# First Taxpayer Victory in a "Willful" FBAR Penalty Case: Analyzing the Significance of *Bedrosian* for Future Foreign Account Disputes (Part 2)

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***Bedrosian* does not change the existing foundation from the first four civil FBAR penalty cases but it adds several important points.**

Taxpayers with unreported foreign accounts have faced a lot of bad news in recent years, as the U.S. government claimed victory in four straight cases starting in 2012, asserting the highest possible penalties for "willful" violations of the duty to file Forms TD F 90-22.1 or FinCEN Forms 114 (FBARs). Things changed in late 2017, though, when a taxpayer managed to buck the trend, convincing a district court that, despite a fairly significant amount of unfavorable evidence, the omission of a multi-million dollar account from his 2007 FBAR constituted mere negligence, not willful behavior.

This case, *Bedrosian*, 120 AFTR2d 2017-5832 (DC PA, 2017), has triggered considerable excitement within the tax community, which is both logical and predictable. The job now is to analyze the case to understand whether, or to what extent, the positive result in *Bedrosian* can benefit other taxpayers facing steep FBAR penalties assessed by the U.S. IRS and litigated by the U.S. Department of Justice (DOJ). This is far less exciting than simply jumping on the *Bedrosian* bandwagon and requires a detailed review of the first four taxpayer losses in the FBAR arena, which were cov-

ered in detail in the March 2017 issue of the Journal.[1] That article also described the evolution of civil "willful" FBAR cases.

## Fifth Case on "Willful" FBAR Civil Penalties—*Bedrosian*

After dealing four straight losses to taxpayers, the IRS and DOJ took it on the chin with *Bedrosian* in September 2017.

### Facts

Getting a clear understanding of the facts was particularly challenging in *Bedrosian*, despite a review of all documents that the parties lodged and three decisions by the court. The information below constitutes a best effort based on the available materials.[2]

Taxpayer started in the pharmaceutical industry in the late 1960s and traveled abroad on business frequently in his career. He opened an account in Switzerland at some point in the 1970s with the predecessor to UBS to facilitate payment of expenses during international trips. The balance started very small and grew over the years as a result of: (1) periodic deposits of after-tax funds via check and wire transfer from the U.S.; (2) a supposed loan that the taxpayer received from UBS of approximately $750,000; and (3) passive income that the accounts generated.

He holds an undergraduate degree and a law degree and is currently the CEO of a large, generic pharmaceutical company. He is, by all accounts, a sophisticated and financially savvy businessperson. As head of the company, he manages hundreds of people, routinely reviews and signs complex financial statements, approves corporate contracts, and analyzes complex industry regulations, among other responsibilities.

When UBS issued a loan of some $750,000 to Taxpayer, it apparently opened a subaccount (Large Account) under the existing account (Small Account), deposited the funds in the Large Account, and began investing them on behalf of Taxpayer. Much of the case centers on what Taxpayer knew, and when, about the Large Account.

The taxpayer instructed UBS not to send him any mail. He kept abreast of the financial status by meeting periodically with a UBS representative when he was in the U.S.

The taxpayer started working in 1972 with an accountant, Seymour Handelman (Accountant Handelman). Apparently, Accountant Handelman never asked Taxpayer specifically about foreign accounts, and Taxpayer never raised the topic unilaterally, at least until some point in the 1990s. At that time, Accountant Handelman allegedly advised Taxpayer (incorrectly) that he would not need to report income from the UBS accounts until he repatriated the funds or died. It is unclear whether Accountant Handelman notified Taxpayer of his duty to report the account on Form 1040, Schedule B, or to file an annual FBAR. What is certain, though, is that these things did not occur until many years later.

Accountant Handelman prepared Forms 1040 for Taxpayer from 1972 through 2006, after which he died. The taxpayer, in need of new help with return preparation, hired another accountant, Sheldon Bransky ("Accountant Bransky"). The content of Taxpayer's discussions with, and the type of documents that he provided to, Accountant Bransky are ambiguous, but there is no dispute that he prepared (1) a timely 2007 Form 1040 that omitted the $220,000 in passive income that the UBS account generated that year; (2) a 2007 Form 1040 Schedule B answering "yes" to the foreign account question and identifying "Switzerland" as the location; and (3) a late 2007 FBAR, filed in October 2008 (instead of by the deadline of June 30, 2008), reporting only the Small Account at UBS and noting that the highest balance in that account ranged from $100,000 to $1 million. The taxpayer did not convey to Accountant Bransky the erroneous advice that he received previously from Accountant Handelman to the effect that he was not required to report passive income from UBS until repatriation or death. Nevertheless, it is evident that Taxpayer continued to follow this flawed guidance because the UBS income did not appear on the original 2007 Form 1040.

