Government Wins Fourth Straight FBAR Penalty Case: Analyzing *Bohanec* and the Evolution of 'Willfulness'

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To effectively mitigate FBAR penalties, taxpayers must understand the relevant law and corresponding regulations, the IRS's changing positions on the subject, and recent case law.

Nobody likes to admit personal failure or fault, and nobody likes to acknowledge that they did something intentionally wrong. Few places is this more apparent than the world of tax disputes, particularly those involving unreported foreign accounts, where the rules are complicated, the stakes are high, and the level of denial by taxpayers (to the IRS, to their representatives, and even to themselves) can be legendary.

For decades, many taxpayers with undeclared accounts avoided detection altogether, and those who were caught managed to dodge severe civil penalties thanks to old laws that capped sanctions at relatively low levels, arguments about utter ignorance of the duty to file annual Forms TD F 90-22.1 or FinCEN Forms 114 (both commonly known as "FBARs"), and the total absence of the definition of "willfulness." Things have changed dramatically, though, in the past few years. This is because the U.S. government has prevailed in four separate cases, asserting maximum FBAR penalties, which are reserved for those taxpayers committing "willful" violations. The most recent case, decided in December 2016, is *Bohanec*, 118 AFTR2d 2016-5537 (DC Calif., 2016). The fact that the U.S. government has achieved this series of victories is discouraging by itself, but the standards set by the courts can be downright dispiriting to taxpayers with ongoing FBAR problems, as well as to the tax representatives tasked with defending them.

Before taxpayers can effectively mitigate FBAR penalties, they must first possess a clear understanding of the relevant law, corresponding regulations, changing positions advanced by the IRS, evolution of the case law from 2010 through 2016, and the current standards for "willfulness." That is the aim of this article.[1]

BACKGROUND

Congress enacted the Bank Secrecy Act in 1970.[2] One purpose of this legislation was to require the filing of certain reports, like the FBAR, when doing so would be helpful to the U.S. government in carrying out criminal, tax, and regulatory investigations.[3] Among the important provisions of the Bank Secrecy Act is 31 U.S.C. section 5314. This statute, in conjunction with the underlying regulations and FBAR Instructions, requires the filing of an annual FBAR in cases where (1) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (2) had a direct financial interest in, an indirect financial interest in, signature authority over, or some other type of authority over (3) one or more financial accounts (4) located in a foreign country (5) and the aggregate value of such account or accounts exceeded $10,000 (6) at some point during the calendar year at issue.[4]

Concerned with widespread noncompliance with the FBAR filing requirement, the U.S. government has taken certain actions in recent years. For instance, the Treasury Department transferred authority to enforce the FBAR provisions from the Financial Crimes Enforcement Network (FinCEN) to the IRS in April 2003.[5] The IRS is now empowered to investigate potential FBAR violations, issue summonses, assess civil penalties, issue administrative rulings, and take "any other action reasonably necessary" to enforce the FBAR rules.[6]

Congress, for its part, enacted new FBAR penalty provisions in October 2004 as part of the American Jobs Creation Act ("Jobs Act").[7] Under the law in existence before the Jobs Act, the government could assert civil penalties against taxpayers only when it could demonstrate that they "willfully" violated the FBAR rules.[8] If the government managed to satisfy this evidentiary standard, it was authorized to assert civil FBAR penalties ranging from $25,000 to $100,000, depending on the highest balance of the unreported foreign financial account or accounts.[9]

Thanks to the Jobs Act passed in 2004, the IRS may now impose a civil penalty on any person who fails to file an FBAR when required, period.[10] In the case of non-willful violations, the maximum penalty is $10,000,[11] but the IRS cannot assert this penalty if the violation was due to "reasonable cause."[12] The Jobs Act calls for higher maximum penalties when willfulness exists. Specifically, in situations where a taxpayer deliberately failed to file an FBAR, the IRS may now assert a penalty equal to $100,000 or 50% of the balance in the account at the time of the violation, whichever amount is larger.[13] Given the astronomical balances in some unreported accounts, FBAR penalties under the Jobs Act can be enormous.

