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IRS Civil/Criminal Penalties - Reasonable Case (Willfulness)

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Chapter 29- IRS Civil/Criminal Penalties-Reasonable Cause (Willfulness)

Under Mortensen v. Commr., 440 F.3d 375, 385 (6th Cir. 2006), it was held that reasonable minds can differ over tax reporting, and under tax audits the IRS may disallow certain transactions.

The U.S. Congress was concerned that taxpayers would participate in the "audit lottery" and take questionable positions on their tax returns in the expectation of not being audited (See: H.R. Rep. No. 101-247, 1388 (1989). H.R. Rep. No. 101-247, as reprinted in 1989 U.S.C.C.A.N. 1906, 2858.

IRC Sec. 6662(b) imposes a civil penalty for substantial understatements of income, or liability overstatements (in addition, other civil penalties may be imposed for negligence and substantial valuation misstatements).

Under IRC Sec. 6064(c), no penalty will be imposed with "respect to any portion of an underpayment if it is shown that there was reasonable cause and the taxpayer acted in good faith."

Under Treasury Regulation Section 1.6664-4(b)(1), "reasonable cause" and "good faith" require courts to review the following taxpayer issues:

Experience;

Knowledge;

Sophistication;

Education;

Taxpayer reliance on a tax professional; and

Taxpayer's effort to assess the taxpayer's proper tax liability.

Under Treas. Reg. Sec. 1.6664-4(c), the IRS minimum requirements for determining whether a taxpayer reasonably relied in good faith on advice including a tax advisor's professional opinion.

The minimum requirements include:

1. The advice must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances;

2. The advice must not be based on unreasonable factual or legal assumptions;

3. The advice must not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person;

4. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed that the regulation in question is invalid (Treas. Reg. Sec. 1.6662-3(c)(2).

Under Treasury Regulation Sec. 1-6664-4(b)(1), reasonable cause and good faith are not necessarily established by reliance on the advice of a professional tax advisor.

However, under Treas. Rg. Sec. 1.6664-4(b)(2), a taxpayer may satisfy the “reasonable cause” and “good faith” exception because the taxpayer believed that the tax professional had knowledge in the relevant aspects of federal tax law.

In United States v. Boyle, 469 U.S. 241, 251 (1985), the U.S. Supreme Court held:

1. Taxpayers may not be sophisticated in tax matters, and that it is unrealistic for taxpayers to recognize errors in the substantive advice of an accountant or attorney;

2. To require the taxpayer to challenge the attorney, to seek a second opinion, or to try to monitor counsel would nullify the purpose of seeking the advice of a presumed expert in the first place.

Under Sklar, Greenstein & Scheer, P.C. v. Commr., 113 T.C. 135, 144-145 (1999) citing Ellwest Stereo Theaters of Memphis, Inc. v. Commr., T.C.M. 1995-610, the Tax Court established a three-prong test to prove reasonable cause, where a taxpayer is asserting a defense against an IRC Sec. 6662 penalty:

1. The tax advisor was a competent professional who had sufficient expertise for justifying reliance;

2. The taxpayer provided necessary and accurate information to the advisor;

3. The taxpayer actually relied in good faith on the advisor’s judgment.

Under Treas. Reg. Sec.1-6664-4(b)(1), reliance on a tax advisor may be considered reasonable when the taxpayer knew that the tax advisor possessed specialized knowledge in the relevant aspects of federal tax law.

In the case Neonatology Assoc., P.A. v. Commr., 115 T.C. 43, 99 (2000), aff’d 299 F.3d 211 (3d Cir. 2002) the court held:

1. Taxpayer reliance on an insurance agent was found to be unreasonable because the insurance agent was not a tax professional;

2. The taxpayers were sophisticated and should have known that the tax benefits discussed were “too good to be true’;

3. The court rejected the evidence the taxpayers presented that they also relied on tax attorneys and accountants.

In Stanford v. Commr., 152 F3d 450 (5th Cir. 1998) the court held:

1. Taxpayer could rely on a CPA with extensive experience in international banking law for advice regarding the taxpayer's controlled foreign corporation.

2. It was not reasonable to expect the couple to monitor their CPA to make sure he conducted sufficient research to give knowledgeable advice.

3. Intelligent investors have independent educated experts to advise them, particularly with respect to arcane matters of the law.

4. The Court vacated the penalty since the CPA was diligent in reviewing the taxpayer's business and tax records, and studying the statute, legislative history and regulations.

