NEW YORK CITY BAR

REPORT BY THE STATE AND LOCAL TAXATION COMMITTEE

RECOMMENDATIONS TO REFORM NEW YORK CITY AND NEW YORK STATE TAX CIVIL PENALTY PROVISIONS

I. INTRODUCTION[1]

This Report provides New York State ("NYS") and New York City ("NYC") public officials and the tax administration agencies, the NYS Department of Taxation and Finance ("DTF") and the NYC Department of Finance ("DOF"), with the recommendations of the New York City Bar Association's State and Local Taxation Committee (the "Committee") concerning the imposition and abatement of civil tax penalties.[2] The Committee's recommendations include increased agency oversight; implementation of administrative fairness and accountability with respect to the initial assertion of tax penalties; the adoption of a first-time abatement ("FTA") program; and the adoption of uniform procedures across all tax types, including definitional uniformity and enhanced guidance regarding "reasonable cause" abatements.

To provide context for the Committee's recommendations, this Report discusses the policy justifications for imposing civil tax penalties (Part II), provides some NYS and NYC historical background regarding civil tax penalty legislation, regulation and guidance (Parts III and IV, respectively), provides an overview of current NYS and NYC civil tax penalty provisions (Parts V and VI, respectively), and discusses how the Internal Revenue Service ("IRS") and certain states other than New York (1) address threshold determinations of penalty applicability; (2) implement a first-time abatement ("FTA") program; and (3) administer reasonable cause abatement requests (Parts VII (IRS) and VIII (Other States)). The Report will then discuss the authors' practical experience with penalty abatement (Part IX) and provide the Committee's recommendations (Part

[1] The Committee is grateful to Ms. Eyunkyung Choi, New York City Taxpayer Advocate, and her staff for presenting its Department of Finance Business Collection Alternative plan (the "BCA Plan") to the Committee. Her presentation motivated the Committee to consider penalty-related provisions, including those in the BCA Plan, to undertake a review of New York State and New York City penalty provisions, and to prepare this Report. The Committee would also like to thank the New York State Department of Taxation and Finance and the assistance of Kathleen Chase.

[2] The Report's scope is limited to a discussion of civil tax penalties for income/franchise and excise taxes. Criminal tax penalties and property tax penalties are beyond the scope of this Report.

X).[3] The Committee remains available to work with the NYS DTF and the NYC DOF to continue to improve tax-related penalty administration in the state.

II. POLICY JUSTIFICATIONS FOR CIVIL TAX PENALTY IMPOSITION

Two significant classic policy justifications cited for enacting civil tax penalty provisions for noncompliance, such as the late filing of tax returns, the late payment of amounts due on tax returns, or an understatement of amounts due, are "deterrence" and "social norms."[4] Under the deterrence theory, it is the fear of being caught and of being subject to punishment, including paying tax penalties, that motivates taxpayers to determine their correct liabilities, and to file returns and pay their taxes in a timely manner.[5] In contrast, under the social norms theory, tax penalties establish a type of social convention and, out of a desire to conform to how society operates and to be known as conformers to social conventions, taxpayers comply with the tax laws.[6]

There is considerable debate as to which theory has greater validity, and whether any theory adequately explains the behavior of all taxpayers.[7] Some taxpayers may be motivated by deterrence-based penalties, while another group of taxpayers may be motivated by norm-enhancing measures.[8] There is also a debate about the strength that tax penalties, and tax enforcement actions generally, have in real life. In actuality, tax audits are rare events and thus much of taxpayer behavior regarding penalties may be based on an overweighting of rare events.[9]

It has been observed that tax penalties serve a definitional function, *i.e.*, any noncompliance for which a legislature has determined that a tax penalty is warranted is, by definition, noncompliance with tax law.[10] The concept is: that which is unlawful as a practical matter is that which is deemed worthy of subjecting to penalties.[11]

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[3] The principal drafters of this Report are: William Funk, Debra Herman, Glenn Newman, Amy F. Nogid, Jonathan Robin, and R. John Smith. David Bunning, Jahlionais (Elisha) Gaston, Malinda Sederquist and Kathryn Pickel recused themselves from the preparation of this report. The Report represents the views of the Committee members and not those of their firms, companies or clients.

[4] Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. 111-12 (2009).

[5] *Id*. at 112.

[6] *Id.*

[7] *Id.* at 134.

[8] *Id.*

[9] James Alm, Gary H. McClelland & William D. Schulze, *Why Do People Pay Taxes?*, 48 J. PUB. ECON. 21, 36 (1992).

[10] Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. at 113.

[11] *Id.*

In contrast to this theoretical definitional function approach, when the U.S. Treasury Department's Office of Tax Policy has evaluated the success or failure of penalty provisions, building on a 1989 report by an IRS Task Force, they have used four criteria: (1) fairness, (2) effectiveness, (3) comprehensibility, and (4) administrability.[12]

Fairness may be broadly understood as equity, *i.e.*, treating similarly situated taxpayers in a similar manner, and punishing more culpable taxpayers with more severe penalties.[13] Effectiveness correlates to deterrence, and thus a more effective tax penalty regime would produce greater levels of compliance.[14] Comprehensibility requires that taxpayers understand both the law and the consequences for noncompliance with the law; the more complex and inconsistently enforced the law is, the less comprehensible the tax law and the penalties related to enforcement may be.[15] Finally, administrability requires both consistency and flexibility under appropriate circumstances.[16] Therefore, the automatic imposition of penalties creates a risk of unfairness due to the failure to take account of unique mitigating circumstances.[17] In contrast, too much discretion without standards may create the impression that compliance with the law is optional or that enforcement is subject to manipulation or favoritism.[18]