Generally, U.S. citizens and residents have four main duties when they hold a reportable interest in a foreign financial account: (1) report all income deposited into and/or generated by the account on the relevant federal income tax return (i.e., Form 1040), (2) check the "yes" box in Part III (Foreign Accounts and Trusts) of Schedule B to Form 1040 to disclose the existence and location of the foreign account, (3) electronically file an FBAR by the deadline, which has historically been June 30 and which is changing to April 15 starting with the FBAR for 2016, and (4) report the foreign account on a Form 8938 (Statement of Specified Foreign Financial Assets), depending on the facts.[14]

With respect to the second duty described above, Part III of Schedule B to Form 1040 contains an FBAR inquiry and a cross-reference. The IRS has slightly modified and expanded this language over the years, with the materials for 2016 stating the following:

> At any time during 2016, did you have a financial interest in or a signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions. If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements. If you are required to file a FinCEN Form 114, enter the name of the foreign country where the financial account is located.

FIRST CASE ADDRESSING 'WILLFUL' FBAR CIVIL PENALTIES—*WILLIAMS*

The first case concerning the imposition of a civil "willful" FBAR penalty was *Williams*, a multi-year, multi-issue case, with stops in the Tax Court ("*Williams I*"),[15] the U.S. District Court ("*Williams II*"),[16] and, ultimately, the Fourth Circuit ("*Williams III*").[17]

Key Facts

Synthesizing various court documents and decisions, the facts underlying the *Williams* cases are as fol-

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1 For readers interested in earlier coverage of this same issue, before the recent decisions in *Bohanec*, 118 AFTR2d 2016-5537 (DC Calif., 2016) and *Bussell*, 117 AFTR2d 2016-439 (DC Calif., 2015), please see the following articles by the same author. Sheppard, "Government Wins Second Willful FBAR Penalty Case: Analyzing What *McBride* Really Means to Taxpayers," 118 JTAX 187 (April 2013); Sheppard, "Third Time's the Charm: Government Finally Collects "Willful" FBAR Penalty in *Williams* Case," 117 JTAX 319 (December 2012); Sheppard, "District Court Rules That Where There's (No) Will, There's a Way to Avoid FBAR Penalties," 113 JTAX 293 (November 2010).

2 P.L. 91-508, Title I and Title II, 10/26/70.

3 *Id.* at section 202.

4 31 U.S.C. section 5314; 31 CFR section 1010.350(a).

5 68 Fed. Reg. 26489 (2003).

6 31 C.F.R. section 103.56(g), 68 Fed. Reg. 26489 (2003).

7 P.L. 108-357, 10/22/04.

8 31 U.S.C. section 5321(a)(5)(A) (as in effect before 10/22/04).

9 31 U.S.C. section 5321(a)(5)(B)(ii) (as in effect before 10/22/04).

10 31 U.S.C. section 5321(a)(5)(A).

11 31 U.S.C. section 5321(a)(5)(B)(i).

12 31 U.S.C. section 5321(a)(5)(B)(ii).

13 31 U.S.C. section 5321(a)(5)(C)(i).

14 For a detailed analysis of the Form 8938 filing requirement, see Sheppard, "The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance," 38 International Tax Journal 11 (May-June 2012); Sheppard, "Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules after IRS Issues Final Regulations," 41 International Tax Journal 25 (March-April 2015); and Sheppard, "Specified Domestic Entities Must Now File Form 8938: Section 6038D, New Regulations in 2016, and Expanded Foreign Financial Asset Reporting," 42 International Tax Journal 5 (May-June 2016).

15 *Williams*, 131 TC 54 (2008).

16 *Williams*, 106 AFTR2d 2010-6150 (DC Va., 2010).

17 *United States v. Williams*, 489 Fed. Appx. 655, 110 AFTR2d 2012-5298 (CA-4, 2012).

lows.[18] The taxpayer was a U.S. citizen at all relevant times. He earned an undergraduate degree from University of North Carolina, followed by a law degree from one of the top law schools in the country, New York University. He began his legal career as an associate attorney with a major international firm. He later worked for Mobil Oil Corporation, where he held various legal and business positions over a span of some 25 years.