UBS notified Taxpayer at some point in 2008 that he must close his accounts, presumably as a result of the U.S. government's criminal investigation of UBS and its dealing with U.S. clients. Therefore, in November 2008, Taxpayer closed the Large Account, with a balance of about $2 million, and transferred the funds to another Swiss bank, Hyposwiss. In December 2008, he sent another letter to UBS, this time closing the Small Account, with a balance of about $250,000, and domesticating the funds to his Wachovia account.

At some point in 2009, Taxpayer began to question the earlier advice from Accountant Handelman with respect to the UBS accounts. He consulted his attorney, who, in turn, hired both

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[1] See Sheppard, "Government Wins Fourth Straight FBAR Penalty Case: Analyzing *Bohanec* and the Evolution of "Willfulness" 126 JTAX 110 (March 2017).

[2] The author obtained from the district court and reviewed the following documents: Complaint filed October 27, 2015; Answer and Counterclaim filed February 26, 2016; Reply to Counterclaim filed March 21, 2016; United States' Motion for Summary Judgment filed November 30, 2016; Memorandum of Law in Support of the United States' Motion for Summary Judgment filed November 30, 2016; United States' Statement of Undisputed Material Facts filed November 30, 2016; Plaintiff's Statement of Undisputed Material Facts filed December 5, 2016; Plaintiff's Motion for Summary Judgment filed December 5, 2016; Plaintiff's Response to Defendant's Statement of Undisputed Material Facts filed December 19, 2016; United States' Response to the Plaintiff's Motion for Summary Judgment filed December 19, 2016; Plaintiff's Response to Defendant's Motion for Summary Judgment filed December 19, 2016; United States' Reply to Plaintiff's Response to Its Motion for Summary Judgment filed December 23, 2016; Order Denying Motions for Summary Judgment, April 13, 2017; Memorandum Regarding Cross-Motions for Summary Judgment, April 13, 2017; Plaintiff's Trial Memorandum filed August 28, 2017; United States' Trial Brief filed August 28, 2017; Plaintiff's Post-Trial Memorandum and Proposed Findings of Fact and Conclusions of Law filed September 14, 2017; United States' Post-Trial Brief filed September 14, 2017; Order, September 20, 2017; Findings of Fact and Conclusions of Law, September 20, 2017.

[3] See "IRS Announces Voluntary Compliance Initiative for Taxpayers With Unreported Offshore Income," JOIT Vol. 20 (June 2009) (Checkpoint only).

a forensic accountant to assist with return preparation, and a Swiss attorney to obtain all necessary data from UBS. The Swiss attorney learned as part of his project that UBS had already provided data to the IRS about the accounts that Taxpayer held. This did not alter Taxpayer's existing plan, which was to apply to resolve issues with the IRS through the 2009 Offshore Voluntary Disclosure Program (OVDP).[3]

In connection with his proposed participation in the OVDP, Taxpayer filed with the IRS in August 2010: (1) Forms 1040X for 2003-2008, reporting the passive income that the UBS accounts generated that was not shown on the original Forms 1040, and (2) a 2006 FBAR, an amended 2007 FBAR, and a 2008 FBAR, reporting both the Small Account and Large Account at UBS. The IRS rejected Taxpayer's application for the OVDP because it had already received data directly from UBS about the unreported accounts.

In April 2011, the IRS initiated an audit, starting with 2007. The taxpayer cooperated with the audit, fully responding to all information document requests (IDRs) and participating in an interview with the revenue agent. The agent determined that the FBAR violations were non-willful and presented this finding to the appropriate "panel" within the IRS. The agent later took unexpected medical leave, during which time the case was reassigned to another revenue agent. In June 2013, the second agent disagreed with the earlier conclusion about the character of the FBAR violation for 2007, asserted a "willful" penalty, and sought the highest sanction, equal to 50% of the highest balance of the Large Account. The highest balance in 2007 was $1,951,578.34, triggering a penalty of $975,789.19.

The taxpayer disputed the penalty administratively, received notice from the IRS that clemency would not be granted, made a partial payment of $9,757.89 (representing 1% of the FBAR penalty amount), and sued for a refund in the appropriate district court. The DOJ filed a counterclaim, contending that Taxpayer was liable for the remaining amount of the penalty.

**Parties' Positions**

The taxpayer and the U.S. government, represented by the DOJ, presented legal and tax positions to the district court primarily through cross-motions for summary judgment, which were denied, followed by briefing before and after the one-day bench trial. Many of these positions are not new; they have been addressed by the courts previously in *Williams*, *McBride*, *Bussell*, and *Bohanec*, often in great detail.[4] Therefore, such positions have been abbreviated or excluded below.

