

# Are You Willful Or Ignorant About Your Taxes? It Matters

By Robert W. Wood

It's 2015, and it's almost tax time for 2014 returns. Oh boy. It won't be long before all those annoying Forms 1099, W-2 and K-1 show up. They come in many flavors, and sometimes they even dribble in reporting more income even after you file your return. And 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 the more complex your affairs, the more you and your tax adviser have judgment calls to make. If you misstep, are you better off being honest and ignorant or more clever and conniving? I'll bet you know the answer. Take offshore bank accounts.

There's lots of talk about whether and how one might try to soften the blow of disclosing foreign bank accounts (or other tax problems) along with their myriad penalties. U.S. citizens and permanent residents must report their worldwide income on U.S. tax returns. They must also disclose foreign bank accounts on an FBAR. The penalties for failing to report worldwide income can be severe, but the penalties for failing to file FBARs are even worse.

Given the costs and penalties, some people may be thinking that they face worse treatment by coming forward than by just klammring up and waiting to be contacted by the Internal Revenue Service. If they're lucky, that might never happen, they figure. Such thoughts are dangerous, as it is safest to come forward.

But suppose you run the risk? How much can the IRS prove if you (usually against your counsel's advice) decide not to come forward? *United States v. J. Bryan Williams*, 489 Fed. Appx. 655 (4th Cir. 2012), suggests that the IRS may have a hard time proving "willfulness" when a U.S. taxpayer with a foreign bank account did not know he had to report it. Williams had checked the "no" box indicating (under penalties of perjury, mind you) that he did not have a foreign bank account. He also did not file FBARs.

Nevertheless, the court was not persuaded that he was trying to evade taxes. Willfully evading federal income taxes is a felony. See 26 U.S.C. Section 7203. You may think your child or pet is willful, but "willful" in this context usually means voluntary or with intent. You are willful if you intentionally violate a legal duty of which you are aware.

Some people have managed 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. See *Cheek v. United States*, 498 U.S. 192, 201 (1991). Another way of not being willful: having a good-faith (even though unreasonable) belief that no tax was due.

**Is ignorance bliss?** Not really, but perhaps sometimes it can be better to be ignorant. In a criminal tax case in Illinois, *United States v. Kokenis*, 743 F. Supp. 2d 988 (N.D. Ill. 2010), a jury found Chris Kokenis guilty of tax evasion.

Asking for a new trial, Kokenis claimed the trial court had erred by excluding evidence of his good faith misunderstanding of the tax law. The district court denied his motion for a new trial, and in doing so, made a worrisome suggestion: that such a defense would require the defendant to take the stand to testify. Had Kokenis testified in his trial? Nope, not according to the court's order.

The district court seemed careful to tiptoe around the issue of drawing negative inferences based a defendant's failure to testify. The court even notes in its order that it instructed the jury that it could *not* draw negative inferences from the fact that Kokenis did not take the stand in his own defense. Still, said the court, how else could he have established what his own good faith belief was?

My favorite cutesy (but still downright weird) part of the court's comments, though, was a reference to a classic old radio show. The judge capped his you-have-to-take-the-stand-to-show-your-belief harrumph with a footnote suggesting that otherwise, who knows (what evil lurks in the hearts of men)? Quoting Orson Welles, the Judge said "only *The Shadow* knows." If you ask me, it sounded better when Orson Welles said it.

On appeal to the 7th U.S. Circuit Court of Appeals, Kokenis contended 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. The 7th Circuit affirmed Kokenis' convictions and sentence, finding that, although the district court applied the wrong standard in determining whether Kokenis could assert good faith, the error was harmless given the overwhelming evidence of a lack of good faith. See *United States v. Kokenis*, 662 F.3d 919 (7th Cir. 2011).

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.

Examples might include reporting \$100 when you actually received \$200, failing to declare offshore account, deducting your family vacation, etc. The concept applies for civil and criminal violations. You may not have meant any harm or to cheat anyone, but that may not be enough.

"Gee, I didn't know," can work in some cases. However, the failure to learn of filing requirements, coupled with efforts to conceal the income or the true facts, may mean a violation was willful. Your conduct is relevant, too. Some courts say willfulness is a purpose to disobey the law, but one that can be inferred by conduct. Watch out for conduct meant to conceal. Setting up trusts or corporations? Filing some forms and not others?

Using cash, keeping deposits below \$10,000, using travelers checks, under-reporting business income, and inflating your expenses can all spell trouble. How many mistakes you make is also relevant. You might be able to explain one failure. But repeated failures to comply can morph conduct from inadvertent neglect into reckless or deliberate disregard. Even willful blindness may be enough, a kind of conscious effort to *avoid* learning about reporting requirements.

Willfulness is much in the news today, from Lionel Messi to Dolce & Gabbana to Beanie Babies billionaire Ty Warner. In one recent case, the question was whether excessive spending alone manifested a willful attempt to evade or defeat taxes. The IRS argued that big spending alone — in the face of unpaid taxes — was willful.

The lower court agreed with the IRS but the appeals court did not. The court in *Hawkins v. Franchise Tax Board*, 11-16276 (9th Cir. 2014), said spending alone isn't willful. Will the decision impact willfulness analysis in other tax contexts? It isn't clear. It could, but it seems unlikely to mean the IRS will stop arguing willfulness. And since big dollars and even one's freedom can turn on what's willful, be careful out there.