The IRS has succinctly stated its view of penalties: "The Internal Revenue Service has a responsibility to collect the proper amount of tax revenue in the most efficient manner. Penalties provide the Service with an important tool to achieve that goal because they enhance voluntary compliance by taxpayers."[19] The IRS's Policy Statement 20-1 elaborates that penalties encourage voluntary compliance by (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance to noncompliant taxpayers.[20] The policy statement urges examiners and managers to "consider the elements of each potentially applicable penalty and then fully develop the facts to support the application of the penalty."[21] In determining the application of penalties to a particular case, IRS procedures should promote: (1) consistency in the application of penalties compared to similar cases; (2) unbiased analysis of the facts in each case; and (3) the proper application of the law to the facts of the case.[22] The IRS recognizes that fairness of the tax system is demonstrated by (1) providing every taxpayer against whom the Service proposes to assess penalties with a reasonable opportunity to provide evidence that the penalty should not apply; (2) giving full and fair consideration to evidence in favor of not imposing

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[12] Office of Tax Policy, Dep't of the Treasury, Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code at 35 (1999) (hereinafter, "Treasury Study").

[13] *Id*.

[14] *Id*. at 39.

[15] *Id*. at 39-40.

[16] *Id*. at 40.

[17] *Id.*

[18] *Id.*

[19] IRM 20.1.5.1.1(1).

[20] Policy Statement 20-1 (formerly P-1-18) (IRS June 29, 2004) at ¶ 2.

[21] *Id.* at ¶ 3.

[22] *Id.* at ¶ 7.

the penalty, even after the Service's initial consideration supports imposition of a penalty; and (3) determining penalties when a full and fair consideration of the facts and the law support doing so.[23] Further, the IRS stresses that "penalties are not [to be] a 'bargaining point' in resolving the taxpayer's other tax adjustments."[24]

One criteria for asserting penalties was notably rejected by the IRS' Office of Tax Policy: revenue raising.[25] The Office of Tax Policy understood that once revenue raising becomes a purpose for imposing tax penalties, inherent perverse incentives are created; an ideal system of tax penalties minimizes noncompliance, but once revenue raising becomes a goal, the legislative body becomes dependent on the existence of noncompliance, and may lead to pressure on enforcement agencies to find noncompliance, even in instances where it does not exist.[26] Revenue generation as a basis for penalty assertion is also antithetical in this "taxpayer as customer" age, as it is bound to foster an adversarial and contentious relationship between taxpayers and the revenue administrators.

III. NYS: HISTORICAL OVERVIEW OF PENALTY PROVISIONS

In April 1978, the Report of the Task Force on Penalty and Interest, commissioned in late 1976 by the NYS Tax Commission, was issued. It focused on the abatement of delinquency and late payment penalties. At that time, income tax penalty abatements were governed by a "reasonable cause" standard, while NYS excise tax statutes generally employed an "excusable" standard. The Task Force recommended that penalties not be automatically assessed if "there is a documented demonstration that reasonable cause exists,"[27] and recognized that using "penalty and interest provisions as a wedge to induce taxpayers to consent to audit findings" was not consistent with the "fair and equitable administration of the Tax Law."[28] The Task Force also rejected the automatic assessment of penalties as "unacceptable."[29]

Of interest was the Task Force's mention of the prior position of the NYS DTF that it "was in the business to collect taxes, not penalties," a position that was supplanted once the State's Tax Compliance Bureau was created.[30] Also of interest, particularly given our current fiscally (and otherwise) challenging times, was the Task Force's discussion of marginal businesses that threatened to leave the State to a "more hospitable" location unless asserted penalties were abated. The Task Force recommended that such abatement requests be "refused on their face [u]nless unusual mitigating circumstances indicate otherwise."[31]

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[23] *Id.* at ¶ 8.

[24] *Id.*

[25] Treasury Study at 35-36.

[26] *Id.*

[27] Report of the Task Force on Penalty and Interest (Apr. 1978) at 4.

[28] *Id.* at 3.

[29] *Id.*

[30] *Id.* at 9.

[31] *Id.* at 12.

The Tax Section of the New York State Bar Association ("NYSBA") issued its own report complimenting the Task Force for trying to administratively achieve "fairness and relative uniformity" given the "hodge-podge statutory framework" that then existed under the various State taxes.[32] The NYSBA recommended that legislation with a uniform "reasonable cause" standard for penalty abatement be enacted for all tax types, that formalized procedures be adopted for review of proposed penalties prior to assessment, and that the policies regarding the imposition of negligence and fraud penalties be reviewed because "[i]t sometimes appears that a penalty is automatically imposed because of the size of the claimed deficiency rather than on the basis of a realistic or objective determination of whether the facts support a claim of negligence or fraud."[33] The NYSBA Tax Section report also urged transparency regarding the administration and procedure surrounding penalties and continuing study.

In another report issued by the NYSBA in July 1984,[34] the State was urged to eliminate certain procedural traps and inequities for taxpayers and suggested ways to streamline the administration of the State's Tax Law by the DTF and the inclusion of both the personal income tax and Article 27 civil penalty provisions in a separate, new administrative article that would apply to all taxes.