**Taxpayer's main arguments.** The taxpayer first argued about which standard should apply in a civil FBAR penalty case. Relying on criminal cases (*Cheek*, 498 U.S. 192 (1991) and *Ratzlaf*, 501 U.S. 135 (1994)), CCA 200603026, and the Internal Revenue Manual (IRM), Taxpayer tried to convince the court that, to sustain a civil willful FBAR penalty, the U.S. government has the burden of proving that Taxpayer intentionally violated a known legal duty, that he had specific intent. The taxpayer also made considerable noise about the incompleteness and inappropriateness of the review by the second revenue agent, who changed the FBAR penalty from nonwillful to willful.

The taxpayer focused most of his time and attention, understandably, on the key issue of whether his failure to report the Large Account on the original 2007 FBAR was willful, negligent, reasonable, or something in between. He emphasized several points in this regard during the litigation, including:

1. He relied on erroneous advice from Accountant Handelman.
2. He did not review closely the relevant Forms 1040 or FBARs before they were filed.
3. Schedule B to the 2007 Form 1040 answered "yes" to the foreign account question and identified "Switzerland" as the relevant country.
4. At the time of filing the original 2007 FBAR, he was unaware that UBS had created a Small Account and a Large Account, and he simply considered it all to be just one account.
5. He did not have in his possession statements from UBS when he filed the original 2007 FBAR.
6. He did not believe that the loan of approximately $750,000 would be counted as part of the reportable balance because that money essentially belonged to UBS, not Taxpayer.
7. He retained legal counsel, a forensic accountant, and a Swiss attorney as part of an effort to become compliant voluntarily through the OVDP, even though his application was rejected.
8. He filed Forms 1040X, FBARs, and an amended 2007 FBAR in August 2010, before the IRS started an audit.
9. He cooperated fully during the IRS audit. The taxpayer also attempted to distinguish the facts in his situation from those in prior FBAR cases, *Williams*, *McBride*, and *Bohanec*, where the courts found willful actions and inactions.[5]

Finally, Taxpayer maintained that, in the worst-case scenario, his FBAR penalty should be reduced in accordance with the "penalty mitigation guidelines." The IRM indicates that the IRS might reduce FBAR penalties if four "mitigation threshold conditions" are met in a particular case: (1) Taxpayer has no history of criminal tax or Bank Secrecy Act convictions for the preceding ten years and no history of FBAR penalty assessments; (2) no money passing through any of the foreign accounts associated with Taxpayer was from an illegal source or used to further a criminal purpose; (3) Taxpayer cooperated during the IRS audit; and (4) the IRS did not determine a fraud penalty against Taxpayer for income tax underpayments related to the foreign account.[6]

**DOJ's main arguments.** The DOJ had a different take on the facts and applicable law, of course. With respect to the burden of proof and the relevant standard, the DOJ, building on earlier successes in *Williams*, *McBride*, and *Bohanec*, argued that it needed to prove the issues by only a preponderance of the evidence (instead of by clear and convincing evidence), and that it could establish will-

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4 See Sheppard, *supra* note 1.

5 *Id*.

6 IRM section 4.26.16.6.6.1 (11/6/15).

7 Findings of Fact and Conclusions of Law, 9/20/17, pp. 7-8.

fulness for purposes of civil FBAR penalties by showing that Taxpayer knowingly violated the law (with either actual or constructive knowledge), recklessly disregarded duties, or made himself "willfully blind."

The DOJ gave little credence to the argument that the second revenue agent's actions, upping the penalty to the willful level, were improper or subject to review during a *de novo* trial before the district court. Like Taxpayer, the DOJ directed most of its energy to the issue of willfulness. It raised a long list of points through the litigation, many of which are summarized here:

