Tax Report #918

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

TAX SECTION

1997-1998 Executive Committee

RICHARD O. LOENGARD, JR.
Chair
Fried Frank Harris et al
One New York Plaza
New York, NY 10004
212/859-8260
STEVEN C. TODRYS
First Vice-Chair
212/455-3750
HAROLD R. HANDLER
Second Vice-Chair
212/455-3110
ROBERT H. SCARBOROUGH
Secretary
212/906-2317
COMMITTEE CHAIRS:
Bankruptcy
Linda Zan Swartz
Lary S. Wolf
Basis and Cost Recovery
Elliot Pisem
Deborah H. Schenk
CLE and Pro Bono
James A. Locke
Victor Zonana
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Joel Scharfstein
David R. Sicular
Corporations
Patrick C. Gallagher
Robert A. Jacobs
Estates and Trusts
Sherwin Kamin
Carlyn S. McCaffrey
Financial Instruments
Samuel J. Dimon
Bruce Kayle
Financial Intermediaries
Erika W. Nijenhuis
Andrew Solomon
Foreign Activities of U.S. Taxpayers
Reuven S. Avi-Yonah
David P. Hariton
Fundamental Tax Reform
Peter v.Z. Cobb
Deborah L. Paul
Individuals
Sherry S. Kraus
Ann F. Thomas
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
Net Operating Losses
David S. Miller
Ann-Elizabeth Purintun
New York City Tax Matters
Robert J. Levinsohn
William B. Randolph
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
New York State Sales and Misc.
William F. Collins
Hollis L. Hyans
Nonqualified Employee Benefits
Stuart N. Alperin
Kenneth C. Edgar, Jr.
Partnerships
Andrew N. Berg
William B. Brannan
Pass-Through Entities
Kimberly S. Blanchard
Marc L. Silberberg
Qualified Plans
Stephen T. Lindo
Loran T. Thompson
Real Property
Michael Hirschfeld
Alan J. Tarr
Reorganizations
Eric Solomon
Lewis R. Steinberg
Tax Accounting
Dickson G. Brown
Stephen B. Land
Tax Exempt Bonds
Linda L. D'Onofrio
Patti T. Wu
Tax Exempt Entities
Michelle P. Scott
Stuart L. Rosow
Tax Policy
David H. Brockway
Dana Trier
U.S. Activities of Foreign Taxpayers
Peter H. Blessing
Yaron Z. Reich

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Dianne Bennett, Benjamin J. Cohen, John Dugan, Kenneth H. Heitner, Thomas A. Humphreys, Charles I. Kingson, Lisa A. Levy, James R. MacDonald, IV, Charles M. Morgan, III, Ronald A. Morris, Leslie B. Samuels, Robert T. Smith, Eugene L. Vogel, David E. Watts, Mary Kate Wold

January 20, 1998

Mr. John W. Bartlett
Chief of Tax Regulations
Technical Services Bureau
Department of Taxation and Finance
Building 9, Room 104
W.A. Harriman Campus
Albany, NY 12227

Re: Proposed Part 2392, *Reasonable Cause*
Chapter IX, Title 20 N.Y.C.R.R.

Dear Mr. Bartlett:

Thank you for providing the Tax Section of the New York State Bar Association with the language of a proposed amendment to the Department's regulations regarding the "reasonable cause" basis for canceling penalties. On behalf of the Tax Section, we submit the following comments.

First, we appreciate and applaud the effort to consolidate the "reasonable cause" provisions currently dispersed throughout the regulations applicable to various articles of the Tax Law. The new regulation would be added to Chapter IX of Title 20 NYCRR, as new Section 2392.1 of new Part 2932, *Reasonable Cause*, in the Procedural Regulations. The new Section 2392.1 appears to replace existing regulations applicable to the following articles: 12-A (motor fuel), 15 (insurance awards [repealed by Ch. 389, § 161, Laws 1997]), 18 (alcohol), 20 (tobacco), 21 (highway use), 21-A (fuel use), 22 (personal income), 28 (sales and use), 31 (real estate transfer), and all the articles governed by Article 27 (i.e., 9 [corporations], 9-A [corporations], 13 [unrelated business income], 32 [banking corporations], 33 [insurance companies], and 33-A [independently procured insurance]). With the exception of the "ignorance of the law" language discussed below, the consolidated provision does not appear to substantively change any of the existing provisions.

FORMER CHAIRS OF SECTION:
Howard O. Colgan, Jr., Charles L. Kades, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey, Jr., Charles E. Heming, Ralph O. Winger, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos, Michael L. Schler, Carolyn Joy Lee, Richard L. Reinhold

Do the Public Good • Volunteer for Pro Bono

However, we note that the examples in the existing "reasonable cause" regulations do not seem to have been carried over into Section 2392.1. *See, e.g.,* Example 1 through Example 6 in existing Section 536.5(c). The existing examples seem to track fairly closely the language of the regulations, and perhaps do not add very much to the regulation itself, but no explanation has been provided for their elimination, or whether taxpayers may continue to use these examples for guidance.