The State amended certain of its regulations in 1987 as a "step in an ongoing project to review and update existing regulations containing grounds for reasonable cause and to draft regulatory provisions for those articles of the Tax Law which contain 'reasonable cause' language in their procedural provisions but do not as yet have regulations thereon."[35] It was projected that the reasonable cause amendments would result in increased revenue because in some cases "it will be more difficult for a taxpayer to show a basis for reasonable cause."[36]

In 1988, the Department prepared a 1988 Study Bill on Uniform Procedure. It proposed enacting a separate Article 35 of the Tax Law, which would govern most State taxes and include most of the penalty provisions scattered throughout the Tax Law. The 1988 Study Bill proposed that the penalties be updated to conform to the changes made by the federal Tax Reform Act of 1986. The NYSBA Tax Section enthusiastically supported the 1988 Study Bill, and issued a report recommending some additional revisions.[37] The NYSBA's Tax Section also urged that the

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[32] NYSBA Tax Section Report No. 197, *Report of Committee on Criminal and Civil Penalties Concerning Penalties Under the New York State Tax Law, and Administration of the Penalty Provisions* (Jan. 5, 1979) at 4.

[33] *Id.* at 8.

[34] NYSBA Tax Section Report No. 460, *Report on Procedural Uniformity in the New York Tax Law* (July 1984) ("1984 Report").

[35] Amendments to Corporate Tax Procedure and Administration, Personal Income Tax and Sales and Use Taxes regulations (promulgated Sept. 29, 1987), Substance of Final Rule at 1.

[36] *Id.* Regulatory Impact Statement, ¶ 4(a).

[37] NYSBA Tax Section Report No. 577, *Report on Department of Taxation and Finance's Uniform Procedure Study Bill by Committee on New York State Tax Matters* (Jan. 14, 1988).

"procedural rules for New York City taxes be conformed with the provisions for the comparable New York State Tax."[38]

The NYSBA's Tax Section issued another report in 1998 addressing the iteration of proposed regulations applicable at that time, 20 NYCRR § 2392, "Reasonable Cause,"[39] which consolidated regulations promulgated under different taxes. This report found helpful that under the proposed regulations "ignorance of the law" could now be considered "in conjunction with other facts and circumstances," and urged that the concept of "honest misunderstanding of fact or law" be included in the regulation. That addition to the proposed regulations was based on certain language in the IRS's Manual and Treasury Regulation 1.6664-4(b)(1). The report also noted that what constitutes "the law" is not always clear and that "an auditor's position is not 'the law' unless the Tax Appeals Tribunal or a court has so held," even though the Audit Division "was known to argue" that a taxpayer's position could not be reasonable if the Audit Division had issued an Advisory Opinion or informal advice to the contrary.

Effective August 11, 1999, the State's DTF promulgated a new reasonable cause regulation, 20 NYCRR § 2392.1, which was intended to replace the myriad regulatory provisions then addressing "reasonable cause." The DTF's Regulatory Impact Statement states that "[c]onsolidating these provisions [existing regulations involving reasonable cause] as a single source will facilitate the process of obtaining information regarding the various grounds for reasonable cause. . . . the amendment will create a broad, uniform reference that will be applicable to many different taxes."[40] The Statement also summarizes the modifications to the scope of reasonable cause to include "consideration of ignorance of the law . . . outlines when a taxpayer's reliance on professional advice may constitute reasonable cause [and] allows an honest misunderstanding of fact or law or reasonable reliance on written advice, professional advice or other facts."[41] Despite the expansion of reasonable cause, the Statement states that there would be "minimal decreases in taxpayer liabilities as a result of the rule."[42]

[38] *Id.* at 2.

[39] NYSBA Tax Section Report No. 918, *Proposed Part 2392, Reasonable Cause Chapter IX, Title 20 N.Y.C.R.R.*, (Jan. 20, 1998).

[40] Regulatory Impact Statement related to promulgation of 20 NYCRR § 2392.1 of new Part 2392 at ¶ 3.

[41] *Id.*

[42] *Id.* at ¶ 4.

IV. NYC: SOME HISTORICAL BACKGROUND ON PENALTY PROVISIONS

Penalties imposed for the failure to properly comply with tax provisions have been included in NYC tax laws since the enactment of the NYC sales and use tax laws in the 1930's. With the imposition of new tax laws throughout the 1960's, including the commercial rent tax in 1963, general corporation and unincorporated business taxes in 1966, the penalty provisions became more complex and, with increasing audit activity, more often asserted.

In 2001, the NYC DOF issued a Statement of Audit Procedure ("SAP") to provide guidance to its auditors in the application of penalties.[43] This SAP advised auditors that in addition to the criteria provided in the various administrative code provisions addressing penalties for the taxes administered by NYC, they could also look to Federal and NYS law, rules, regulations, procedures, bulletins or case law in considering whether to impose or abate penalties. Auditors were also told that they were to inform taxpayers that penalties might be asserted, and that taxpayers be afforded "a reasonable opportunity to address potential penalties before they are asserted."[44] This SAP explained the procedure for asserting penalties including the issuance of a pre-assertion Penalty Letter that would explain the bases for the DOF's assertion of the penalty, and offer the taxpayer 30 days within which to provide facts and supply reasons why the penalty should not be asserted. With respect to negligence penalties, the auditor was required to identify "the issue or issues for which the Taxpayer is alleged to have been negligent" and describe "the specific circumstances that form the basis for the auditor's finding of negligence or intentional disregard of the tax statute."[45] The SAP provided questions that auditors should consider in determining whether substantial understatement or negligence penalties should be asserted, and also stated that "[g]enerally, negligence and substantial understatement penalties will not be imposed where the proposed audit change is based upon a discretionary adjustment by the Commissioner," but mentioned instances where this general rule might not be applicable.[46] The DOF issued a superseding SAP in 2008.[47] This SAP eliminated the pre-assertion Penalty Letter requirement, and stated that penalties might be automatically generated and included in the Notice of Proposed Tax Adjustments ("NOPTA"), but that "[t]he auditor must review each penalty to assure that asserting the penalty is appropriate given his or her knowledge of the specific information gathered during the audit."[48] Taxpayers could challenge the assertion of penalties in the NOPTA, but were required to do so in writing. No mention was made to any sources for guidance on how to administer penalties, but as with the prior SAP, certain questions were to be considered when determining whether to issue substantial understatement or negligence penalties.