1. Taxpayer is an accomplished, intelligent, experienced professional who understood, or should have taken the necessary steps to understand, his tax duties, FBAR duties, and facts related to funds held with UBS.
2. Because he signed his annual Forms 1040, taxpayer had at least constructive knowledge of, and was placed on inquiry notice about, his FBAR duties.
3. Taxpayer cannot claim ignorance of his FBAR duty for 2007 because he actually filed one, even though it was late and incomplete.
4. That taxpayer sent two separate letters to UBS to close the Large Account and the Small Account, and that funds from the Large Account were transferred to another Swiss bank, while the funds from the Small Account were repatriated, indicate that he knew that he had two accounts, not one, at UBS.
5. Taxpayer closed the Large Account merely two weeks after filing the original 2007 FBAR, which did not report the Large Account.
6. Taxpayer's supposed reliance on erroneous advice from Accountant Handelman is questionable because there is no written evidence or third-party testimony to support it; the advice was limited to income tax issues, not FBAR issues; and taxpayer did not discuss such advice with his new Accountant Bransky when Bransky took over return preparation starting with 2007.
7. Taxpayer instructed UBS to hold all mail related to the accounts, and taxpayer received only oral updates when he met periodically with UBS personnel in the U.S.
8. Taxpayer did not take any steps to resolve noncompliance with the IRS voluntarily until after he learned in 2009 that UBS had already remitted data about his accounts to the U.S. government.
9. Taxpayer presented no evidence that the $750,000 deposited into the Large Account constituted a "loan," and even if it were, a loan amount cannot be excluded when calculating the highest balance for FBAR purposes.
10. Taxpayer's noncompliance was significant, lasting for several decades, and resulting in approximately $375,000 in passive income from 2003-2007 alone.

The DOJ rejected Taxpayer's argument about entitlement to a reduced FBAR sanction under the "penalty mitigation guidelines" on the following grounds. The DOJ conceded that Taxpayer met the four thresholds described in the IRM, in that he had no previous FBAR penalty assessments before 2007; the funds in the UBS accounts were not derived from illegal sources or used for criminal purposes; Taxpayer cooperated fully during the audit; and the IRS did not assert a civil fraud penalty with respect to the unreported income stemming from the UBS accounts.

However, the DOJ underscored that the applicable process has two steps—first, to meet the four threshold criteria, and second, to check the highest balance of the relevant account. If it exceeds $1 million, a taxpayer is still subject to the most severe FBAR penalty (50% of the highest balance in the account). Because the Large Account was not declared specifically on the original 2007 FBAR, and because its balance reached over $1.9 million, the DOJ argued that the "penalty mitigation guidelines" simply do not help Taxpayer.

#### District Court Analysis

The taxpayer and the DOJ each filed a motion for summary judgment, which the court rejected, predictably. In doing so, the court noted that the "precise contours" of the concept of willfulness in the civil FBAR penalty context "have not been clearly established by statute or precedent," including CCA 200603026, the IRM, and three federal cases (*Williams*, *McBride*, and *Bohanec*). The court also said that whether Taxpayer in *Bedrosian* willfully failed to file a timely, accurate, and complete 2007 FBAR is an "inherently factual question" that is inappropriate for resolution through summary judgment. Thus, the case proceeded to trial.

**Trust fund recovery penalties are one of the most commonly litigated tax issues in the federal courts.**

After holding a one-day bench trial and reviewing the corresponding pre- and post-trial briefs, the district court rendered a taxpayer-favorable decision, the first of its kind. The main points from the decision are as follows.

In terms of standards, the district court held that for civil FBAR purposes, (1) "willful intent is satisfied by a finding that the [taxpayer] knowingly or recklessly violated the statute"; (2) "the government need not prove improper or bad purpose" by Taxpayer; (3) "willful blindness" by Taxpayer meets the standard; and (4) the government can prove willfulness through circumstantial evidence and inference, including Taxpayer's "conduct meant to conceal or mislead sources of income or other financial information."[7]

The district court identified some favorable facts for Taxpayer: 2007 Form 1040, Schedule B, checked the "yes" box in response to the foreign account question and indicated "Switzerland" as the relevant country; Taxpayer filed a 2007 FBAR reporting at least one account the balance of which ranged from $100,000 to $1 million; and Taxpayer approached his attorney to rectify matters with the

IRS before he learned that UBS had already supplied his account data to the U.S. government and it had started an investigation.[8]

It was not all positive, though. The court acknowledged expressly that Taxpayer is an educated and financially literate businessman; he took a "calculated risk" for many years before 2007 by not reporting the UBS accounts or the income that they generated (but such years were not at issue during the trial); there is "no question" that Taxpayer could have discovered easily that UBS had split the funds into a Small Account and Large Account based on the annual statements or periodic meetings with UBS personnel; and Taxpayer filed the questionable 2007 FBAR showing one account just two weeks before sending two separate letters to UBS to close two accounts. Despite all this, the court held that Taxpayer's actions "were at most negligent" and the omission of the Large Account from the original 2007 FBAR was an "unintentional oversight or a negligent act" because there "is no indication that he did so with the requisite voluntary or intentional state of mind."[9]

The court reached this determination by comparing the facts in *Bedrosian* with those in *Williams*, *McBride*, *Bussell*, and *Bohanec:*

> [W]e cannot conclude, *based on a comparison of the facts of this case compared with those of cases in which a willful FBAR penalty was imposed*, that the government has proved, by a preponderance of the evidence, that [Taxpayer's] violation of Section 5314 was willful.[10] (Emphasis added.)

