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What IRS Calls 'Willful' Depends On All The Facts

By Robert W. Wood

Can you get out of IRS penalties? As with so many other things relating to taxes, it depends. The tax law draws a line between non-willful and willful conduct. Big penalties, and sometimes even prosecution, can hang in the balance. Innocent, even careless mistakes can often be forgiven. Conduct that appears to be intentional, much less so.

But there is still the topic of penalties. Even being forgiven does not necessarily mean that you will be pain-free when it comes to the IRS. A common question from taxpayers is just how big IRS penalties can be. There is no easy answer, since there are many different penalties. For example, there are various ways that the IRS can add 20 or 25 percent on to your tax bill.

Some penalties you can contest based on your documents or timing, or based on what your advisers told you to do. Some penalties are rigid, as where you pay late. But among the more worrisome penalties are the bigger ones. For example, there is a civil fraud penalty that is 75 percent of the tax deficiency.

So, if you fraudulently fail to report income on your return and therefor skip paying taxes of $1,000, the IRS may be able to add a penalty of $750. Some penalties are not based on an underpayment of tax, but rather based on something else. For example, if you fail to report a foreign bank or financial account, the penalty can be based on the *size* of that account, even if any underpayment of tax was tiny.

In general, you must report such foreign accounts if their aggregate value exceeds $10,000 at any time during the year. The reporting form is known as an FBAR, or foreign bank account report. The statute of limitations for these forms is generally six years, and the non-willful penalty for failure to file is $10,000 per account per year.

That kind of penalty can add up. Thus, even if you were not willful, if you have three foreign accounts, you could face $30,000 in penalties for each of six years. The total would be $180,000. However, suppose that the IRS says you *intentionally* didn't report?

The penalties for a *willful* violation can range up to the greater of $100,000 or 50 percent of the amount in the account. If you have a $500,000 account, the penalty could be $250,000 for a single violation. And since there are up to six years available to the IRS under the statute of limitations, the penalty could be 300 percent of the account value!

Fortunately, the IRS uses a practical limit of 100 percent of the account value in assessing such willful penalties. But even then, 100 percent is worrisome. What's worse, the IRS can even seek criminal penalties. Criminal penalties for violating the FBAR requirements can go up to a $500,000 fine, 10 years' imprisonment, or both. Civil and criminal penalties can even be imposed together.

Intent in tax matters can be elusive. Many people think that even civil penalties cannot be imposed if you were not actually *trying* to cheat anyone. Unfortunately, your conduct can sometimes be used to infer knowledge. Willfulness can be shown by your knowledge of reporting requirements, and your conscious choice not to comply.

Willfulness involves a voluntary, intentional violation of a known legal duty. In taxes, it applies for civil and criminal violations. This definition causes some people to think that they are home free. For example, if you didn't know you had a legal duty to report income or a foreign bank account, how can you be prosecuted? Unfortunately, it is not that simple.

Take the recent case of *Arthur Bedrosian v. U.S.*, 15-5853, Eastern District Court of Pennsylvania (April 13, 2017). In the 1970s, he opened two Swiss bank accounts. His accountant prepared his tax returns, and Bedrosian did not inform the accountant about the Swiss accounts. In the 1990s, he finally mentioned the accounts to the accountant, who said that he had been breaking the law for *years* by failing to report them.

Even so, the accountant said that he should do nothing. He said the issue would be resolved on Bedrosian's death, when the assets in the Swiss accounts would be repatriated as part of his estate. The accountant said taxes would be paid then. Again, Bedrosian did nothing.

But in 2007, his accountant died, and Bedrosian hired a new accountant. The new accountant reported the much smaller of the two accounts on Bedrosian's tax return — omitting the larger one. He also helped Bedrosian file an FBAR, but the reporting was incomplete, omitting all of the income from his tax return.

The Swiss bank eventually warned that it was reporting the accounts to the IRS. So in 2010, Bedrosian amended his 2007 tax return to report correctly, picking up hundreds of thousands of dollars of unreported income. The IRS investigated, and Bedrosian supplied documents and cooperated. The IRS was apparently ready to treat him as non-willful, imposing the $10,000 per account per year penalty for non-willful FBAR violations.

Remember, that could be $10,000 for each account for up to six years. Still, that seemed manageable. However, then the case was transferred to another IRS agent, who wrote the case up as a willful one. In 2013, the IRS sent Bedrosian a letter stating that it was imposing a penalty for his *willful* failure to file an FBAR for 2007. The penalty was $975,789, 50 percent of the maximum value of the account.

Bedrosian filed suit in the district court claiming that the penalty was unwarranted. Both the IRS and Bedrosian moved the court for summary judgment. The district court denied summary judgment to the IRS and to the taxpayer. The court concluded that whether Bedrosian *willfully* failed to submit an accurate FBAR was an inherently factual question. The court said there were still genuine disputes about what the taxpayer knew about his reporting requirements, and when he knew it.

Remember, the facts — all of the facts — matter.

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