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[43] Statement of Audit Procedure 01-3-AU, *Penalties* (NYC DOF Aug. 13, 2001). The SAP does not address penalties that are imposed by the DOF's Revenue Operations Division.

[44] *Id.* at 2.

[45] *Id.* at 3.

[46] *Id.*

[47] Statement of Audit Procedure, *All Units, Procedure for Imposition of Civil Penalties*, PP-2008-19 (NYC DOF Apr. 9, 2008).

[48] *Id.* at 2.

V. NYS: CURRENT LAW

NYS's penalty provisions for its income and other taxes are found in various sections of New York Tax Law such as Sections 685(a) [personal income tax], 1085(a) [corporate tax], Section 1145 [sales tax], and 289-b.1[motor fuels] of the New York Tax Law. Not all penalties can be abated. However, in those instances where a taxpayer can request penalty abatement, these sections contain the common exception: "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." In the case of substantial understatement penalties, the standard for abatement is "reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith."[49] Further, up through July 1, 2024, the power to waive penalties on such a finding is vested with the Commissioner.[50]

Greater detail regarding penalty imposition is provided in regulation 20 NYCRR § 2392.1(a)(1), which sets the uniform procedural standard in stating that the NYS DTF "must" impose penalties "unless its shown that such failure was due to reasonable cause and not due to willful neglect." The regulation further states that such penalties "will" be cancelled if due to reasonable cause and not due to willful neglect. To underscore that both elements must be satisfied to obtain penalty abatement, the regulation also states, "[t]he absence of willful neglect alone is not sufficient grounds for not imposing or for canceling these amounts."

While it is helpful for the taxpayer to present evidence of reasonable cause and lack of willful neglect, the NYS DTF has the authority to determine that reasonable cause exists without a submission from the taxpayer: "Except where reasonable cause exists or is presumed to exist pursuant to subdivision (c) of this section, all of the facts alleged as a basis for reasonable cause may be required to be affirmatively shown in a written statement made by the taxpayer."[51] Such evidence may be provided by persons other than the taxpayer.[52] While there is no first-time abatement program provided for in the NYS's regulations, the regulation also states: "In determining whether reasonable cause exists, in addition to an evaluation of such facts, the taxpayer's previous compliance record with respect to all of the taxes imposed pursuant to the Tax Law may be taken into account."[53]

The regulation also provides detailed guidance on circumstances that can support a determination of reasonable cause and not of willful neglect. Listed circumstances are: (1) death, illness or absence; (2) destruction of place of business or business records; (3) inability to timely assemble information "for reasons beyond the taxpayer's control to timely obtain and assemble essential information required for the preparation of a complete return, despite the exercise of reasonable efforts" if supported by a statement of facts, the return is timely filed and any tax is timely paid or paid over on that portion of the tax liability which can be ascertained; (4) pending petitions, actions or proceedings; and (5) "any other ground for delinquency which would appear

[49] N.Y. Tax Law § 1085(k).

[50] N.Y. Tax Law § 1085(k)(1).

[51] 20 NYCRR § 2392.1(b).

[52] *Id.*

[53] *Id.*

to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause."[54]

The regulation also provides guidance on how to interpret the taxpayer's conduct for purposes of determining reasonable cause and lack of willful neglect in cases of understatement and omissions, specifically stating that this, "may be determined to exist only where the taxpayer has acted in good faith."[55] For evaluating reasonable cause and good faith, "the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability."[56] The regulation lists several circumstances that will support reasonable cause and good faith: (1) an "honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer"; (2) a computational or transcriptional error; (3) disclosure of additional tax due in an amended return provided that it is provided before contact by the NYS DTF; and (4) reasonable reliance on written information or professional advice.[57]

Not all penalty assertions can be appealed to the NYS Division of Tax Appeals. For example, the Division of Taxation may assert penalties in connection with an issuance of a Notice and Demand, but the DTA generally does not have subject matter jurisdiction over such notices.[58] However, taxpayers may obtain DTA review by paying the amount asserted in the notice and filing a refund claim that, once denied, will provide the DTA with subject matter jurisdiction.

VI. NYC: CURRENT LAW

The penalty provisions applicable to the corporate business taxes, the unincorporated business tax, and various excise taxes administered by NYC are found in various sections of the NYC Administrative Code ("Code"). For example, Code Section 11-676 sets forth the corporate business taxes penalties. The other major income-based taxes and excise taxes include comparable penalty provisions. Moreover, most of the penalty provisions applicable to the City's business taxes were included in the original adoption of those taxes and were modeled after NYS tax penalty provisions for comparable NYS taxes.