In distinguishing the facts in *Bedrosian*, the court seemed to focus on the unreported accounts in the other cases being part of a larger or complex "tax evasion scheme"; the taxpayers made no efforts to disclose matters voluntarily to the IRS; the taxpayers had already been convicted of a crime; or the taxpayers lied or otherwise failed to cooperate with the IRS audit.[11]

The court summarized its ultimate holding:

> In summary, the only evidence supporting a finding that Bedrosian willfully violated Section 5314 is: (1) the inaccurate [original 2007 FBAR] itself, lacking reference to the [Large Account], (2) the fact that he may have learned of the existence of the [Large Account] at one of his meetings with a UBS representative, which is supported by his having sent two separate letters closing the accounts, (3) Bedrosian's sophistication as a businessman, and (4) [Accountant] Handelman's having told Bedrosian in the mid-1990s that he was breaking the law by not reporting the UBS accounts. None of these indicate "conduct meant to conceal or mislead" or a "conscious effort to avoid learning about reporting requirements," even if they may show negligence.[12]

**Why *Bedrosian* is Significant**

Many taxpayers facing potential FBAR penalties in the future will cite *Bedrosian*. The thrust of their arguments likely will be that the "willfulness" standard is not nearly as broad as early cases would have one believe and that the U.S. government faces significant hazards if it insists on litigating FBAR penalty cases when serious indicia of wrongdoing and specific intent are lacking. In relying on *Bedrosian*, taxpayers and their advisors might overlook other important aspects of the case, as described below.

**Potential applicability of trust fund recovery cases.** The DOJ raised for the first time in its post-trial brief the argument that the district court should interpret willfulness for purposes of civil FBAR penalties by considering this same term in the context of trust fund recovery penalties under Section 6672.[13] Except for those few diehards who obtain and read all court filings related to an important case like *Bedrosian*, everyone else will miss that the district court agreed with this, in theory. Because the district court decided in favor of Taxpayer based solely on its review and comparison of the four civil FBAR penalty cases on record, it did not address any cases decided under Section 6672. However, it did say:

> *[W]hile the court's analysis of willfulness in the context of Section 6672 of the Internal Revenue Code is surely relevant to the instant determination*, as it arises in the civil tax penalty context, we find the specific FBAR penalty cases more persuasive because they deal with the same unique requirement at issue here.[14] (Emphasis added.)

This statement indicates a clear willingness, by at least certain courts, to look to other civil cases outside the narrow context of FBAR penalties, for guidance about "willfulness." To understand the significance of this, one must first understand how broadly the IRS and the courts define "willfulness" for employment tax withholding. Section 6672(a) and Reg. 301.6672-1 contain the following general rule:

> Any person required to collect, truthfully account for, and pay over any tax imposed by [the Internal Revenue Code] who *willfully* fails to collect such tax, or truthfully account for and pay over such tax, or *willfully* attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. (Emphasis added.)

In other words, before the IRS may assert penalties on an individual under Section 6672, it must show that the individual: (1) was a "responsible person," and (2) "willfully" failed to collect, truthfully account for, and pay over certain taxes, such as payroll taxes. It is clear that the IRS must meet *both* of these elements. Indeed, the IRS's own official policy is that "the trust fund recovery penalty may be asserted against those determined to have been responsible and willful in failing to pay over the tax. *Responsibility and willfulness must both be established.*"[15] (Emphasis added.)

Trust fund recovery penalties are one of the most commonly litigated tax issues in the federal courts. They are fact-intensive and results vary depending on the court hearing the case. According to some courts, "willfulness" in the context of Section 6672 exists when the responsible person either: (1) was aware

that the taxes were unpaid and, possessing the power to pay them with funds of the entity, signed checks paying another creditor, or (2) acted "grossly negligent" or in "reckless disregard" of the fact that the taxes were due and would not be paid.[16] Other courts have held that when a responsible person lacks knowledge that the trust fund taxes are not being paid to the IRS, "willfulness" does not exist, unless the responsible person's ignorance is the result of recklessness.[17] Finally, various courts have determined that an individual's mere negligence is not "willfulness" for purposes of Section 6672.[18]

It is also helpful to turn to the IRS's own internal guidance on the issue. According to the IRM, "willfulness" means "intentional, deliberate, voluntary, reckless, knowing" failure to pay employment taxes.[19] The Manual also says that to prove willfulness, the government generally must demonstrate that "a responsible person was aware, or should have been aware, of the outstanding taxes and either intentionally disregarded the law or was plainly indifferent to its requirements."[20]

It will be interesting to see the evolution of the "willfulness" standard in civil FBAR penalty cases if future courts, following the dicta in *Bedrosian*, decide to consider Section 6672.

