Income Tax: Fraud vs. Negligence

The IRS estimates that only a small percentage of tax crime convictions, .0022 percent of taxpayers, occur in a year. Yet the IRS also estimates that 17 percent of taxpayers fail to comply with the tax code in some way. It is individual taxpayers, rather than corporations, that commit 75 percent of income tax fraud. But are all violations of the tax code fraud?

Below are some definitions and ways in which the IRS attempts to distinguish between income tax fraud and negligence.

What is Income Tax Fraud?

Income tax fraud is the willful attempt to evade tax law or defraud the IRS. Tax fraud occurs when a person or a company does any of the following:

- Intentionally fails to file a income tax return
- Willfully fails to pay taxes due
- Intentionally fails to report all income received
- Makes fraudulent or false claims
- Prepares and files a false return

Is it Negligence or Income Tax Fraud?

The IRS understands that the tax code is a complex set of regulations and rules that are difficult for most people to decipher. When careless errors occur, if signs of fraud are absent, the IRS will usually assume that it was an honest mistake rather than the willful evasion of the tax code. In this circumstance, the tax auditor will usually consider it a mistake that is attributable to negligence. Although unintentional, the IRS may still fine the taxpayer a penalty of 20 percent of the underpayment.

The IRS can usually distinguish when an error is the result of negligence or the willful evasion of the tax law. Tax auditors look for common types of suspicious and fraudulent activity, such as:

- Overstatement of deductions and exemptions
- Falsification of documents
- Concealment or transfer of income
- Keeping two sets of financial ledgers
- Falsifying personal expenses as business expenses
- Using a false Social Security number
- Claiming an exemption for a nonexistent dependent, such as a child
- Willfully underreporting income

Who Commits Income Tax Fraud?

Service workers paid mostly in cash and self-employed taxpayers running cash-based businesses have been identified as the taxpayers committing most of the tax fraud because it is easy to underreport cash income. Restaurant and clothing storeowners, car dealers, salespeople, doctors, lawyers, accountants, and hairdressers were ranked as the top offenders in a government study of income tax fraud. Service workers, such as restaurant servers, mechanics, and handymen, also commonly underreport cash income.

IRS Criminal Investigation into Income Tax Fraud

The IRS conducts investigations into alleged violations of the tax code through the IRS Criminal Investigation (CI), the law enforcement branch of the agency. CI agents investigate tax crimes, money laundering, and Bank Secrecy Act violations. Investigators use sophisticated methods to uncover computer information protected by encryption, passwords, and other barriers.

Because the tax system relies on "voluntary compliance," or the self-assessment of the taxes owed, the IRS attempts to discourage violations by publicizing convictions, seeking prison time for offenders, and by assessing fines, civil taxes, and penalties.

Penalties for Income Tax Fraud

A taxpayer that willfully attempts to evade paying income taxes is subject to criminal and civil penalties. The type of fraud will determine the applicable penalty. The following are some examples of possible punishments for specific types of tax fraud:

- **Attempt to evade or defeat paying taxes:** Upon conviction, the taxpayer is guilty of a felony and is subject to other penalties allowed by law, in addition to (1) imprisonment for no more than 5 years, (2) a fine of not more than $250,000 for individuals or $500,000 for corporations, or (3) both penalties, plus the cost of prosecution (26 USC 7201).
- **Fraud and false statements:** Upon conviction, the taxpayer is guilty of a felony and is subject to (1) imprisonment for no more than 3 years, (2) a fine of not more than $250,000 for individuals or $500,000 for corporations, or (3) both penalties, plus the cost of prosecution (26 USC 7206(1)).
- **Willful failure to file a return, supply information, or pay tax at the time or times required by law.** This includes the failure to pay estimated tax or a final tax, and the failure to make a return, keep records, or supply information. Upon conviction, the taxpayer is guilty of a misdemeanor and is subject to other penalties allowed by law, in addition to (1) imprisonment for no more than 1 year, (2) a fine of not more than $100,000 for individuals or $200,000 for corporations, or (3) both penalties, plus the cost of prosecution (26 USC 7203).

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