Similar to NYS, not all City penalties can be abated. However, in those instances where a taxpayer can request penalty abatement, there are common exceptions to the assertion of penalties:

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[54] 20 NYCRR § 2392.1(d).

[55] 20 NYCRR § 2392.1(g)(1).

[56] 20 NYCRR § 2392.1(g)(2).

[57] *Id*.

[58] N.Y. Tax Law § 173-A(c) ("Provisions of law which authorize the issuance of a notice and demand for an amount without the issuance of a notice of determination for such amount, including any interest or penalties related thereto, shall be construed as specifically denying and modifying the right to a hearing with respect to any such notice and demand for purposes of subdivision four of section two thousand six of this chapter in cases of mathematical or clerical errors or failure to pay the tax due shown on the return or for any stamps purchased, and any interest or penalties related thereto. Any such notice and demand shall not be construed as a notice which gives a person the right to a hearing under article forty of this chapter.); *see, also, e.g.*, *In re Country House Corp.*, DTA No. 824403 (N.Y.S. Div. of Tax App. Mar. 8, 2012); *In re Grand Central JT VT*, DTA No. 825201, 824560 (N.Y.S. Div. of Tax App. Mar. 10, 2016) (DTA had jurisdiction to consider a petition filed in response to the Division of Taxation's issuance of a notice and demand, since the notice and demand was issued after an audit).

"unless it is shown that such failure is due to reasonable cause and not due to willful neglect." In the case of substantial understatement penalties, the standard for abatement is "reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." Unfortunately, unlike NYS, the City's regulations provide limited or no additional guidance, although City auditors, taxpayers and practitioners have referred to NYS guidance in the absence of detailed City guidance.

Statement of Audit Procedure ("SAP"), PP-2008-19 4/9/08, *Procedure for Imposition of Civil Penalties*, provides the most comprehensive guidance on the process for imposing and abating penalties for all tax types administered by DOF. The SAP is intended to provide guidance to auditors in the context of an audit. In addition to this SAP, tax return instructions include limited guidance concerning applicable penalties, and guidance is available on the City's website.[59]

The penalties for the failure to timely file and the failure to pay tax shown on the return are typically imposed at the time a return is filed as part of the return processing function. In the context of an audit, as explained below, there is some ability to get penalties abated, but it is difficult to secure a "reasonable cause" abatement of penalties asserted during the processing function. As noted above, the SAP only applies to matters under review in Audit.

In the context of a DOF audit, penalties for the failure to timely file, underpayment of tax due to negligence and the substantial underpayment of tax, *i.e.*, audit penalties, are typically addressed at the end of the audit following the issuance of the informal Notice of Proposed Tax Adjustment. As stated in the SAP, DOF's Audit Division insists that the request for abatement be in writing. If the case is settled with the Audit Division, the penalties are typically abated with a brief written explanation regarding reason for the failure to fully comply with the filing requirements. If the audit is closed without taxpayer agreement, then the penalties are often not abated notwithstanding a statement supporting reasonable cause. Taxpayers and their representatives have complained that it appears that there are different standards for abating penalties depending on whether or not the taxpayer agrees with the audit adjustments.

Once a case is closed and a Notice of Determination (the statutory notice) is issued, penalties may still be addressed as part of the protest process. The protest process includes review by the Conciliation Bureau and appeals to the NYC Tax Appeals Tribunal. However, the City Tribunal's administrative law judge division is not authorized and cannot review "Notices of Tax Due."[60]

VII. FEDERAL TAX REGIME

The Internal Revenue Code imposes a variety of civil penalties on taxpayers to promote voluntary compliance.[61] Treasury has also promulgated regulations that provide additional guidance on the scope of these civil penalties, including whether a taxpayer qualifies for relief

[59] *See* https://www1.nyc.gov/site/finance/taxes/business-filing-information.page (All site last vistied June 4, 2021).

[60] *See, e.g., In re Doros Restaturant, inc.*, TAT(H) 13-3(GC) (N.Y.C. Tax App. Trib., ALJ Division, June 28, 2013).

[61] *See* generally Ch. 68, IRC §§ 6651 -- 6725.

from such penalties.[62] The regulations often contain definitions and examples of circumstances that may be helpful in determining if a taxpayer has established a basis for relief.[63]

a. Historical Background

In November 1987, the Commissioner of the IRS established a task force to study civil penalties and develop a fair, consistent, and comprehensive approach to penalty administration.[64] In February 1989, the Commissioner's Executive Task Force issued the Treasury Study, which resulted in the establishment of a consolidated penalty handbook (the "IRS Penalty Handbook" or "IRM 20.1").[65] The IRS Penalty Handbook "is the primary source of authority for the administration of civil penalties by the IRS and serves as the foundation for addressing administration of civil penalties by IRS functions. By providing one source of authority for the administration of civil penalties, the IRS greatly reduces inconsistencies regarding civil penalty application."[66] Specifically, the IRS Penalty Handbook "sets forth general policy and procedural requirements for assessing and abating penalties, and it contains discussions on topics such as criteria for relief from certain penalties."[67]

b. Current Law

Despite statutory language in the Internal Revenue Code that states penalties "shall" be imposed, Section 6751(b)(1) of the Internal Revenue Code provides that no penalty under the Internal Revenue Code "shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."[68] Accordingly, an IRS supervisor must generally approve the initial determination of the assessment, with certain relevant statutory exceptions. First, managerial approval of penalty assessments does not apply to additions to tax under sections 6651 (failure to file or pay tax), 6654 (failure by individual to pay estimated income tax) and 6655 (failure by corporation to pay estimated income tax) of the Code, with the exception of the imposition of a fraud penalty (i.e., fraudulent failure to file penalty under IRC 6651(f).[69] Second, managerial approval is not required for penalties that are automatically calculated through electronic means.[70] IRM 20.1 makes clear that "a penalty is only considered to

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[62] *See e.g.,* Treas. Reg. 1.6664 (accuracy related penalties); Treas. Reg. 301.6651 (failure to file a tax return and/or failure to pay tax penalties); Treas. Reg. 301.6724 (information return penalties); Treas. Reg. 1.6694 (tax return preparer penalties).

