IT 01-16
Tax Type: Income Tax
Issue: Reasonable Cause on Application of Penalties

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	Docket No. 01-IT-0000 FEIN 00-0000000
v.	Tax Year 1999
"THROCKMORTON & ASSOCIATES", Taxpayer	**Ted Sherrod** **Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Ralph Bassett on behalf of the Illinois Department of Revenue; John W. Loeb, *pro se* on behalf of "Throckmorton & Associates".

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest of an LTR 353 issued by the Illinois Department of Revenue (hereinafter referred to as the "Department") on January 23, 2001 denying the taxpayer's claim for refund for the tax year 1999. Pursuant to a prehearing order, the parties identified the issue to be resolved at the hearing as: " whether the taxpayer had reasonable cause for late filing of the taxpayer's state income tax return and late payment of the taxpayer's state income tax due for the tax year ending 12/31/99". Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the

Department. In support of this recommendation, I make the following findings of fact and conclusions of law.

Findings of Fact:

1. The Department's *prima facie* case against the taxpayer, inclusive of all jurisdictional elements, was established by the admission into evidence of the LTR-353 Notice of Claim Status, dated January 23, 2001 denying the taxpayer's request for refund for the tax year ending 12/31/99. [1]

2. The taxpayer, a corporation, made an election to be taxed under Subchapter S of the Internal Revenue Code, 26 **U.S.C.A.** § 1361 *et seq.* and is subject to the Illinois Personal Property Tax Replacement Income Tax; the taxpayer's principal place of business is located at (Address), Chicago, Illinois 60611. Tr. p. 16; Dept. Ex. 1,2,3,4.

3. "John Doe" is the owner and sole shareholder of the taxpayer. Tr. p. 16; Department Ex. 2.

4. "John Doe" is a partner in an investment banking firm and "Mary Contrary" is a secretary employed by this firm. Tr. pp. 15, 16; Taxpayer's Ex. 5.

5. "Ms. Contrary" was responsible for picking up mail left in the out box and the "to be mailed" box of "John Doe" and five other partners in the investment banking firm where "John Doe" worked. Tr. pp. 10, 11, 16; Taxpayer's Ex. 5.

6. The taxpayer's 1999 IL-1120-ST return was prepared by the taxpayer's accountant, prior to March 15, 2000, the due date for filing this return. Tr. p. 4; Taxpayer Ex. 5.

7. "John Doe" signed the taxpayer's 1999 return as the authorized officer of the taxpayer and placed an envelope containing the return and a check for the amount of tax due in

[1] Unless otherwise noted, findings of fact apply to the tax year 1999.

the out box on his desk at the investment banking firm where he worked, on March 15, 2000. Tr. p. 4; Dept. Ex. 2; Taxpayer's Ex. 5.

8. "Ms. Contrary" picked up the envelope containing the taxpayer's 1999 return and check from "John Doe's" out box on March 15, 2000 but did not mail it on this date; instead she inadvertently left the envelope on her desk and did not mail it until over a week after it was picked up from "John Doe's" out box. Tr. pp. 4, 5.

9. The taxpayer was assessed a 20 percent late payment penalty because the taxpayer's payment was received after it was due. Tr. pp. 5, 9; Dept. Ex. 1,3,4.

10. The taxpayer paid the penalty that was assessed and filed a claim for refund requesting a refund of the penalty it paid on January 5, 2000. Dept. Ex. 3.

11. The Department issued a Notice of Denial denying the taxpayer's refund claim on January 23, 2001. Dept. Ex. 1.

<u>Conclusions of Law:</u>

The Illinois Income Tax Act ("IITA") provides for the imposition of a Personal Property Tax Replacement Income Tax (hereinafter "replacement income tax")[2] on all corporations, including corporations electing to be taxed under subchapter S of the Internal Revenue Code, 26 **U.S.C.A.** § 1361 *et seq.* (hereinafter "Subchapter S corporations"), that receive income in, or as residents of Illinois. 35 **ILCS** 5/201(c). Corporations, including Subchapter S corporations, must file annual returns and pay all taxes due by the 15th day of the third month following the close of the taxpayer's fiscal year. 35 **ILCS** 5/505(a)(1); 86 Ill. Admin. Code § 100.5000(a)(2). Pursuant to this

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[2] The replacement income tax applies to those taxpayers who formerly had to pay personal property taxes and is intended to replace the revenue lost when those taxes were repealed. <u>Continental Illinois National Bank and Trust Company, et al. v. Zagel</u>, 78 Ill. 2d 387 (1979).

provision, the due date for calendar year taxpayers is March 15 of the year following the close of the calendar year for which the return is due.