**Refund action instead of collection action.** Until *Bedrosian*, all four previous civil FBAR penalty cases (*Williams*, *McBride*, *Bussell*, and *Bohanec*) were collection actions, initiated by the DOJ against Taxpayer, pursuant to 31 U.S.C. section 5321(b)(2). This provision allows the DOJ to commence a civil action to recover FBAR penalties within two years of the date of assessment.

*Bedrosian* was the first case where the taxpayer went on the offensive, paying a portion of the FBAR penalty and then suing for a refund instead of waiting for the DOJ to attack. This strategy would seem to have some advantages for the taxpayer, including the ability to accelerate the fight, deprive the DOJ of additional time to develop its case, and limit the accumulation of the late-payment penalties and interest charges associated with unpaid FBAR penalties.

An interesting tidbit, which surely passed unnoticed by most, is the small amount that Taxpayer paid in *Bedrosian* to get this started. The IRS asserted an FBAR penalty for 2007 of $975,789.19, and Taxpayer paid merely $9,757.89 (1% of the total penalty) to gain access to district court. This will strike many tax professionals as odd because in federal tax and tax penalty cases (which an FBAR action is *not*), the courts generally adhere to the full-payment requirement summarized below.

With respect to jurisdiction, 28 U.S.C. section 1346(a)(1) says:

> (a) The district courts shall have original jurisdiction, concurrent with the United States Court of Federal Claims, of: (1) Any civil action against the United States for the recovery of any *internal-revenue tax* alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected *under the internal-revenue laws*. (Emphasis added.)

The federal courts have interpreted 28 U.S.C. section 1346(a)(1) to require the taxpayer to pay the entire tax assessment for the tax year at issue before filing a suit for refund.[21]

**Motion in limine—evidence about administrative actions.** As explained above, Taxpayer contended that, at the conclusion of the audit, the revenue agent and his group manager agreed that the FBAR violation was not willful, garnered support for this conclusion from the appropriate "panel" within the IRS, and expected to close the case on these terms. However, after the revenue agent unexpectedly took medical leave, a second revenue agent was assigned to the case and she decided independently to elevate the FBAR penalty to willful status. The taxpayer attempted to address this issue at trial by presenting evidence and eliciting testimony concerning the procedures, actions, analyses, and viewpoints of IRS personnel at the administrative level regarding willfulness. The DOJ opposed this by filing a motion in limine.[22]

The DOJ relied on two principal arguments. First, it argued that the proposed evidence and testimony would be irrelevant because the issue of whether Taxpayer willfully failed to file a timely and accurate 2007 FBAR is determined by the district court *de novo*, which means that the decision is based solely on the merits of the case presented to the district court, and not on any record developed at the administrative level. More specifically, the DOJ maintained that "what occurred at the administrative level is irrelevant because the enforcement action is not a review of an existing administrative record."[23]

The DOJ expanded on its position, claiming that the principles that guide judicial review of tax assessments are instructive even though the FBAR penalty, which is assessed under Title 31 of the U.S. Code instead of under

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8 *Id*. pp. 13-14.

9 Findings of Fact and Conclusions of Law, 9/20/17, p. 10.

10 *Id*.

11 *Id*. pp. 11-13.

12 *Id*. pp. 13-14.

13 United States' Post-Trial Brief filed 9/14/17, pp. 6-7.

14 Findings of Fact and Conclusions of Law, 9/20/17, p. 13.

15 IRS Policy Statement 5-14 (formerly P-5-60), IRM section 1.2.14.1.3 (6/9/03) (emphasis added). *See also* IRM 5.7.3.3 (April 1, 2005), IRM 5.17.7.1 (9/20/00).

16 See, e.g., *Muck*, 3 F.3d 1378 (CA-10, 1993); *Blais*, 612 F. Supp. 700 (DC MA, 1985).

17 Honey, 963 F.2d 1083 (CA-8, 1992), *cert. den*. 506 U.S. 1028 (1992).

18 See, e.g., *Kalb*, 505 F.2d 506, 511 (CA-2, 1974); *Dudley*, 428 F.2d 1196, 1200 (CA-9, 1970); *Calderone*, 799 F.2d 254 (CA-6, 1986).

19 IRM section 5.7.3.3.2 (4/1/05).

20 *Id*.

21 *Flora*, 362 U.S. 145 (1960); *Tracy*, 226 F. Supp. 708 (DC CA, 1963); *Kearney v. A'Hearn*, 210 F. Supp. 10 (DC NY, 1961), *aff'd* 309 F.2d 487 (CA-2, 1962); *Magnone*, 733 F. Supp. 613 (DC NY, 1989).