[63] *Id.*

[64] IRM 20.1.1.1.1 (Nov. 25, 2011).

[65] *Id.*

[66] IRM 20.1.1.1.2 (Nov. 21, 2011).

[67] *Id.*

[68] IRC § 6751(b)(1).

[69] IRC 6751(b)(2); *see also* IRM 20.1.1.2.3(1)-(3) (Nov. 21, 2017) (discussing "Managerial Approval for Penalty Assessments").

[70] *Id.*

be 'automatically calculated through electronic means' if no Service human employee makes an independent judgment with respect to the applicability of the penalty."[71]

Generally, penalty relief falls within four different categories, and unless otherwise set forth in the IRS Penalty Handbook, such relief is considered and applied by the IRS in the following order (assuming criteria are established): (1) correction of IRS error; (2) statutory and regulatory exceptions; (3) administrative waivers; and (4) reasonable cause.[72]

i. *Correction of IRS error*

Penalty relief is provided to correct an IRS error. "An IRS error can be any error made by the IRS in computing or assessing tax, crediting accounts, etc.," a math error when manually computing a penalty, or "any other error, when it can be shown that: (1) the taxpayer did in fact comply with the law, and (2) the IRS did not initially recognize that fact."[73]

ii. *Statutory and regulatory exceptions*

Penalty relief may be set forth as an exception in the Internal Revenue Code or accompanying Treasury Regulation. The IRS Penalty Handbook has an enumerated list of statutory and regulatory exceptions that allow for penalty relief.[74]

iii. *Administrative waivers –First Time Abatement (FTA) policy*

"The IRS may formally interpret or clarify a provision to provide administrative relief from a penalty that would otherwise be assessed."[75] IRM 20.1 states that "an administrative waiver may be addressed in either a policy statement, news release, or other formal communications stating that the policy of the IRS is to provide relief from a penalty under specific conditions."[76]

First Time Abatement (FTA) is an example of an administrative waiver that applies to a single tax period. Since 2001, the IRS offers a FTA to taxpayers who have incurred failure to file, failure to pay or failure to deposit penalties. Stated in its most general terms, the penalty will be abated under the FTA if the taxpayer has properly and timely filed in the preceding three years. In addition, the taxpayer must also have "filed, or filed a valid extension for, all required returns currently due" and "paid, or arranged to pay, any tax currently due."[77]

The FTA waiver does not apply to: (1) returns with an event-based filing requirement (e.g., estate and gift tax returns); (2) the daily delinquency penalty; and (3) information return reporting

[71] IRM 20.1.1.2.3(5) (Nov. 21, 2017).

[72] IRM 20.1.1.3(Nov. 21, 2017).

[73] IRM 20.1.1.3.4 (Aug. 5, 2014).

[74] IRM 20.1.1.3.3.1 (Nov. 21, 2017).

[75] IRM 20.1.1.3.3.2 (Aug. 5, 2014).

[76] *Id.*

[77] IRM 20.1.1.3.3.2.1 (Nov. 21, 2017).

that depends on another filing, *e.g.*, where various forms are attached. For business taxpayers, in addition to the criteria discussed above, the following rules also apply: (1) an FTA waiver is not available for any portion of a failure to deposit penalty relating to a failure to use the Electronic Federal Tax Payment System (the IRS online payment system); (2) an FTA waiver is not available if there are four or more failure to deposit waiver codes present in the taxpayer's three-year penalty history with respect to the tax account under review; (3) an FTA waiver is not available for a Form 1120 or Form 1120-S penalty if, in the prior three years, at least one S corporation return was filed late but not penalized; and (4) an FTA waiver is not available if the penalty is charged for an incomplete S-corporation return (Form 1120-S) or partnership return (Form 1065).[78]

Taxpayers are not required to specifically request penalty relief under the FTA waiver to be eligible. The IRS has the authority to waive penalties based on FTA policy and to automate execution of this abatement policy. Penalty relief under administrative waivers, including FTA, are considered and applied before reasonable cause abatement requests.[79] This aspect of the program has faced criticism because taxpayers who have reasonable cause for penalty relief prefer to request abatement on that basis in order to allow them to be eligible under the FTA for any future failures where there is no reasonable cause to justify relief.[80] However, IRS policy is clear: "If FTA criteria are met, the FTA waiver will be applied before reasonable cause and the taxpayer must be notified that we removed their penalty or penalties based on their prior history of compliance and not based on their reasonable cause statement."[81]

iv. *Reasonable Cause*

The IRS Penalty Handbook states that "[r]easonable cause is based on all the facts and circumstances in each situation" and "is generally granted when the taxpayer exercised ordinary business care and prudence in determining his or her tax obligations but was nevertheless unable to comply with those obligations."[82] The IRS Penalty Handbook further provides that the non-assertion or abatement of certain civil tax penalties based on reasonable cause must be made in a consistent manner and should conform with the considerations specified in the Internal Revenue Code, Treasury Regulations, policy statements and IRS Penalty Handbook and taxpayers have reasonable cause when their conduct justifies the non-assertion of abatement of a penalty.[83] (In

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[78] *Id.*

[79] *Id.*

[80] *See e.g.*, Nina E. Olson, National Taxpayer Advocate (NTA) Blog: *The Systemic First Time Abatement Policy Currently Under Consideration by the IRS Would Override Reasonable Cause Relief and Jeopardize Fundamental Taxpayer Rights*, available at: https://taxpayeradvocate.irs.gov/news/NTA-blog-Systemic-Abatement.

