Insights: Publications

What is a Penalty & Penalty Abatement?

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Penalty Abatement at the State and Local Level:

Everybody makes mistakes. Some are honest, some are dumb, and some are even intentional. However, few things are more frustrating than a mistake that leads to or is discovered in an audit. Everything about an audit is aggravating, from the time it takes to resolve and the collection of years-old records, to the re-assessment of tax liabilities owed, with interest and penalties added for good measure. Penalties are particularly aggravating, as they cannot be written off as an expense from income at the end of the tax year. Understanding how penalties are assessed and potentially discharged (also called “abatement”) can thus provide taxpayers a strategic advantage. For a detailed analysis of the various forms of penalties imposed, please view our prior article on the subject here. While each case is unique, knowing these general principles may help you achieve a tax penalty abatement.

Penalties used to be a relatively rare occurrence, often waived by tax authorities with minimal pushback from taxpayers. However, this leniency has significantly diminished in recent years. The frequency of penalty imposition has skyrocketed, and abatement has become a more involved process. This shift in the tax landscape highlights the need for taxpayers to be proactive in understanding how and when penalties are assessed. It also underscores the importance of seeking advice from experienced tax professionals to navigate the existing abatement strategies.

When a Penalty is Assessed:

Tax penalties can arise from various actions or inactions by taxpayers, but they most commonly result from the non-prompt payment of the taxpayer's entire tax liability. It's important to note that any tax collection agency, such as the IRS, a state, or a local tax agency, can impose these penalties. For example, a business might have correctly calculated and promptly paid its entire tax liability to the IRS for a given tax year but failed to do the same for its state tax obligations in the same year. In this scenario, the IRS would not have grounds to impose a penalty, but the state tax agency would. As such, it is vital to ensure that your business's federal, state, and local tax obligations are promptly met each tax year to avoid penalties.

Penalty Abatement Timelines:

Penalty abatement can occur during the taxpayer's audit in some states. However, more recently, it seems to require an appeal to one of several courts or administrative bodies. The number of courts and administrative bodies available will vary among states and localities. In Illinois, for example, a taxpayer can request abatement at the audit level itself or appeal the assessment to the Board of Appeals, the Informal Conference Board, the Illinois Independent Tax Tribunal, or the Illinois Circuit Courts. For more information on Illinois audits and appeals, please refer to our prior article on the subject here.

Emerging Trends in Penalty Abatement Proceedings:

It is important to note that what an individual must demonstrate in their appeal will be a creature of state law and precedent, and consulting an experienced tax lawyer well-versed in these issues is highly recommended. However, the State and Local Tax group at Kilpatrick has noticed several emerging trends among courts and reviewing tribunals in several states that we feel compelled to share here. These general principles are that you, as the taxpayer: will bear the burden of proof demonstrating why your penalty should be abated; must demonstrate so-called “reasonable cause” for having your penalty abated; were not negligent in your failure to calculate and pay your tax liability in-full and on-time, and; can show the court the extent of your and your business's history of compliance with the taxing authority. We will cover each of these in more detail below.

Burden of Proof – Who Must Show What?

In many states, an imposed penalty will have a statutory or common-law presumption that such imposition was proper. Thus, as the taxpayer, you will bear the burden of demonstrating that its imposition was improper. Practically speaking, you will be tasked with presenting “clear and convincing” evidence and reasoning for your business decisions before, during, and after the audit to the tribunal's satisfaction to have your penalty abatement granted.

Reasonable Cause – What is and is not Reasonable?

Penalties are abated when the taxpayer demonstrates that their failure to pay their tax liability in full and on time was due to reasonable cause. Some states have ruled that determining whether a taxpayer's failure was due to reasonable cause will be made on a “case-by-case basis” and will consider all “pertinent facts and circumstances” before reaching a conclusion.[1]

Many states contain these “reasonable cause” exceptions to tax penalties. However, each state may vary on what is and is not deemed “reasonable cause.” Reviewing courts, tribunals, and boards throughout the country have repeatedly noted that there are several factors they will consider, but that the most crucial factor analyzed is the extent to which the taxpayer made a good faith effort to calculate their proper tax liability and to file and promptly pay such liability. Illinois has further defined a “good faith effort” as an effort that exercises ordinary business care and prudence in determining liability and filing and paying such liability.[2] A taxpayer acting with ordinary business care and prudence will depend on the clarity of the law at issue, its interpretation, and the taxpayer's experience, knowledge, and education of tax law generally and as applied to the issues at hand.[6] If the taxpayer can demonstrate that they acted with reasonable, ordinary business care and prudence and in good faith, then they will have provided “reasonable cause” for such non-prompt or incomplete payment of their

tax liability.

Negligence – Is Ignorance Bliss?

Unfortunately, ignorance of the law will not help a taxpayer in a penalty abatement hearing. Most states have increasingly been unwilling to offer abatement simply because the taxpayer was intentionally or unintentionally unaware of the extent, difficulty, or time limitations of tax obligations and elections. In some states, ignorance of the law has been equated to negligence. For example, New Mexico has defined “negligence” as including a taxpayer's inadvertence, indifference, thoughtlessness, carelessness, erroneous belief, and inattention to their tax obligations.[3] Similarly, California has stated that the reasonable cause exception will not be granted if the taxpayer fails due to willful neglect of their obligations under the relevant tax code.[4] Simply claiming that you were unaware of the extent or timing of your tax obligations will likely doom your chances of being granted a tax penalty abatement.

History of Compliance – Do Past Rights Rectify a Current Wrong?

In Illinois, at least one reviewing body has recently stated that a business's history of tax compliance with the tax authority at issue is “necessarily” considered when judging whether reasonable cause exists to abate the penalty.[5] However, this ruling reiterates that the primary and most important factor considered is whether a “good faith” effort was made to calculate, file, and pay the proper liability. This indicates that keeping records of your long-standing tax compliance with the state and local tax authorities is beneficial in Illinois.

Conclusion:

If not compliant with state and local tax laws, businesses risk receiving a highly unwelcome letter from tax authorities informing them of a pending audit. Getting audited is an expensive hassle. Worst of all, if the audit results in an adjusted tax liability, you will be responsible for penalties on top of the liability and interest payments. Understanding that these penalties exist and the existing remedies should one arise is vital to navigating the audit process. If such a letter arrives, we urge you to contact the State and Local Tax group at Kilpatrick so that we may assist you throughout the process and, if need be, assist you in the penalty abatement process.

Thank you for reading this article. Please reach out to the State and Local Tax group at Kilpatrick if you have any questions about your business.

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[1] Id. At 6.

[2] Id.

[3] Id.

[4] Herbalife at 4 (2024).

[5] Red Vision Systems, Inc. at 3 (2023).

Related People



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