In Larson v. Commr., TC Memo 2002-295, 84 T.C.M. 608 (2002), the Court held that to satisfy the "reasonable cause" and "good faith" exception, the taxpayer must provide necessary and accurate information to the tax advisor. In Larson, the taxpayer received an incorrect Form 1099 which due to a printing error, read $1,891 (not $21,891). Here, the "reasonable cause" and "good faith" exception did not apply since the taxpayer had reason to believe that the tax reported on the tax return was not accurate and the taxpayer should have made additional efforts to assess the proper amount of his tax liability.

In Woodson v. Commr., 136 T.C. 585 (2001), the court held that the taxpayer's reliance on a return preparer did not constitute reasonable cause, since to qualify for the "reasonable cause penalty exception" the taxpayer must rely in good faith on the tax advisor's judgment or advice.

In Woodson, the tax return failed to include a $3.4M tax item and substantially understated the tax liability, the result of a "clerical mistake". Here the court did not apply the reasonable cause exception because the tax professionals did not provide advice to the taxpayers.

Under Treas. Reg. Sec. 1-6664-4(c)(2), tax advice constitutes analysis on the conclusions of a professional tax advisor. Here, the taxpayers did not provide evidence to show that a professional tax advisor's analysis or conclusions led to the omission of the item on the tax return. The taxpayers were not able to satisfy the "reasonable cause" and "good faith" defense as the taxpayers did not review the proposed return to ensure that the income items were included.

In Thomas v. UBS, 7th Cir. (2013), the court held that the Swiss Bank, UBS, is not liable to U.S. account owners for fines and interest paid when confessing to the IRS about their foreign accounts. The U.S. accountholders sued UBS, claiming the bank didn't give them accurate tax advice and should have kept them from breaking the law. The court threw out their lawsuit, saying they were tax cheats who didn't merit a day in court.

In Canal Corp. v. Commr., 135 T.C. 199 (2010), the court held that taxpayers may defend against the “accuracy-related” penalty, when the taxpayers rely on a tax professional, under a “three-prong test”:

1. The taxpayer provided necessary and accurate information to the advisor.

2. The taxpayer acted in good faith on the tax professional’s advice.

3. The tax advisor had apparent expertise to justify reliance.

In Canal the test was not satisfied and the court imposed accuracy-related penalties despite the taxpayer’s reliance on a sophisticated advisor.

Taxpayers must not rely on tax professionals that provide tax advice that they personally know is incorrect or that they believe might not be correct based on their previous experience or business knowledge. Additionally, taxpayers should review any Form 1099s or other informational returns they receive to ensure they are complete and accurate.

In the case of U.S. v. Williams (U.S. App. Lexis 15017), (4th Cir. Va., July 20, 2012) (unpublished)), the 4th Circuit reviewed a District Court judgment that for civil penalty purposes Williams did not willfully fail to report his interest in two foreign bank accounts under 31 U.S.C. 5314.

The court held that Williams’ conduct constituted “willful blindness” since:

1. He chose not to report the income;

2. He knew he had an obligation to report the existence of the Swiss accounts;

3. He knew what he was doing was wrong and unlawful;

4. On his Form 1040 tax return, he “checked no” on Schedule B regarding having an interest in foreign accounts.

The 4th Circuit ruled that Williams willfully violated 31 U.S.C. Sec. 5314 (to report two foreign bank accounts).

Civil Penalties (Tax Advice)

A U.S. taxpayer who relies on the advice of a tax professional may relieve the U.S. taxpayer from civil penalties if there has been no willful neglect. Under the IRC Sec. 6664: “No penalty shall be imposed… with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion“. Under related Treasury Regulations: “Reliance on an information return, professional advice, or other facts constitutes reasonable cause and good faith if under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.”

Under IRS Circular No. 230, U.S. taxpayers may now rely on tax opinions for relief from penalties only, if:

1. The tax opinion is based on a full legal and factual review and covers all the issues;

2. The drafter of the tax opinion may not be involved directly or indirectly with the "tax-shelter" promoter; i.e., it must be an independent tax opinion.

In the case of Canal Corp. v. Commr.,135 T.C. 199 (2010), the court held that the taxpayer could not rely upon Price Waterhouse Cooper's (PWC) tax opinion (for which they paid $800,000) because of PWC's involvement with the "underlying structures"; i.e. the tax shelter.

A U.S. taxpayer may avoid civil penalties if the U.S. taxpayer;

Makes full disclosure;

To an independent tax professional;

Who is experienced in the area of law;

Receives, reviews and understands the advisor's tax opinion;

No "blind reliance" on the tax opinion; i.e. two tests: "You should know better", or "It's too good to be true".