The Uniform Penalty and Interest Act ("UPIA"), found at 35 **ILCS** 735/3-1 *et seq.* addresses the imposition of a penalty for failure to pay a tax that is due on or before the due date. Specifically, section 3-3(b-5) of the UPIA, 35 **ILCS** 735/3-3(b-5) provides as follows:

> This subsection is applicable to returns due on and after January 1, 1998 and on or before December 31, 2000. A penalty of 20% of the tax shown on the return or the tax required to be shown due on the return shall be imposed for failure to pay:
>
> (1) the tax shown due on the return on or before the due date prescribed for payment of that tax, an amount of underpayment of estimated tax, or an amount that is reported in an amended return other than an amended return timely filed as required by subsection (b) of Section 506 of the Illinois Income Tax Act (penalty for late payment or nonpayment of admitted liability); or
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> (2) the full amount of any tax required to be shown due on a return and which is not shown (penalty for late payment or nonpayment of additional liability), within 30 days after a notice of arithmetic error, notice and demand, or a final assessment is issued by the Department. In the case of a final assessment arising following a protest and hearing, the 30-day period shall not begin until all proceedings in court for review of the final assessment have terminated or the period for obtaining a review has expired without proceedings for a review having been instituted. In the case of a notice of tax liability that becomes a final assessment without a protest and hearing, the penalty provided in this paragraph (2) shall be imposed at the expiration of the period provided for the filing of a protest.

35 **ILCS** 735/3-3(b-5)

Section 3-8 of the UPIA, 35 **ILCS** 735/3-8 addresses the issue of when penalties can be abated. It states:

> No penalties if reasonable cause exists. The penalties imposed under the provisions of sections 3-3, 3-4, 3-5 and 3-7.5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at

> the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. A taxpayer may protest the imposition of a penalty under Section 3-3, 3-4, 3-5, or 3-7.5 on the basis of reasonable cause without protesting the underlying tax liability.

35 **ILCS** 735/3-8

Pursuant to the authority granted by the legislature, the Department has promulgated rules interpreting reasonable cause at 86 Ill. Admin. Code, Ch. I, § 700.400. These rules provide as follows:

> a) The penalties imposed under the provisions of Sections 3-3, 3-4, 3-5, and 3-7.5 of the Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with this Section. (Section 3-8 of the Act)
> b) The determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion.
> c) A taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether the taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor doe reliance on incorrect facts such as an erroneous information return.
> d) The Department will also consider a taxpayer's filing history in determining whether the taxpayer acted in good faith in determining and paying his tax liability. Isolated computational or transcriptional errors will not generally indicate a lack of good faith in the preparation of the taxpayer's return.
> e) Examples of Reasonable Cause. The following non-exclusive list of situations will constitute reasonable cause for purposes of the abatement of penalties:

1) Reasonable cause for abatement of penalty will exist if a liability results from amendments made by the Department to regulations or formal

administrative policies or positions after the return on which the liability was computed was filed.

2) Reasonable cause for abatement may also be based on the death, incapacity or serious illness of the taxpayer (or his tax preparer) or a death or serious illness in his or her immediate family which causes a late filing and payment of tax due. In the case of a corporation, estate, trust, etc., the death, incapacity, or serious illness must have been of an individual having sole authority to file the return (not the individual preparing the return) or make the deposit/payment, or a member of such individual's immediate family.
3) An unavoidable absence of a taxpayer (or tax preparer) due to circumstances unforseeable by a reasonable person may also constitute reasonable cause for purposes of abatement of the penalty. An unavoidable absence does not include a planned absence such as a vacation. In the case of a corporation, estate, trust, etc., the absence must have been of an individual having sole authority to file the return (not the individual prerparing the return) or make the deposit/payment.
4) Inability to timely obtain records necessary to determine the amount of tax due to reasons beyond the taxpayer's control. For example, some taxpayers, particularly those with income from banks, partnerships, trusts, estates or Subchapter S corporations, must secure information from those entities in order to properly compute the amount of tax due.
5) Factors beyond taxpayer's control such as destruction by fire, other casualty or civil disturbance, of the taxpayer residence or place of business records.
6) Taxpayer mailed the return or payment to the Department in time to reach the Department on or before the due date, given the normal handling of the mail. However, through no fault of the taxpayer, the return or payment was not delivered within the prescribed time period. This fact situation would constitute reasonable cause for the abatement of the penalty.
7) Reasonable cause will exist for purposes of abatement of the penalty if a taxpayer makes an honest mistake, such as inadvertently mailing a Department of Revenue check to a local government, another state's Department of Revenue, or to the Internal Revenue Service .
8) An Illinois appellate court decision, a U.S. appellate court decision, or an appellate court decision from another state (provided that the appellate court case in the other state is based upon substantially similar statutory or regulatory law) which supports the taxpayer's position will ordinarily provide a basis for a reasonable cause determination.
9) The Department gave erroneous information, or delayed a process under its control. …

11) Emblezzlement or employee fraud not reasoanbly within the knowledge of the taxpayer. …

f) Relevant factors used by the Department in determining the existence of reasonable cause.