In 1991, the taxpayer, on Mobil's behalf, started exploring strategic business opportunities in the former republics of the Soviet Union. Two years later, in 1993, the taxpayer opened two accounts at Credit Agricole Indosuez, S.A. (then known as Banque Indosuez) in the name of ALQI Holdings, Ltd. (ALQI), a British Virgin Islands corporation controlled by the taxpayer. The accounts were designed to hold funds earned by the taxpayer from 1993 through 2000 in connection with his oil trading in Russia and his consulting for various companies through ALQI.

The taxpayer used the same U.S. accountant for all relevant years, 1993 to 2000. He did not discuss the foreign accounts with such accountant. Moreover, when the accountant sent him a questionnaire/organizer in early 2001 to be completed by the taxpayer in order to assist the accountant in preparing the 2000 Form 1040, the taxpayer indicated that he did not have a reportable interest in a foreign account.

Swiss government officials notified the taxpayer in August 2000 of their desire to interview him with respect to the ALQI accounts. The Swiss authorities, who were apparently coordinating with their U.S. counterparts, interviewed the taxpayer in November 2000. The next day, the U.S. government directed Switzerland to freeze the accounts. It did so.

In early June 2001, the taxpayer retained U.S. tax attorneys at a reputable national firm to advise him with respect to the ALQI accounts and related tax issues. The firm met with IRS attorneys in January 2002 to discuss a possible resolution of this case on a non-criminal basis. No such settlement was reached.

The U.S. government has prevailed in four separate cases, asserting maximum FBAR penalties, which are reserved for those taxpayers committing "willful" violations.

The IRS announced a tax amnesty program, the Offshore Voluntary Compliance Initiative (OVCI), in January 2003.[19] The OVCI offered lenient settlement terms to those taxpayers who came forward of their own free will. The taxpayer, enticed by this offer, submitted his OVCI application in February 2003. The IRS rejected his application, citing the fact that the OVCI was not available to taxpayers whose applications arrived after the IRS had already initiated a civil audit or criminal investigation of the taxpayer or a related entity, or after the IRS had received information from a third-party alerting the IRS to the taxpayer's non-compliance.[20]

The IRS first pursued criminal charges against the taxpayer. In May 2003, he agreed to plead guilty to one count of criminal tax evasion and one count of criminal conspiracy to defraud the U.S. government. This plea agreement was confirmed in June 2003, when the taxpayer allocuted to the following: (1) He opened two bank accounts in the name of ALQI; (2) The purpose of the accounts was to hold funds that he received from foreign sources; (3) During the relevant years, he deposited more than $7 million in the accounts, and these funds generated more than $800,000 in passive income; (4) He knew that the funds in the accounts constituted taxable income, but he chose not to report the income to the IRS in order to avoid U.S. taxes; and (5) He was guilty of evading taxes and of conspiring with others to defraud the United States of tax revenues. The taxpayer said relatively little in his allocution regarding the non-reporting of foreign accounts, and he never specifically mentioned the FBAR:

> I also knew that I had the obligation to report to the IRS and/or the Department of the Treasury the existence of the Swiss accounts, but for the calendar year tax returns 1993 through 2000, I chose not to in order to assist in hiding my true income from the IRS and evade taxes thereon, until I filed my 2001 tax return.

At the criminal sentencing hearing in September 2003, the court imposed the following punishment on the taxpayer: nearly four years in jail, three years of supervised release, a $25,000 fine, and more than $3.5 million in restitution.

The IRS initiated a civil examination against the taxpayer approximately one year after the criminal sentence was announced. The Revenue Agent assigned to the case asked the taxpayer, in January 2007, to file an FBAR for 2000. The taxpayer claimed that this was the first time that he learned of the FBAR filing requirement. As part of the examination process, the Revenue Agent indicated that he would not conclude the matter until the taxpayer filed FBARs for all years going back to 1993. The taxpayer did so.

In May 2007, under the FBAR law in effect for 2000, the Revenue Agent asserted the maximum penalty of $100,000 per account for the two ALQI accounts on grounds that the taxpayer "willfully" violated the law.