The taxpayer must rely upon the opinion; and

The taxpayer must follow the plan and the opinion.

Criminal Penalties (Willfulness)

For a U.S. taxpayer to avoid criminal prosecution, the tax rules are different than those tax rules for imposition of civil penalties. Tax crimes require "intent"; i.e. the U.S. taxpayer deliberately and intentionally pursued a criminal course of conduct.

The U.S. taxpayer must demonstrate that he had "a good faith belief" that he did not owe tax. If so, the U.S. taxpayer may be able to prevent a criminal conviction but not necessarily prevent being criminally prosecuted. The U.S. taxpayer must demonstrate that their "tax theory" (however misguided) was in "good faith" in order to negate the "intent element" of the crime of tax evasion.

For example, in the case of Vernice Kuglin, she successfully convinced a jury that the IRS's failure to respond to her written inquiry regarding the need to file a tax return or pay tax on over $900,000 in U.S. taxable income was a "reasonable, good faith belief" and she was not convicted of tax evasion.

For example, in the 2007 case of Tom Cryer (an attorney in Louisiana) tax evasion charges were dropped and he was acquitted on charges of willfully failing to file a tax return. Cryer's defense was that the IRS refused to respond to his repeated demand that the government explain why his "tax theories" were not viable, instead they refused to respond to Cryer, stating his tax positions were "frivolous".

At trial, Cryer convinced jurors that he genuinely believed he owed no tax for the years in question, and without proof of criminal intent, he was acquitted.

In the case of the actor Wesley Snipes, he provided the IRS with a 600-page explanation of why he was a "non-taxpayer" which the IRS ignored as a "tax protester" manifesto. He was not convicted of tax evasion (i.e. a felony) but was convicted for failure to file a tax return (misdemeanor) and was sentenced to three one-year consecutive prison terms.

For civil tax penalties, U.S. taxpayers must demonstrate the key element for a penalty defense; i.e. reasonable reliance on counsel. In criminal courts, reliance on counsel is essential but the courts give wide latitude with respect to a willfulness defense and the taxpayer's "good faith belief".

In criminal cases, the prosecutor must prove beyond a reasonable doubt willfulness, or specific criminal intent, which means that the defendant:

1. Knew and understood the law; and

2. Intentionally set out to violate it; i.e. had the purpose of evading assessment or collection of taxes.

Regarding willfulness, the defendant may present a good faith defense, including good faith belief and reliance when reliance includes all that the defendant read and heard. According to the U.S. Supreme Court, good faith is a defense, no matter what the belief. However, the defendant is not allowed willful blindness; i.e. the defendant intentionally concealed the truth from himself.

Criminal penalties may be imposed for intentionally violating federal tax laws (i.e. willful violation). "Ignorance of the law excuses no one" is a legal principle holding that a person who is unaware of a law may not escape liability for violating that law merely because he or she is or was unaware of its content.

Under U.S. Model Penal Code Sec. 2.02(9), knowledge that at an activity is unlawful is not an element of an offense unless the statute creating the offense specifically makes it one.

In Cheek v. U.S. (1991), 498 U.S. 192, willfulness is required for federal tax crimes. In Cheek, the U.S. Supreme court reversed his conviction for willful failure to file a tax return.

Cheek's "tax theory" was that wages did not constitute income and he therefore failed to file a tax return. The U.S. Supreme Court held that Cheek was entitled to a good faith instruction to the jury; i.e. the jurors could acquit him if they found Cheek believed in good faith that he was not required to file. The prosecutor had to prove that Cheek did not rely in good faith on what he heard and read. Cheek was eventually convicted and served a year and a day.

In order to avoid criminal convictions, U.S. taxpayers must rely upon independent, competent counsel. In the case of U.S. v. Lindsey Springer, (Case No. 09 C.R. 043 JHP, Northern District of Oklahoma), the taxpayer and his attorney each received a 15 year sentence for conspiracy to defraud the U.S. and evasion of taxpayer's taxes by use of the attorney's trust account to funnel client funds and from which account client expenses were paid.

Although the good faith belief and reliance arguments may be usable as a defense in a criminal tax case, often these off-shore situations involve "money laundering" (i.e. disguising the nature or origin of the funds), in which the government may criminally prosecute under the principal of "intentional blindness" or "ignoring what is reasonable" as a basis for conviction.

The best defense is a specific tax opinion letter from an independent, competent tax professional.