



Robert W. Wood

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Tax Fraud Or Innocent Mistake? What Is 'Willful' To IRS?

Tax time is just around the corner. It won't be long before all those annoying Forms 1099, W-2 and K-1 start to show up. Sometimes, the forms dribble in, reporting income 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.

Yet even simple reporting problems can lead to [crippling mistakes that cost big](#). The more complex your affairs, the more you and your tax adviser must make judgment calls. If you misstep, are you better off being honest and ignorant, or more clever and conniving? Taxes are complex, and U.S. taxes are especially confusing. You might assume that *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!



For example, 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, 25% is at stake. Civil fraud is 75%, but that's not often asserted. Criminal violations are asserted even less frequently. Still, most criminal tax cases start with civil audits. Even a smidgen of fraud or intentional misstatements can land you in jail.

If your mistakes are serious, the IRS can say you are willful. According to the IRS, willfulness involves a voluntary, intentional violation of a known legal duty. 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 intended as legal advice.