In addition to asserting the FBAR penalty for 2000, the IRS issued a Notice of Deficiency in October 2007, proposing significant federal income

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tax liabilities, accuracy-related penalties, and civil fraud penalties for all eight years, 1993 through 2000. The IRS was able to attack the taxpayer on tax issues going back to the beginning because no statute of limitations exists in cases involving fraudulent Forms 1040.[21]

Williams I—Tax Court Opines on Novel Jurisdictional Issues

The taxpayer filed a timely Petition with the Tax Court contesting all the proposed adjustments set forth in the Notice of Deficiency, as well as the FBAR penalties that were not included therein. The IRS, predictably, filed a Motion to Dismiss the case for lack of jurisdiction as to the FBAR penalties.[22] The IRS's theory was that the provision under which FBAR penalties are asserted (i.e., 31 U.S.C. section 5321) does not fall within the Tax Court's jurisdiction. This is based on Section 7442, which provides that the Tax Court and its divisions "shall have such jurisdiction as is conferred on them by this title [26] . . . ."

No Pre-Assessment Tax Court Jurisdiction. The Tax Court began the opinion in *Williams I* by explaining that Section 6212(a) authorizes the IRS to issue a Notice of Deficiency in certain situations. For its part, Section 6213(a) provides that the tax in question may not be assessed until the IRS has issued the requisite Notice of Deficiency. It further provides that the tax assessment must be delayed pending a possible redetermination by the Tax Court if the taxpayer files a timely Petition. The Tax Court pointed out, however, that these two provisions expressly state that the Notice of Deficiency is to be sent in the case of taxes imposed by subtitle A of Title 26 (i.e., income taxes), by subtitle B of Title 26 (i.e., estate and gift taxes), or by chapters 41, 42, 43 or 44 in subtitle D of Title 26 (i.e., miscellaneous excise taxes). Therefore, by negative implication, any other taxes and items fall outside the limited jurisdiction of the Tax Court. Extending this logic, the Tax Court reasoned as follows with respect to FBAR penalties:

> The same conclusion must be reached as to the FBAR penalties imposed in Title 31: The Secretary of the Treasury is authorized by 31 U.S.C. sec. 5321(b)(1) to assess the FBAR penalty; no notice of deficiency is authorized by Section 6212(a) nor required by Section 6213(a) before that assessment may be made; and the penalty therefore falls outside our jurisdiction to review deficiency determinations.

No Post-Assessment Tax Court Jurisdiction. The issue of whether the Tax Court would have jurisdiction over a subsequent action by the government to collect FBAR penalties was not raised in the taxpayer's Petition in *Williams I*, nor was it broached in the IRS's Motion to Dismiss. Nevertheless, the Tax Court addressed this topic on its own.

A brief overview on the normal tax collection process helps put this second issue in context. The IRS is required to send a taxpayer a Notice of Intent to Levy at least 30 days before it seizes his property to satisfy tax debts.[23] To dispute the intended governmental taking, a taxpayer may file a Form 12153 (Request for Collection Due Process or Equivalent Hearing), which triggers a collection due process (CDP) hearing.[24] At the CDP hearing, the IRS Settlement Officer is charged with deciding whether the levy "balances the need for efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[25] The Settlement Officer ultimately issues a so-called Notice of Determination, which represents the IRS's final administrative decision regarding the propriety of the levy. If the Notice of Determination upholds the levy, the taxpayer may seek further review, this time from the judiciary. He exercises this right by filing a Petition with the Tax Court.[26]

In *Williams I*, the Tax Court explained that the provisions under which the IRS may place a lien or effectuate a levy are narrow. They apply only to "taxes," as well as the additions to tax, additional amounts, and penalties described in Chapter 68 of Title 26 (i.e., Sections 6651 through 6751 of the Code).[27] The Tax Court then made three points as to why it would lack jurisdiction to address any FBAR-penalty-collection issue: (1) There is no statute expanding the definition of "tax" as used in the lien and levy provisions of the Code to include the FBAR penalty; (2) The collection mechanism in the applicable FBAR statute, 31 U.S.C. section 5321(b)(2), is not a lien or levy, but rather a "civil action to recover a civil penalty;" and (3) Even if the FBAR penalty were a tax subject to the IRS's lien and levy provisions, the IRS had not issued a Notice of Determination, which is a prerequisite to filing a Petition with the Tax Court.

