

Big IRS Penalties Even for Non-Willful Violations?

By Robert W. Wood

Oops, you made a mistake on your taxes. Will the IRS let it go this time or slap a penalty on you? If there is a penalty, can you get out of paying it if you have a sympathetic story, say that you didn't know and promise to fly right next time? Some of the answer may depend on what specific provision of the tax law you violated, how it comes to light, and more. Even how the penalty is computed will influence how much penalty leeway you may have with the IRS.

There can be some wild swings in IRS penalties. Many people assume that the IRS will not impose penalties if you weren't actually *trying* to cheat on your taxes. After all, taxes are complex, and mistakes happen. But the burden is on *you* to show that you acted reasonably. Relying on professional tax advice can be one way. If you can't convince the IRS, you will probably end up with penalties. The size of penalties varies, but they are often around 25%.

Higher penalties and even criminal prosecution are possible in some cases. You might even have to prove you are right or that your mistakes were innocent. If the IRS believes you were *trying* to cheat, you could face a civil penalty of 75% or even criminal prosecution. And remember, some criminal tax cases grow out of regular civil IRS audits.

Innocent mistakes can often be forgiven if you can show that you tried to comply and got some advice. But it would be a mistake to assume that merely saying that it was an innocent mistake. In fact, you can be *attributed* knowledge. Everyone has heard that ignorance of the law is no excuse. On many key tax subjects, the IRS says that with hardly any effort, you could easily learn the IRS requirements. The tax law draws a line between non-willful and willful, and penalties or even prosecution can hang in the balance.

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 many people to think they are home free. You may not have *meant* any harm, but that may not be enough. The failure to learn of filing requirements, coupled with efforts to conceal the facts, can spell willfulness.

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, such as keeping two sets of books, cash deposits and cash withdrawals, and so on. They might suggest willfulness. Even if you can explain one failure to comply with the law, repeated failures can morph conduct from inadvertent neglect into reckless or deliberate disregard.

Even willful blindness—a conscious effort to *avoid* learning about reporting requirements—may be enough. And failing to follow-up can provide evidence of willful blindness. Ask yourself if your explanation passes the straight face test, or get some advice about your facts from an experienced tax lawyer. A case to be decided by the U.S. Supreme Court provides a good

example of just how bad penalties—even civil penalties—can be.

If you failed to report a foreign bank account but were not willful, which is a reasonable IRS penalty, \$50,000 or \$2.72M? The Supreme Court has announced that it will decide, considering the non-willful FBAR violations in *Bittner v. United States*, No. 21-1195.

The Court is expected to clarify whether non-willful foreign bank account reporting violations apply per form or per account.

In 2021, the Fifth Circuit held in *United States v. Bittner*, that a Romanian-born businessman and investor with foreign bank accounts was liable for the penalties based on each of the dozens of accounts he failed to report each year rather than on the single FBAR form he failed to file each year (\$2.72 million in FBAR penalties for his five years of violations instead of \$50,000). See *United States v. Bittner*, No. 20-40597 (5th Cir. 2021).

The *Bittner* decision is in direct conflict with a Ninth Circuit ruling which held that non-willful FBAR penalties apply per form. See *United States v. Boyd*, No. 19-55585 (9th Cir. 2021). If you have dealt with the IRS, you may know that penalties can add up, and that how you calculate them can matter—a lot. This was no mere rounding error, but the IRS and the Justice Department have long had a focus on offshore accounts and disclosure.

As an American citizen, green card holder or U.S. tax resident, you must report your worldwide income, and that includes interest income from bank accounts overseas. If you don't, there are taxes, interest and penalties. On top of these tax penalties, there are bigger and uglier penalties for failing to file bank account reporting forms known as FBARs. Another name is FinCEN Form 114. These annual forms are not filed with the IRS, they are filed with the Financial Crimes Enforcement Network, part of the U.S. Treasury Department.

Make no mistake, the penalties for failing to file an FBAR are far *worse* than tax penalties. Failing to file an FBAR can carry a civil penalty of \$10,000 for each non-willful violation. Non-willful means you didn't intend any harm, you were just ignorant. And that \$10,000 is each year, and the statute of limitations on FBAR violations is six years. So that is \$60,000 per account. You have 10 accounts? That's \$600,000—even if you were *non-willful*. It can get worse. (Actually, because FinCEN adjusts FBAR penalties for inflation each year, for 2022 the non-willful penalty is \$14,489, not \$10,000.)

If your violation is found to be *willful*, the penalty is the greater of \$100,000 or 50 percent of the amount in the account for each violation—and each year you didn't file is a separate violation. Criminal penalties for FBAR violations are even more frightening, including a fine of \$250,000 and five years of imprisonment. If the FBAR violation occurs while violating another law (such as tax law, which it often will) the penalties are increased to \$500,000 in fines and/or ten years of imprisonment. Many violent felonies are punished less harshly. The assessment of a civil penalty does not preclude criminal penalties or prosecution.

Is it possible to argue your way out of a tax penalty? As a general proposition, taxpayers claim that penalties are not warranted for many reasons, but one of the biggest is the defense that a tax position was based on reasonable cause. How the IRS evaluates this depends on which penalty has been assessed. On top of reasonable cause, certain penalty defenses involve other concepts, such as the absence of willful neglect. Isn't that proving a negative? Yes, and the taxpayer has to carry this burden too. Who wins in a tax penalty stalemate? This one should not surprise you. The IRS does, of course.

Put differently, taxpayers bear the burden of substantiating that they acted with reasonable cause. We all must exercise ordinary business care and prudence in reporting our proper tax liability. Remember, all tax returns are signed under penalties of perjury. The IRS applies a facts-and-circumstances test on a case-by-case basis to determine whether a taxpayer meets the reasonable-cause exception. But with foreign account penalties—and many other ones too—it can be particularly difficult to carry the day.

Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of *"Taxation of Damage Awards & Settlement Payments"* (www.TaxInstitute.com). This is not legal advice.