[81] IRM 20.1.1.3.3.2.1(11)(Nov. 21, 2017).

[82] IRM 20.1.1.3.2(1) (Nov. 21, 2017).

[83] The IRS Penalty Handbook makes clear that "[e]ach case must be judged individually based on the facts and circumstances at hand" and the following items should be considered: (1) What happened and when did it happen? (2) During the period of time the taxpayer was non-compliant, what facts and circumstances prevented the taxpayer from filing a return, paying a tax, and otherwise complying with the law? (3) How did the facts and circumstances result in the taxpayer not complying? (4) How did the taxpayer handle the remainder of his or her affairs during this time?; and, (5) Once the facts and circumstances changed, what attempt did the taxpayer make to comply? Reasonable cause does not exist, per the IRS Penalty Handbook, when "if, after the facts and circumstances that

this regard, the Internal Revenue Code may also require taxpayers to establish that the taxpayer acted in good faith or that the taxpayer's failure to comply with the tax laws was not due to willful neglect.)

The IRS Penalty Handbook provides that "any reason that establishes a taxpayer exercised ordinary business care and prudence but nevertheless failed to comply with the tax law may be considered for penalty relief." It also makes clear that "an acceptable explanation is *not* limited to those given in IRM 20.1. Penalty relief may be warranted based on an 'other acceptable explanation,' provided the taxpayer exercised ordinary business care and prudence but was nevertheless unable to comply within the prescribed time."[84] The IRS Penalty Handbook directs taxpayers to certain Treasury Regulations and IRS Policy Statements that set forth examples of circumstances that may be helpful in determining if the taxpayer has established reasonable cause. The IRS Penalty Handbook also provides detailed guidance on certain facts and circumstances that may or may not establish reasonable cause, including the following: (1) death, serious illness or unavoidable absence; (2) fire, casualty, natural disaster or other disturbances; (3) inability to obtain records; (4) mistake was made; (5) erroneous advice or reliance; (6) ignorance of the law; and, (7) forgetfulness. The taxpayer generally bears the burden to demonstrate the existence of reasonable cause at the time the failure occurred.[85]

A revenue agent also has access to the Reasonable Cause Assistant (RCA), a "decision support interactive software program developed to reach a reasonable cause determination."[86] This tool was implemented to ensure consistent and equitable administration of penalty relief consideration. Any determination to override RCA's conclusion must be justified and documented in the files maintained by the IRS.

VIII. SURVEY OF CERTAIN OTHER STATES' PENALTY ABATEMENT POSITIONS

While states have not generally conformed to the IRS' FTA waiver, a taxpayer's compliance history often factors into the reasonable cause evaluation and may yield a result similar to that offered by the IRS. This section will provide a sampling of other states' penalty provisions that afford generally compliant taxpayers with penalty abatement relief.

Several states provide some type of automatic penalty relief for taxpayers with a good compliance record including Connecticut, Minnesota, North Carolina and Washington. Connecticut presumes that reasonable cause exists if it is the first time the taxpayer has been subject to a penalty. Minnesota similarly provides that "[r]easonable cause will be presumed if the late payment, late filing, or failure to pay by electronic means is a first-time occurrence for the specific tax type involved. This presumption is based upon the taxpayer's previous history of filing timely returns and making timely payments." North Carolina allows taxpayers one

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explain the taxpayer's noncompliant behavior cease to exist, the taxpayer fails to comply with the tax obligation within a reasonable period of time."[83]

[84] IRM 20.1.1.3.2(3).

[85] *See, e.g.*, Treas. Reg. § 301.6651-1(c); *see generally* IRM 20.1.1.3.5 (11-21-2017).

[86] IRM 20.1.1.3.6 (Nov. 21, 2017).

automatic penalty waiver for most types of taxes once every three years, recognizing that "everyone makes mistakes and sometimes has difficulty complying with the tax statutes." Washington also provides penalty abatement relief based on a taxpayer's tax filing history:

> When a taxpayer has filed and paid (on time) all tax returns required for 24 months prior to the period in question, the department has the authority to waive a penalty even when the late filing was not the result of a circumstance beyond the taxpayer's control. This type of penalty is only available for one return within a 24-month period.

Other states explicitly provide that a taxpayer's tax filing history is relevant to determining whether reasonable cause exists for the waiver of the asserted penalty.

IX. PRACTITIONER EXPERIENCE

In practice, the NYS DTF automatically asserts penalties for the failure to file or the late filing in instances of the delinquent or untimely filing of returns. When conducting an audit of tax returns, the auditor is required to address the issue of penalties with the taxpayer and the taxpayer must submit a written statement in order to avoid penalties subject to abatement for reasonable cause. Those written submissions are generally accepted and the penalty is abated when the audit adjustments are consented to by the taxpayer; as mentioned earlier, in practice penalty abatements are more difficult to achieve when the tax asserted in the audit is contested.