1) Could the taxpayer's federal filing status have cause confusion about his or her Illinois filing requirements? Under Illinois law, many taxpayers that are not required to file with the Internal

Revenue Service are required to file with the Department.

2) Does the taxpayer's reason address the penalty assessed? For example, if a taxpayer was assessed both a late filing and late payment penalty for the same return, the taxpayer's explanation of the failure to file and pay may apply to one penalty, but not the other.
3) Does the length of time between the reason cited and the actual violation support abatement? If the taxpayer cites a specific event or set of events (e.g., illness, unexpected absence, or natural disaster) or set of events that led to the imposition of the penalty, the Department will determine whether those events are directly related to the return or payment under review.
4) Could the event cited have been reasonably anticipated? Was the event one that should have been anticipated (e.g., a vacation or scheduled absence) or was it unexpected, unavoidable, or otherwise unplanned (e.g., an emergency or disaster).
5) Was ordinary business care and prudence exercised? In the absence of new or unusual circumstances, most filing and payment requirements are common knowledge or are readily available to most taxpayers. If the taxpayer did all that could be reasonably expected of him or her and was still unable to file or pay on time, reasonable cause may be present.

86 Ill. Admin. Code, ch. I, § 700.400.

The record in this case indicates that the taxpayer did not file its replacement income tax return for 1999 on or before the due date for this return, and did not pay the tax due in a timely manner. Accordingly, the Department assessed a late payment penalty pursuant to section 3-3(b-5) of the UPIA, 35 **ILCS** 735/3-3(b-5). The taxpayer seeks abatement of the penalty that has been assessed on the grounds that his failure to timely pay was due to "reasonable cause". The Department determined that the circumstances of the late filing of the taxpayer's return did not constitute "reasonable cause" as currently defined by the Department's rules. Section 904(a) of the Illinois Income Tax Act, 35 **ILCS** 5/904(a), provides that the Department's *prima facie* case is established by the admission into evidence of the correct amount of tax due. Balla v.

Department of Revenue, 96 Ill. App. 3d 293 (1st Dist. 1981). By introducing the LTR-353 denying the taxpayer's request for refund into evidence under the certificate of the Director, the Department established its *prima facie* case against the taxpayer. 35 **ILCS** 5/914; Balla, *supra*. Once the Department establishes the *prima facie* correctness of the amount of tax due, the burden shifts to the taxpayer to prove that this determination was in error. *Id.*

The existence of reasonable cause justifying abatement of a penalty is a factual determination that can only be decided on a case by case basis (Rohrabaugh v. United States, 611 F. 2d 211 (7th Cir., 1979)), and has generally been interpreted to mean the exercise of ordinary care and prudence (Du Mont Ventilation Co. v. Department of Revenue, 99 Ill. App. 3d 263 (3d Dist. 1981)). The burden of proof is on the taxpayer to show by a preponderance of evidence that it acted in good faith and exercised ordinary care and prudence in providing for the timely payment of its tax liability. Balla, *supra*.

Mr. "Doe", the owner and sole shareholder of the taxpayer, has admitted that he was responsible for filing the taxpayer's return, that the return was not filed on time and that the tax due was not timely paid. Tr. pp. 5, 8. However, Mr. "Doe" contends that this failure was due to solely to the negligence of "Mary Contrary", his secretary at the investment firm where he was a partner, in failing to mail the envelope containing the return and the check. Tr. p. 8; Taxpayer's Ex. 5. Mr. "Doe's" claim is not fully supported by the record. During trial proceedings, the taxpayer admitted that his office contained 2 boxes the secretary was responsible for clearing. Tr. pp. 10, 11. One box was for miscellaneous outgoing items including some mail. Tr. p. 10. However, a second box was to be used exclusively for items Mr. "Doe" wanted to be deposited in the

mail. Tr. pp. 10, 11. The record shows that the envelope containing the taxpayer's 1999 return and check was not deposited in the box for items to be mailed, but was instead placed in Mr. "Doe's" general out box for miscellaneous outgoing items. Tr. pp. 10, 11. Based on this record it can be concluded that Mr. "Doe", or the firm where he worked, had in place procedures to better insure that mail, including mail of a time sensitive nature, was properly handled. However, these procedures were not followed in this case. While evidence of procedures to better insure compliance, and evidence that such procedures were followed, might show that Mr. "Doe" exercised ordinary care and prudence in filing the taxpayer's return and support a finding of "reasonable cause", (see RIA SLT IL IT 00-4), the fact that such procedures existed but were not followed does not support the taxpayer's claim. Furthermore, this evidence indicates that the taxpayer's untimely payment of tax due may not have been entirely the fault of Mr. "Doe's" subordinate.

