Code § 700.400(c); *Kroger Co. v. Department of Revenue*, 284 Ill. App. 3d 473, 673 N.E.2d 710 (1st Dist. 1996), citing *Du Mont Ventilation Co. v. Department of Revenue*, 99 Ill. App. 3d 263, 266, 425 N.E.2d 606 (35d Dist. 1981); *PPG Industries, Inc. v. Department of Revenue*, 262 Ill. Dec. 208, 765 N.E.2d 34 (1st Dist. 2002).

3. See 86 Ill. Admin. Code § 700.400(c); Internal Revenue Manual 20.1.1.3.1.2(1); and *McInturff v. Chicago Title & Trust Co.*, 243 N.E.2d 657, 661, 102 Ill. App. 2d 39 (1st Dist. 1968) ("It has long been the law that ordinary care in a particular case is that degree of care which is exercised by ordinarily prudent persons under the same or similar circumstances . . .").

4. These additional statutory requirements are closely related to the meaning of reasonable cause, but should be addressed separately to ensure that all of the statutory requirements for pen-

alty abatement are satisfied.

5. Black's Law Dictionary 762 (9th ed. 2009) ("A state of mind consisting in (1) honesty belief or purpose . . . or (4) absence of intent to defraud or to seek unconscionable advantage"). Additionally, the Department considers a taxpayer to have acted in "good faith," if the taxpayer exercised ordinary care and prudence to comply with the taxpayer's Illinois tax responsibilities. 86 Ill. Admin. Code § 700.400(c).

6. *U.S. v. Boyle*, 469 U.S. 241, 105 S. Ct. 687 (1985).

7. See Illinois Dep't of Revenue Hearing Decision No. MF 01-22 (08/09/2001) (Where the taxpayer "self-reported the error and paid the additional tax that was due along with interest . . . the taxpayer made a good faith effort . . . and therefore has established reasonable cause for penalty abatement"); see also Cal. Code Regs. § 1703(c)(3) (D), relating specifically to sales and use tax; Fla. Admin. Code Ann. 12-13.007(9), excluding obvious errors; Fla. Admin. Code Ann. 12-13.0075(3); and Michigan Revenue Administrative Bulletin 2005-3, 07/19/2005.

8. FLA. ADMIN. CODE ANN. 12-13.007(1)(b); MICH. ADMIN. CODE R205.1013(3).

9. See, e.g., 86 Ill. Admin. Code § 700.400; NYCRR 2392.1; Mich. Admin. Code R205.1013; Fla. Admin. Code Ann. 12-13.007;

10. 86 ILL. ADMIN. CODE § 700.400(d); ILLINOIS DEP'T OF REVENUE HEARING DECISION No. ST 02-29 (9/13/2002).

11. 86 ILL. ADMIN. CODE § 700.400(b).

12. 86 ILL. ADMIN. CODE § 700.400(d).

13. *Id.*

14. ILLINOIS DEP'T OF REVENUE HEARING DECISION No. IT 01-16 (10/19/2001), "[E]vidence of procedures to insure [tax] compliance . . . might show that Mr. 'Doe' exercised ordinary care and prudence . . . and support a finding of 'reasonable cause.'"

15. ILLINOIS DEP'T OF REVENUE HEARING DECISION No. MF 01-22 (08/09/2001);

16. 86 Ill. Admin. Code § 700.400(e)(8). However, a taxpayer should not disregard relevant Illinois case law in a preference for more favorable rulings from other states. *Kroger Co. v. Department of Revenue*, 284 Ill. App. 3d 473, 673 N.E.2d 710 (1st Dist. 1996)

17. 86 Ill. Admin. Code § 700.400(c) ("clarity of the law or its interpretation"). *Du Mont Ventilation Co. v. Department of Revenue*, 99 Ill. App. 3d 263, 54 Ill. Dec. 741, 425 N.E.2d 606 (3rd Dist. 1981).

18. *U.S. v. Boyle*, 469 U.S. 241, 105 S. Ct. 687 (1985) (When the accountant or attorney advises the client on a matter of tax law, then reasonable cause may be warranted, but a client's reliance on an accountant or attorney as to a filing date or deadline will most likely not rise to the level of reasonable cause or the exercise of good faith for an ordinary person). See also *Hollinger Int'l, Inc. v. Department of Revenue*, 841 N.E.2d 447, 363 Ill. App. 2d 313 (1st Dist. 2005); *Exxon Corp. v. Department of Revenue*, Circuit Court of Cook County Nos. 99 L 51234 and 99 L 51326 (5/21/2004) and 86 Ill. Admin. Code § 700.400(c).

19. See 86 Ill. Admin. Code § 700.400(f)(5); *Columbia Quarry Co. v. Department of Revenue*, 40 Ill. 2d 47 (1968); and Illinois Dep't of Revenue Hearing

Decision No. ST 99-14 (7/30/1999).

20. INTERNAL REVENUE MANUAL 20.1.1.3.1.2.1 – 2.3 (8/20/1998).

21. *Conklin Bros. of Santa Rosa, Inc v. U.S.* 896

F.2d 315, 71 A.F.T.R. 2d 93-1087 (9th Cir. 1993).

22. *Thom v. U.S.*, 47 A.F.T.R.2d 81-430, 10/23/1980; 80-2 USTC P 9814, citing *Dustin v. Commissioner*, 467 F.2d 47, 30 A.F.T.R.2d 72-5313

(9th Cir. 1972) (Nothing that the exercise of ordinary care and prudence dictates that a person should not take on more responsibilities than they can handle).

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