Historically, with respect to the administration of penalties by the NYC DOF, the assertion of penalties and their abatement was discussed with the auditor handling the case and the auditor's immediate supervisor. Often, that discussion focused on whether the taxpayer would agree with the audit adjustments—if the audit adjustments were agreed to by the taxpayer, penalties would be waived; if the case went forward without an agreement, penalties would be asserted. Indeed, one drafter of this Report has heard a manager in the DOF's Legal Affairs Division state that "auditors should always assert penalties on an unagreed case; that gives me something to walk away from when I talk settlement."

With the professionalization of the NYC DOF audit program in the 1970s and 1980s and the increased coordination with Federal and NYS tax authorities, and as discussed above in Section VI, additional guidance was given to audit staff and written policies were established formalizing how penalties were to be handled. Auditors were told to address whether penalties were to be asserted and taxpayers were provided with guidance on how to respond if penalties were asserted.

We note also that the forms used to close NYC DOF audits are problematic. When a NYC DOF auditor closes a case with an agreement by the taxpayer to all adjustments and no penalties have been asserted, the document closing the audit is a Consent to Audit Adjustments that permits the taxpayer to seek a refund of the tax and interest paid. If penalties are abated based upon the statement presented by the taxpayer, the auditor will require the taxpayer to sign a Consent and Waiver. That form requires that the taxpayer not only agree to the tax adjustment, but also give up his or her right to protest the adjustment and waive the ability to request a refund for the tax period. This improperly penalizes taxpayers where there are facts that clearly establish reasonable

cause to abate penalties, or more significantly, when penalties should not have been asserted in the first instance based on the facts of the case.

X. RECOMMENDATIONS

The purpose of imposing penalties for failing to comply with tax laws is to ensure that, in addition to tax and interest that is due on a delinquency, voluntary compliance is promoted. Ensuring the fair and appropriate use of penalties is vital to proper tax administration. The Committee provides the following suggestions for improvement of the NYS and NYC penalty provisions and their administration.

a. Adoption of audit procedures by the NYS DTF and the NYC DOF to provide increased oversight, fairness and accountability with respect to threshold penalty assertions

To ensure that any initial penalty determination reflects a considered decision that imposition of penalties is warranted based on the particular facts (1) the audit procedures should require that auditors provide their rationale for asserting penalties, and (2) such determination should be required to be reviewed and approved by the auditor's manager or supervisor. These requirements should be set forth in either regulations, statement of audit procedures, or other guidance. Further, the regulations, statement of audit procedures or other guidance should provide in no uncertain terms that penalties are not to be asserted for the purpose of raising revenue or to secure leverage in resolving cases.

b. Adoption of a FTA program

The Committee recommends that both the NYS DTF and the NYC DOF should create a FTA program, similar to that of the IRS. Because both the NYS and NYC regulations generally provide that the taxpayer's history of compliance be considered in determining whether good faith and lack of willful neglect exist, creating a FTA program should not require legislation, but can be adopted via regulation.

c. Establish procedures, definitional uniformity and enhanced guidance for taxpayers to obtain "reasonable cause" abatements.

An important part of deterring noncompliance and creating norms, and for improving the public perception of state and local tax administration, is to ensure that the procedures for seeking abatement are clear and the standards and procedures for evaluating such requests are fair, and subject to appeal to ensure consistency.

Accordingly, the Committee urges that new or revised regulations be promulgated to (1) specify the factors that establish reasonable cause; (2) provide that such factors be applicable to all taxes; and (3) allow for reasonable cause to be established in circumstances other than those specifically enumerated to provide some latitude in addressing unusual circumstances. Further, the new or revised regulations should specify how the taxpayer is to be informed of penalty impositions (e.g., in audit situations versus non-audit situations), how the taxpayer can seek review

of a penalty imposition, and how the taxpayer may appeal an initial adverse determination regarding such imposition. In addition, the Committee recommends that the NYS DTF and NYC DOF provide an optional simple form that taxpayers can use to request penalty abatements. While taxpayers should continue to have the flexibility to submit requests for penalty abatement by letter or other mode of correspondence, the availability of a form would streamline and standardize the process.

d. Create a Centralized Unit to Oversee and Administer Penalty-Related Matters

The Committee believes that establishing a dedicated centralized unit within the NYS DTF and NYC DOF to oversee and administer all penalty-related matters will help ensure that penalties are imposed only when appropriate and that requests for penalty abatement are reviewed and addressed in a consistent and fair manner. The individuals in the unit should be distinct and separate from the personnel who initially authorized the imposition of the penalties. The Committee believes that having the same personnel who issued the penalties review the abatement requests is likely to create a vested interest in upholding penalty assessments and is likely to be perceived as structurally unfair to taxpayers.

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The Committee appreciates the consideration given to this report and is available and would be happy to assist the NYS DTF and/or the NYC DOF in their efforts towards improving penalty administration.

State and Local Taxation Committee[87]
Amy F. Nogid, Chair

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Contact
Mary Margulis-Ohnuma, Policy Counsel | 212.382.6767 | mmargulis-ohnuma@nycbar.org
Elizabeth Kocienda, Director of Advocacy | 212.382.4788 | ekocienda@nycbar.org

[87] This report was reviewed and approved by the Taxation of Business Entities Committee.