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Dear IRS: Sorry, A Typo On My Taxes Dropped Some Zeros

Tax time is here, with all those annoying Forms 1099, W-2 and K-1. Sometimes, the forms dribble in even after you've filed your return. There may be some surprises too, where you *think* you were paid $1,000, but the 1099 says $100,000! If your income is all there in black and white, you may not have many choices. But what if you somehow report less than you should? When it comes to mistakes, what kinds of mistakes the IRS can forgive. Some mistakes are crippling, and the more complex your affairs, the more you and your tax adviser may have to make judgment calls.

But suppose you do misstep. Are you better off being honest and ignorant, or more clever and conniving? Clearly the former. Sure, taxes are complex. That might cause you to assume that just about *anything* can be called an innocent mistake. Actually, the tax law draws a line between non-willful and willful. Willfully evading federal income taxes is a felony. See 26 U.S.C. § 7203. "Willful" usually means voluntary or with intent. You are willful if you intentionally violate a legal duty of which you're aware. Yet what IRS calls 'willful' can be tough to predict. And even if you're ignorant, the IRS can say you are guilty of willful blindness–where you *intentionally* remain ignorant!

If you truly made an innocent mistake, you can say so. But bear in mind that the IRS has heard every excuse in the book. Say you made $500,000, but somehow report $50,000. Will it be credible if you say it was a typo omitting those extra zeros? Hardly. You might begin by asking if that passes the straight face test. And since all IRS returns carry penalties of perjury, don't make matters worse by lying. In this kind of delicate situation, it is best not to have any direct contact with the IRS. Another setting that can be delicate?

There's lots of talk about how to soften the blow of disclosing foreign bank accounts or other tax problems. U.S. citizens and permanent residents must report worldwide income. They must also disclose foreign bank accounts on FBARs. Penalties for failing to report income can be severe, and penalties for failing to file FBARs are even worse. Consider *United States v. J. Bryan Williams*. Mr. Williams had checked the "no" box stating under penalties of perjury that he did not have a foreign bank account. He also did not file FBARs. It turned out that he *did* have foreign accounts.

Nevertheless, the court was not persuaded that Mr. Williams was trying to evade taxes. Some people manage to avoid the taint of willfulness in tax matters based on a genuine misunderstanding of the tax law. The misunderstanding can even be *unreasonable* as long as it's genuine. Another way of not being willful: having a good-faith (even though unreasonable) belief no tax is due. In *United States v. Kokenis*, a jury found Mr. Kokenis guilty of tax evasion. Asking for a new trial, Kokenis claimed that the trial court improperly excluded evidence of his good faith misunderstanding of the tax law.

You cannot hold it against a criminal defendant who chooses not to testify in his own defense. For that reason, the court in *Kokenis* even noted in its order that it instructed the jury *not* to draw negative inferences from Kokenis' failure to take the stand. Still, said the court, how else could Mr. Kokenis have established his own good faith belief? On appeal to the Seventh Circuit, Mr. Kokenis argued that the district court erred in ruling that he could not present evidence of good faith unless he waived his Fifth Amendment rights and testified. Nevertheless, the Seventh Circuit affirmed Mr. Kokenis' convictions and sentence.

The size of penalties varies but often, a 25% penalty is at stake. In more serious cases, the civil fraud penalty is 75%. Finally, there are potential criminal violations. Although prosecutions are rare, most criminal tax cases start with civil audits. And in tax cases, the cover-up (or even *attempted* cover-up) is often much worse than the crime. If your mistakes are serious, the IRS can say you are willful. Willfulness is shown by your knowledge of reporting requirements and your conscious choice not to comply. Willfulness means you acted with knowledge that your conduct was unlawful—a voluntary, intentional, violation of a known legal duty.

Watch out for conduct meant to conceal. Setting up trusts or corporations, or filing some forms and not others, can look bad. Using cash, keeping deposits below $10,000, using travelers checks, under-reporting business income, and inflating your expenses can all spell trouble. Perhaps you can explain one failure, but repeated failures can morph conduct from inadvertent neglect into reckless or deliberate disregard. 'Willful blindness' is a kind of conscious effort to *avoid* learning about reporting requirements, and that too can be enough to land you in jail.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.