IRS Is Pushing Willful Foreign Account Penalties, Be Careful

by Robert W. Wood and Joshua D. Smeltzer

In taxes, willful and non-willful are different. Innocent tax mistakes can often be forgiven, maybe with no penalty. When there is a penalty, non-willful is vastly lower than willful. In a criminal tax case, this fundamental dichotomy can mean the difference between innocence or guilt, freedom v. incarceration. And in civil cases, what happens if you are audited and the IRS tries to hit you with big penalties? To the IRS, bad intent may not be bad at all.

Take offshore accounts. Both willful and non-willful failures to report an account can be penalized. U.S.C. 5321(a)(5). Civil penalties for non-willful violations be $10,000 per account per year. But if the IRS says you were willful, you can pay the greater of $100,000 or 50 percent of the amount in the account. This is civil, imposed in the context of regular old IRS audits, even through the mail.

If the IRS says you were willful and wants big penalties, you can pay them, or push back to the IRS Appeals Division. IRS Appeals is the classic place where the IRS and taxpayers settle disputes. But sometimes either the IRS or the taxpayer won't budge.

Some courts say willfulness is a resolution to disobey the law, but one that can be inferred by conduct. Watch out for conduct meant to conceal.

However, much less can now be willful. The IRS asserts willful penalties for willful blindness and recklessness. The IRS often refers to Section 6672 of the tax code, involving payroll taxes. Every employer must withhold taxes and promptly send the money to the IRS. If you don't, Section 6672 permits the government to collect it from officers, directors and even just check signers, any "responsible" person who willfully fails to pay employment taxes.

Willful in this context is very favorable to the government. Taxpayers are readily found to be willful if they merely ought to have known there was a risk withholding taxes were not being paid, and if they were in a position to find out. The IRS usually wins these payroll tax cases, so willful in this context means pretty little.

Aren't foreign bank accounts different? The IRS appears not to think so. In Bedrosian v. U.S., 912 F.3d 144 (3d Cir. 2018), a man opened two Swiss bank accounts in the 1970s, but did not tell his accountant until the 1990s. The accountant advised him to do nothing. He said it would be cleared up at Mr. Bedrosian's death, when the assets in the accounts were repatriated as part of his estate. But in 2007, a new accounted listed one account and not the other.

Eventually, Mr. Bedrosian amended his tax returns to correctly report both accounts. The IRS said the violation was willful and slapped on a penalty of $975,789 --- 50 percent of the maximum value of the account. The District Court found Bedrosian's actions "were at most negligent," and that the omission of the large account was "unintentional oversight or a negligent act." So the government appealed to the Third Circuit.

The Third Circuit reversed in the face of IRS arguments about the much harsher willful standards from Section 6672 payroll tax cases. The Third Circuit cited two Section 6672 cases, and quoted the standard for reckless disregard from one. The Bedrosian case was remanded to the District Court to apply the new standard. The fear is that willfulness is beginning to look quite broad --- just as the IRS likes.

The IRS can almost always show willfulness any time payroll taxes were not paid. The flimsy "in a position to find out" standard in the context of Section 6672 non-compliance is very broad. In short, is the government seeking a sort of carte blanche when it comes to proving willful FBAR penalties? The Justice Department's reply in Bedrosian claims that the taxpayer, by signing and filing his return without reviewing it, "ought to have known" that there was a "grave risk" the form might not be accurate.

This argument suggests an attempt to use the signing of a return as inherent reckless disregard of the duty to report foreign accounts. The Justice Department has successfully argued in other cases that merely signing a return without the proper box checked is per-se willfulness. States v. Horowitz, et al., 123 AFTR 2d 2019-500 (DC MD); Kimble v. United States, 122 AFTR 2d 2018-7109 (Ct. Fed. Cl.). The courts in both cases said taxpayers have constructive knowledge of the content of their tax returns, and cannot claim ignorance. In Horowitz, the taxpayers are arguing on appeal that the Section 6672 standard is inappropriate because FBAR willfulness occurs in a much different context.

Uneasy Conclusions

It may be too soon to tell how all of this will shake out. Perhaps many taxpayers facing willful penalties may end up with understanding IRS agents who opt for non-willful penalties, at least if the taxpayer's explanation and behavior seem reasonable. Taxpayers should be prepared to justify their mistake or misunderstanding in their particular circumstances if they hope to avoid the ever-expanding net of willfulness that seems to be brewing from the government.

There are growing concerns about whether IRS penalties are getting harsher and harsher. So far, the specific context for this drive seems to be in the offshore account arena. That is an easy one for the government. These days, the IRS has mountains of information and documentation about offshore accounts nearly everywhere. That makes any infractions, however, minor, perhaps even more risky than most other tax gaffes.

Still, if the IRS drive for penalties continues, one wonders if we might one day have strict liability for tax problems. In the meantime, when it comes to penalty notices and disputing penalty findings at any level, extra care is likely to be required.