Of course, the most significant change incorporated into Section 2932.1 is the addition of the provision modifying the consideration that may be given to "ignorance of the law" as a factor in determining whether reasonable cause exists. The existing regulations generally provide, in frequently quoted language, that ignorance of the law "will not be considered to be a basis for reasonable cause." The proposed modification provides that "ignorance of the law in conjunction with other facts and circumstances, such as limited education or the lack of previous tax and penalty experience, may support reasonable cause." Proposed Section 2392.1 (d) (5)(ii).

The language of Section 2392.1(d)(5)(ii) tracks verbatim the language of the IRS Manual, Subsection (20) 333.5, dealing with ignorance of the law. The Federal Treasury Regulations dealing with the issue provide that reasonable cause and good faith may be indicated by "an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer." Treas. Reg. § 1.6664-4(b)(1). This language is consistent with and supportive of the language in the IRS Manual.

In general, we believe it is helpful and correct to recognize that, in certain circumstances, ignorance of the law should be taken into account in determining whether a penalty is appropriate. It would be useful, however, to set out some criteria for the invocation of the "ignorance of the law" grounds, or some examples of a situation in which this ground may be considered, to avoid problems in applying the provision. We suggest that the standard should more explicitly embrace the concept of an "honest misunderstanding of fact or law."

One possible problem that may arise is determining "the law". In some circumstances, the answer is clear, where there are statutes, regulations, or precedential cases directly on point. However, such situations seem to be more the exception than the rule, particularly

when an issue has not been resolved in the audit process and has reached litigation at the Tax Appeals Tribunal. In such cases, "the law" itself is directly a matter of dispute between the parties. On some occasions, a taxpayer will have been advised of the Audit Division's interpretation, either through a formal Advisory Opinion, or through informal direction from auditors. In such a case, the Audit Division has been known to argue that that taxpayer's position cannot be reasonable, because it knew that the Audit Division disagreed. *See* In re Smarte Carte, Inc., DTA Nos. 812942 - 812945 (N.Y.S. Div. of Tax App., June 13, 1996).[1] Will a taxpayer be able to have its ignorance of "the law" taken into consideration, even if it has been advised that the Audit Division has taken a position? We would suggest that, in such situations, it be made clear that the taxpayer is not barred from relying on an "ignorance of the law" ground, if in fact such grounds could otherwise be established, merely because the Audit Division may have already advised of a contrary position. The Audit Division's position is, after all, just that, and may not even be entitled to the deference generally accorded an agency's interpretation of its governing statutes (because the Audit Division is not the "agency"); an auditor's position is not "the law" unless the Tax Appeals Tribunal or a court has so held. Indeed, it is not unusual for the Audit Division's interpretation and position to be rejected by the Tribunal, and on occasion even a regulation has been held invalid as exceeding or violating the statute. *See* In re James R. Shorter, Jr., DTA No. 813571 (Tax App. Trib., July 31, 1997) (invalidating a regulation requiring individuals to compute their New York tax liability by adding back amounts that were not actually deducted on their federal returns due to federal limitations).

Another phrase that we think requires clarification is the phrase "history of the taxpayer's involvement in the issue at hand." This language appears to have come directly from the IRS Manual, but there seems to be no federal case law interpreting its meaning. There are many possibilities for what this phrase could cover. For example, it could be interpreted to mean that the Department would consider whether the taxpayer, on its New York return, was taking a position consistent with its current filing positions in other states, or a position that is consistent with its filing position in New York for other years, particularly if that filing position had never before been challenged. Would the Department consider whether the issue was successfully litigated in another state under a similar tax law? Will it give any

---

1 While this decision by an Administrative Law Judge is not to be considered as precedent, pursuant to Tax Law Section 2010(b), it is cited here to demonstrate the argument made by the Audit Division.

weight to the argument that returns had been filed consistently for many years and had never before been challenged? Alternatively, the phrase might be interpreted to cover only whether the taxpayer had cooperated with the current audit.[2] Given the great range of possibilities, some further guidance would be useful, perhaps by including examples of when and how the "history of the taxpayer's involvement in the issue" would be considered.