22 See Memorandum of Law in Support of the United States' Motion in Limine filed 8/11/17, Memorandum of Law of Plaintiff in Opposition to Defendant's Motion in Limine filed 8/18/17, and Memorandum Regarding Motion in Limine, 9/5/17 (slip op. 2017 WL 3887520), and Velarde, "Taxpayer, Government Fighting Over Evidence in FBAR Case," 2017 TNT 161-5 (Tax Analysts), 8/22/17.

Title 26 (Internal Revenue Code), is not a tax penalty. The DOJ went on to analyze the holdings in various tax refund cases and to highlight that the same conclusion about the irrelevance of the administrative record has been reached by courts addressing trust fund recovery penalty issues under Section 6672, where one key matter is whether the taxpayer acted "willfully."[24] The DOJ summarized its position:

> This trial, however, is not about what the [IRS] believed or did not believe years after Bedrosian failed to comply with the FBAR requirements, the facts considered and not considered, nor alleged flaws in its analysis. Nor is this trial about whether the [IRS] could have reached a different conclusion. Even evidence that [IRS] employees disagreed about the facts and analysis prior to the final administrative determination is not probative of whether Bedrosian's noncompliance was willful. It is for this Court to determine based on the evidence before it at trial if Bedrosian willfully kept his $2 million UBS account secret, not to review an administrative record. Consistent with tax cases and other civil actions in which courts conduct a *de novo* review, the Court should exclude as irrelevant evidence of the [IRS's] factual and legal analysis regarding Bedrosian's intent in failing to comply with the FBAR requirements.[25]

The DOJ's second main argument in its motion in limine was that even if evidence of the IRS's administrative record regarding the 2007 FBAR penalty and willfulness were relevant, it should still be excluded from trial because it would cause undue delay, a waste of time and resources, and the needless presentation of cumulative evidence. The DOJ urged the district court to consider that Taxpayer was simply attempting to convert a one-day bench trial into a multi-day affair focused not on the key legal issues (i.e., Taxpayer's actions and intent) but rather on the IRS's administrative procedures, actions, analyses, and conclusions.[26]

The district court sided quickly and completely with the DOJ on this issue. In doing so, the court said that the cases that Taxpayer cited were inapplicable, while those that the DOJ identified, particularly with respect to the preclusion of the administrative record in tax refund cases, were precedential and supported the DOJ's arguments. The district court offered the following reasoning for deciding that the evidence and testimony that Taxpayer sought to present was irrelevant and thus inadmissible under the Federal Rules of Evidence:

> Bedrosian cannot show that documents relating to the underlying IRS investigation and penalty assessment are relevant to the only question that remains in this case—whether he acted willfully when he failed to report one of his foreign accounts on his 2007 FBAR….[T]hat determination solely requires our consideration of Section 5321 and evidence pertaining to Bedrosian's state of mind in failing to accurately file his 2007 FBAR.[27]
>
> Bedrosian additionally argues that the fact that Section 5321 did not afford him an adjudicatory hearing sways in favor of admitting evidence relating to the IRS's administrative findings because he did not have "an adequate opportunity to be heard at the administrative level before the willful FBAR penalty was imposed." We disagree. Bedrosian has the chance before this Court to put forth any relevant, admissible evidence of the only issue left to be adjudicated—his state of mind in not filing an accurate 2007 FBAR. The IRS's analysis of Bedrosian's case, its preliminary conclusions regarding his FBAR violation, and the viewpoints of its personnel plainly do not go to Bedrosian's willfulness in failing to list one of his foreign accounts on his 2007 FBAR.[28]

**Additional penalties and interest charges.** Most people are familiar with penalties and interest on tax underpayments, but knowledge about these items in connection with FBAR violations is less common. *Bedrosian* presents an opporunity to highlight this obscure yet important issue. As indicated above, the taxpayer in *Bedrosian* is the only one thus far to take the attack to the DOJ, by paying a portion of the FBAR penalty and starting a refund suit in district court. The process is still a long one, even with this type of assertivness. Specifically, in *Bedrosian*, the IRS started the audit in April 2011 and asserted the FBAR penalty in June 2013; Taxpayer filed the refund suit in October 2015; and the district court ruled in September 2017.

The relevant law, which is likely to be alien to many tax practioners and their clients, provides generally that the head of an executive, judicial, or legislative agency will charge interest on any outstanding debt to the U.S. government.[29] In terms of timing, the law says that interest starts to accrue on the date that demand for payment is made[30] and that in addition to interest, the government is empowered to assess on a debt that is more than 90 days past due a late-payment penalty of up to 6% per year.[31] In *Bedrosian*, the DOJ claimed that Taxpayer was liable for not only an FBAR penalty of $975,789.19, but also interest charges and late-payment penalties, which had been accruing since around September 2013.