In summary, the Tax Court set important precedent in *Williams I*, holding that it lacks jurisdiction to address FBAR issues at both the pre-assessment stage and collection stage.[28]

Williams II—District Court Refuses to Uphold FBAR Penalties

After dispensing with the FBAR jurisdictional issues,, the dispute turned to the substance in district coutrt.

Chronicle of the Briefing Battle. The taxpayer in *Williams* did not hand

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18 The facts were derived from various pleadings, briefs, and other documents filed by the parties in *Williams I*, *Williams II*, and *Williams III*, as well as the decisions in *Williams*, TCM 2009-81 (Tax Court decision granting the IRS's Motion for Partial Summary Judgment on the issue of whether the taxpayer's guilty plea to tax evasion in the earlier criminal trial collaterally estopped him from contesting in the subsequent civil tax litigation that he fraudulently underpaid his federal income taxes for 1993 through 2000) and *Williams*, TCM 2011-89 (Tax Court decision upholding the federal income taxes and civil penalties for 1993 through 2000).

19 Rev. Proc. 2003-11, 2003-1 CB 311, section 1.

20 Rev. Proc. 2003-11, 2003-1 CB 311, section 4.

21 Section 6501(c)(1).

22 The motion raised other issues that are beyond the scope of this article.

23 Section 6330(a).

24 Sections 6330(a)-(c).

25 H. Rep't 105-599, 105th Cong., 2d Sess. 263 (1998) (Conference Report); Section 6330(c)(3)(C).

26 Section 6330(d); U.S. Tax Court Rule 331(b).

27 Sections 6301, 6230, 6231, 6330, 6331, and 6665.

28 The Tax Court later issued an opinion on the substantive tax issues, holding that the taxpayer, for 1993 through 2000, was liable for federal income taxes on the net consulting income deposited into the ALQI accounts, federal income taxes on the investment income generated by the ALQI accounts, civil fraud penalties on both the consulting income and investment income, and accuracy-related penalties related to tax underpayments resulting from disallowed charitable contribution deductions. *Williams*, TCM 2011-89.

over the $200,000 to the IRS after the Revenue Agent asserted the maximum penalty in May 2007; rather, he took the position that he did not "willfully" fail to file an FBAR for 2000, so the penalty could not apply. The government, therefore, filed a Complaint in the U.S. District Court in April 2009 "for the purpose of collecting outstanding civil penalties." The government did so pursuant to 31 U.S.C. section 5321(b)(2), which provides that the government may commence a civil action to recover an FBAR penalty within two years of the date on which it is assessed.

The government then filed a Motion for Summary Judgment on the FBAR penalty issue, with the focus being whether the taxpayer "willfully" failed to file an FBAR for 2000. The government, citing *Ratzlaf*, 510 U.S. 135 (1994) (a case involving a criminal violation of the structuring provisions of the Bank Secrecy Act) and *Sturman*, 951 F.2d 1466 (CA-6, 1991) (a criminal FBAR case), argued that it needs to prove only that the taxpayer intentionally violated "a known legal duty" to prevail. Referring to his earlier guilty plea back in 2003, the government maintained that the taxpayer had already admitted in the criminal trial that he knew he had an obligation to report the existence of the Swiss accounts, he knew that the foreign-source income deposited into and generated by the such accounts constituted taxable income to him, and he knew that he was conspiring with others to escape detection by the IRS. Thus, reasoned the government, the taxpayer acted "willfully" in not filing the FBAR. In a subsequent brief on the issue, the government contended that the taxpayer's guilty plea to the criminal charges had the "collateral consequence" of subjecting him to a $200,000 civil FBAR penalty. The government also claimed that the taxpayer was trying to "have his cake and it eat too" by allocuting at the criminal trial to obtain a reduced sentence for acceptance of responsibility, and then attempting to avoid civil FBAR penalties by retracting his earlier statements.