Moreover, even if the untimely filing was entirely the secretary's fault, there is no Department regulation finding "reasonable cause" for an abatement of penalties to exist where a taxpayer relied upon his secretary to mail tax payments and she failed to timely mail them. While there is no Illinois case directly on point, the conclusion that such evidence is insufficient for a finding of "reasonable cause" is supported by case law and other authority construing comparable "reasonable cause" provisions of the IRC contained at 26 **U.S.C.A.** § 6651. Such authority is relevant in determining what constitutes "reasonable cause" under the IITA because section 102 of the IITA, 35 **ILCS** 5/102, provides that terms used in the IITA have the same meaning as when used in a comparable context in the Internal Revenue Code. 26 **U.S.C.A.** § 6651 and 35 **ILCS**

735/3-8 are clearly used in comparable contexts since both address what constitutes reasonable cause for failure to timely file and pay income taxes. Consequently, IRS rulings and regulations, and federal case law interpreting "reasonable cause" provide guidance in construing the meaning of this term under the IITA. Bodine Electric Co. v. Allphin, 81 Ill. 2d 502 (1980); Rockwood Holding Co. v. Department of Revenue, 312 Ill. App. 3d 1120 (1st Dist. 2000).

The federal courts have repeatedly held that a taxpayer will not be excused from penalties for failure to timely file returns and pay taxes because its secretary or other agent failed to act, or acted negligently. HGA Cinema Trust v. C.I.R., 950 F. 2d 1357, 1363, 1364 (7th Cir. 1991) ("It is well-settled that a taxpayer has a personal, non-delegable duty to file the return when due, and reliance on an agent cannot constitute reasonable cause to excuse the taxpayer's failure to file on time"); Conklin Brothers of Santa Rosa, Inc. v. U.S., 986 F. 2d 315 (9th Cir. 1993); J.C. Shepherd v. Commissioner of Internal Revenue, BTA Memo, CCH Dec. 11,280-A (July 30, 1940) (Reasonable cause not found where taxpayer's secretary gave his return, prepared and signed, to the office assistant to be delivered to the post office, and the office assistant failed to do so). Moreover, the Internal Revenue Manual Part XX, Penalties Handbook states as follows: "(T)he taxpayer may try to establish reasonable cause by claiming forgetfulness or an oversight by the taxpayer or another party caused the noncompliance. … this is not in keeping with ordinary business care and prudence standard and does not provide a basis for reasonable cause". IRM 120.1.1.3.1.2. These authorities make it clear that if a subordinate, acting as the taxpayer's agent, makes a mistake or was forgetful in meeting a tax filing obligation, such a mistake or failure to remember would not provide a basis for

a finding of "reasonable cause" under the IRC. For the reasons noted above, "reasonable cause" as used in section 3-8 of the UPIA, 35 **ILCS** 735/3-8 should be similarly construed.

The taxpayer notes that the late payment penalty has been changed for returns due on or after January 1, 2001. For such returns, the late payment penalty is a graduated penalty that increases as the time period during which the tax liability remains unpaid increases. As a result of this change, a maximum late payment penalty of 15% of the unpaid tax can only be imposed after the tax liability has remained unpaid for more than 180 days. 35 **ILCS** 735/3-3(b-10). As noted above, the penalty applicable to the taxpayer in this case is 20% of the tax shown as due on the taxpayer's return. 35 **ILCS** 735/3-3(b-5). The taxpayer infers from the change in the penalty provisions after December 31, 2000 that the legislature intended to alleviate the harsh burden resulting from the imposition of a flat 20% penalty regardless of the length of payment delinquency and thus tacitly recognizes that the 20% penalty is unfair.

Even if the taxpayer is correct in his assumptions regarding the legislature's motives, the statute plainly indicates that the legislature did not intend to provide any relief for the tax period that is at issue in this case. 35 **ILCS** 735/3-3(b-10) plainly states that the reduced penalty provisions are applicable only to "returns due on and after January 1, 2001". Moreover, the statute grants no authority to this tribunal to modify or reduce the 20% penalty based on its perceived unfairness. The only mechanism the statute provides for the alleviation of this penalty is through a showing of "reasonable cause". For the reasons set forth above, I find that the circumstances resulting in the late payment of the taxpayer's replacement income tax for 1999 did not constitute

"reasonable cause" and therefore affirm the Department's determination denying the taxpayer's refund claim.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's denial of the taxpayer's refund claim for the tax year at issue be upheld.

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Ted Sherrod
Administrative Law Judge

Date: October 19, 2001