**Impact on current voluntary disclosure programs.** The inconsistency between the recent taxpayer victory in *Bedrosian* and taxpayer losses in *Williams III*, *McBride, Bussell,* and *Bohanec* will trigger uncertainty for taxpayers who are (1) participating in the OVDP and entertaining the idea of "opting out" to seek reduced penalties; or (2) evaluating whether to approach the IRS through the Streamline Foreign Offshore Procedure (SFOP) or Streamline Domestic Offshore Procedure (SDOP).[32]

The government victories in *Williams III*, *McBride, Bussell,* and

NOTES

23 Memorandum of Law in Support of the United States' Motion in Limine filed 8/11/17.
24 *Id.*
25 *Id.*
26 *Id.*
27 Memorandum Regarding Motion in Limine, 9/5/17.
28 *Id.*
29 31 U.S.C. section 3717(a)(1).
30 31 U.S.C. section 3717(a)(2).
31 31 U.S.C. section 3717(e)(2).
32 For a detailed discussion of these programs, see Sheppard, *supra* Note 1.

*Bohanec* caused taxpayers to be more cautious about opting out of the OVDP or applying for the SFOP or SDOP. The recent taxpayer win in *Bedrosian* might alter this mindset, triggering more confidence about reaching the nonwillful standard and an increase in applications to opt out of the OVDP or to resolve matters through the SFOP or SDOP.

## Conclusion

The first four civil FBAR penalty cases, *Williams III*, *McBride*, *Bussell*, and *Bohanec*, laid out the following groundwork:

1. The standard for asserting the highest penalties is willfulness.
2. The government is required to prove willfulness by only a preponderance of the evidence, not by clear and convincing evidence.
3. The government can establish willfulness by showing that a taxpayer violated the FBAR duty either knowingly or recklessly.
4. Recklessness might exist when a taxpayer fails to inform his accountant about foreign accounts.
5. Recklessness might also exist when a taxpayer is "willfully blind" to his FBAR duties, which can occur when the taxpayer executes but does not read and understand every aspect of a Form 1040, including all attached Schedules (e.g., Schedule B containing the foreign account question) and any separate forms referenced in the Schedules (e.g., the FBAR).
6. If the taxpayer makes a damaging admission during a criminal trial, the government will use that statement against the taxpayer in a later FBAR penalty action.
7. The taxpayer's motives for not filing an FBAR are irrelevant, as nefarious, specific intent is not necessary to trigger the highest FBAR civil penalty.
8. The government can prove willfulness through circumstantial evidence and inference, including actions by the taxpayer to conceal sources of income or other financial data.

*Bedrosian* does not change this existing foundation but it adds at least three important points:

1. A taxpayer can advance an FBAR dispute quickly, with little economic outlay upfront, by paying a small portion of the total FBAR penalty, filing a refund suit in district court, and obligating the DOJ to file a counterclaim for the unpaid amount.
2. The district court will review the matter of willfulness on a *de novo* basis, which means that the taxpayer generally will be unable to offer at trial evidence related to the IRS's administrative process in conducting the audit, determining whether willfulness existed, etc.
3. *Williams III*, *McBride*, *Bussell*, and *Bohanec* are extreme cases, entailing egregious behavior by taxpayers, with abnormally strong signs of intentional wrongdoing. They also show that some courts are still willing to draw a distinction between "negligent" behavior and willfulness, thereby forcing the government to proffer serious evidence before depriving a taxpayer of 50% of the highest value of a noncompliant foreign account.

**The government victories in *Williams III*, *McBride*, *Bussell*, and *Bohanec* caused taxpayers to be more cautious about opting out of the OVDP or applying for the SFOP or SDOP.**

FBAR disputes are no laughing matter, but *Bedrosian* engenders an old joke that goes something like this: Two guys are hiking through the woods when they come upon a large bear, growling and ready to attack. One guy kneels, grabs his running shoes from his backpack, and starts removing his heavy hiking boots. The other guy stares at him and whispers, "What are you doing? You can't outrun a bear." The first guy responds, "I don't need to outrun the bear; I only need to outrun you." Perhaps the biggest lesson from *Bedrosian* is that while taxpayers with unreported foreign accounts cannot avoid the IRS and DOJ, they just need to distance themselves from the taxpayers in *Williams III*, *McBride*, *Bussell*, and *Bohanec* to sidestep a gruesome ending. ■