Tax Avoidance vs. Tax Evasion

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Many CPAs and lawyers do not know the difference between conduct that is tax avoidance versus conduct that is criminal tax evasion. There is a big difference in both what constitutes tax avoidance versus tax evasion, and in the consequences that can result.

Tax avoidance is a lawful attempt to reduce your taxes through interpretations of the Internal Revenue Code and other federal tax law. If the IRS disagrees with your tax return position, it may audit your tax return and propose an additional amount of tax, plus interest. If the IRS finds that the reporting position was negligent, or if the additional tax is large enough, the IRS can also impose a 20% accuracy penalty. If the IRS concludes that the return position resulted from a *fraudulent* position on the return, the penalty increases to 75% of the additional tax due. The IRS can do all of this, without prosecuting the taxpayer or otherwise involving the criminal justice system.

In contrast, tax evasion could result in you serving jail time in a federal prison. You will also have to pay taxes that you owe, plus the 75% civil fraud penalty and interest. The court can also impose an additional fine as part of your punishment. This article explains how the IRS determines whether actions taken by a taxpayer rise to the level of criminal tax evasion or merely merit asserting a civil fraud or lesser penalty. This article also explains what the IRS must prove to prosecute and convict a taxpayer for tax fraud.

Distinguishing Criminal Tax Fraud from Criminal Tax Evasion

One of the most significant factors that distinguishes civil tax fraud from criminal tax evasion is the amount of tax that is owed by the taxpayer. The IRS Criminal Investigation Division is not likely to criminally prosecute a taxpayer when the deficiency amount is less than $10,000. If the tax deficiency is at least $10,000, the IRS will apply a series of factors to determine if the deficiency was caused by civil tax avoidance or criminal tax evasion.

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Tax crimes are different from most other criminal offenses because the IRS must prove that the taxpayer knew the law and intended to violate it. The U.S. Supreme Court has said that the IRS must prove an intentional violation of a known legal duty. The IRS will likely view a case as a criminal tax violation if it can prove both a substantial deficiency and that the taxpayer intentionally violated the tax laws.

Some of the factors that the IRS will consider when determining whether actions by a taxpayer are criminal violations are discussed below. In short, the IRS must prove that the taxpayer "willfully" violated the tax law. The IRS proves willfulness by investigating and identifying affirmative acts of evasion. Some of those acts of evasion are as follows:

- Is the tax return materially false? Are there false books and records?
- Has the taxpayer destroyed the accounting records?
- Is there a pattern of underreporting income for several years in a row?
- Is there a substantial amount of tax owed to the IRS?

Taxpayer Status

Another factor is the status of the taxpayer. If a taxpayer is an individual with a "profile" of note within a particular business area, otherwise "prominent" or a professional, the IRS may prosecute the taxpayer to enforce their goal of general deterrence (i.e., by sending the message to other taxpayers engaging in similar conduct that they too might end up being subject to criminal prosecution). The IRS Criminal Investigation division has very few Special Agents, so they carefully select the cases that they prosecute. The IRS wants each case to garner as much media attention as possible in order to deter other taxpayers from committing tax crimes.

Difference in Investigations

Finally, taxpayers should understand that an investigation by the Criminal Investigation Division is very different from the civil audits conducted by the IRS. Agents who investigate and prosecute tax

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crimes are “Special Agents” who carry guns and badges. In contrast, IRS “Revenue Agents” merely audit tax returns to determine if additional tax is due and owing. It is very dangerous for taxpayers to talk with IRS Special Agents because their goal is to send taxpayers to federal prison. If Special Agents show up at a taxpayer’s home and request an interview, the taxpayer should immediately call a criminal tax lawyer and not talk to the Special Agents without legal advice and representation.

For more information about how these investigations could impact you, visit FBT’s Tax Law Defined Blog.

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