Another area of interest concerns the question of how the new "ignorance of the law" provision interacts with existing law concerning reliance on the advice of professionals. Neither the existing regulations nor the proposed regulation explicitly include reliance on the advice of a professional as a basis for establishing reasonable cause, unlike the federal regulations, which explicitly recognize such grounds and set out parameters for when reliance on the advice of others can be asserted. *See, e.g.,* Treas. Reg. § 1.6664-4(c). However, this ground has been recognized to exist in New York by the Tax Appeals Tribunal and the courts, although only in very limited circumstances. *See, e.g.,* Auerbach v. State Tax Commission, 142 A.D.2d 390, 395, 536 N.Y.S.2d 557, 561, (3d Dep't 1988); (rejecting petitioner's claim of reasonable cause); LT & B Realty v. State Tax Commission, 141 A.D.2d 185, 188, 535 N.Y.S.2d 121, 123 (3d Dep't 1988) (rejecting reliance on advice of professionals, noting that none of the petitioner's principals or attorneys testified, and noting that ignorance of the law is not to be considered); In re Koether, DTA Nos. 801737 and 804085 (Tax App. Trib., Dec. 15, 1994) (finding reasonable cause where the tax advisor gave explicit advice to the taxpayer, based on an uncertain question of law). Since ignorance of the law now may be considered as an element of reasonable cause, we would recommend including in the regulation, again perhaps in an example, an illustration of the kind of reliance on a professional advisor that would be considered reasonable. Consideration might be given to adopting guidelines similar to those in the federal regulations. We would also recommend an explicit statement that, in considering whether a taxpayer has established ignorance of the law, the Audit Division will not require the taxpayer to demonstrate that it did, in fact, seek advice from a competent and knowledgeable advisor. To do otherwise would have the undesirable effect of requiring every taxpayer to seek professional advice before filing returns, or run the risk of being unable to seek relief from penalties. This would

---

2 It should be noted that cooperation during the audit has been held to be an insufficient basis for a finding of reasonable cause. *See* In re River Terrace Associates, DTA No. 807404 (Tax App. Trib. Oct. 22, 1992); In re Normandy Associates, DTA No. 804333 (Tax App. Trib. Mar. 23, 1989).

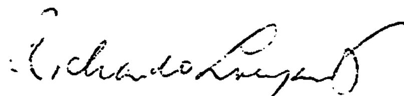
obviously impose serious burdens, particularly on individual taxpayers and small businesses. Obviously, a taxpayer would have to have a reasonable argument for his or her position, but it would not be necessary that the position be buttressed by professional advice.

Finally, since the penalty regulations are being amended and consolidated at this time, we suggest that this might be an appropriate time to consider the administration of penalties in general. Specifically, we recommend that a comprehensive review be conducted with respect to New York's usual practice of applying penalties automatically. This is very different from the federal system, where penalties are not applied automatically, and an individual determination is made in each case before penalties are applied, despite the existence of statutory language in the Internal Revenue Code, similar to that in the Tax Law, that penalties "shall" be imposed in certain cases. *See, e.g.*, IRS Manual, Section (20)947.2 (before the substantial understatement penalty may be asserted, "the examiner is required to include a comment in the case file as to whether the penalty is to be asserted . . . . [T]he examiner must give a thorough explanation for assertion or non-assertion of the penalty."); IRS Manual Section (20)913.2 ("The penalties for substantial understatement and valuation overstatement require a minimum review by the group manager before assertion. Cases with fraud penalties will be reviewed by District Counsel . . . ." *Compare* I.R.C. §§ 6651(a), 6662(a) ("there *shall* be added to the . . . tax") (emphasis added) *with* Tax Law § 1085(k) ("there *shall* be added to the tax") (emphasis added). Similar controls exist in many states, where penalties are never automatic. In New York State, many penalties are imposed virtually automatically, or "by the computer," as taxpayers are sometimes advised, without any individual determination having been made that penalties are in fact justified. Taxpayers are therefore often placed in the position of being advised that the penalties "have to" be added at the conclusion of an audit, and that penalties will be waived only if the taxpayer agrees to all issues, many of which may be the subject of dispute. Penalties should be considered completely separately from audit issues, and a showing of good faith and reasonable cause should eliminate penalties regardless of the taxpayer's agreement or disagreement on the underlying issues. It seems inappropriate to apply penalties automatically if there is a reasonable cause exception to their application, since such an exception clearly requires an analysis, on a taxpayer-by-taxpayer basis, of this issue.

If consideration of the automatic imposition issue must be deferred to another day, we suggest that, at a minimum, the new regulation recognize that, unlike in the federal system, penalties may have been imposed automatically, and take that fact into consideration in determining whether reasonable cause exists for abatement of penalties.

We appreciate the opportunity of commenting on the proposed regulation, and would be pleased to discuss these comments further with you or other members of the Department's staff who are working on this project. If you do wish to discuss this matter, please call either the undersigned at (212) 859-8260 or Hollis Hyans, the principal author of this letter, at (212) 468-8050.

Very truly yours,



Richard O. Loengard, Jr.
Chair

CC: Michael H. Urbach
Commissioner of Taxation and Finance
New York State Department of
Taxation and Finance
W. A. Harriman Campus
Albany, NY 12227

Steven U. Teitelbaum
Deputy Commissioner & Counsel
New York State Department of
Taxation and Finance
W. A. Harriman Campus
Albany, NY 12227

Ms. Leslie Verde
Tax Regulations Specialist II
New York State Department of
Taxation and Finance
W.A. Harriman Campus
Albany, NY 12227