The district court was dissuaded by the government's argument. In rejecting its Motion for Summary Judgment, the court made two main points. First, the court noted that the primary issue, whether the taxpayer "willfully" failed to file an FBAR, was an "inherently factual question" that was inappropriate for summary judgment. Second, while acknowledging that the taxpayer generally cannot disaffirm in a subsequent civil action the facts underlying an earlier criminal guilty plea, the district court explained that the real issue in this case is defining which specific facts were actually part of the taxpayer's plea in 2003. The taxpayer previously admitted that he intentionally omitted income from his Forms 1040 for 1993 through 2000, but "there is a disconnect between this broad factual basis underlying his plea and the specific question at issue here: whether on June 30, 2001, [the taxpayer] willfully failed to submit [an FBAR] for tax year 2000."

The case thus advanced to trial. In its post-trial briefs, the government recognized that "willfulness" is rarely demonstrated with direct evidence since it involves the taxpayer's state of mind. Therefore, the government pointed toward the taxpayer's overall course of conduct, focusing on his guilty plea to tax evasion and conspiracy to defraud, his actions to conceal the unreported income, and his willful ignorance, i.e., his "conscious effort to avoid learning about reporting requirements."

Counsel for the taxpayer countered by arguing here, as he had in previous briefs, that (1) the taxpayer did not "willfully" fail to file the FBAR for 2000, (2) the government waived its right to assert the FBAR penalty when it took control of the accounts by having them frozen before the FBAR deadline of 6/30/01, (3) the government abused its administrative discretion in asserting the maximum FBAR penalty of $100,000 per account when congressional reports confirm that thousands of other taxpayers in similar situations had received little to no penalties, and (4) even if penalties were appropriate, only one account (divided into sub-accounts for administrative purposes) instead of two accounts existed, thereby cutting the penalty to $100,000.

District Court Finds that the Taxpayer Did Not Act 'Willfully.' The district court in *Williams II* issued its opinion in favor of the taxpayer in September 2010, basing its determination on two principal factors.

The court first indicated that the government did not adequately differentiate between simply failing and "willfully failing" to disclose an interest in foreign accounts. In this regard, the court explained that, after examining all the surrounding facts and circumstances presented during the trial process, it was not persuaded that the taxpayer was lying about his ignorance of the law and the contents of his Form 1040. The court acknowledged that the box on Schedule B to the taxpayer's Form 1040 for 2000 was checked "no" in response to the foreign-account question, and further understood that the taxpayer did not initially file an FBAR for 2000. However, the court underscored that both of these actions (or inactions) occurred *after* the taxpayer discovered that the Swiss and U.S. authorities knew about the ALQI accounts. Indeed, the FBAR filing deadline for accounts existing in 2000 (i.e., 6/30/01) was approximately eight months after the interview with the Swiss authorities and the resulting freezing of the accounts. According to the court, these "strongly indicate to the Court that [the taxpayer] lacked any motivation to willfully conceal the accounts from authorities after that point." The court also noted that subsequent disclosures by the taxpayer, through his representatives, corroborated his lack of willfulness with respect to 2000. In particular, the court identified the disclosures made by the taxpayer's attorneys in their meeting with the IRS attorneys in January 2002 and the revelations made in the course of applying for the OVCI in February 2003. These disclosures, noted the court, indicate the taxpayer's "consciousness of guilt for evading income taxes, which he never equated with the foreign banking disclosure."

The court next stressed that a guilty plea to *certain* charges in a previous criminal trial does not necessarily support *all* civil penalties in a subsequent matter. It held the following on this score:

> The Government argues that Williams' guilty plea should estop him from arguing that he did not willfully violate § 5314 for the tax year 2000. However, the evidence introduced at trial established that the scope of the facts established by Williams' 2003 guilty plea are *not* as broad as the Government suggests, and there remains a factual incongruence between those facts necessary to his guilty plea to tax evasion and those establishing a willful violation of § 5314. That Williams intentionally failed to report income in an effort to evade income taxes is a separate matter from whether Williams specifically failed to comply with disclosure requirements contained in § 5314 applicable to the ALQI accounts for the year 2000. As Williams put it in his testimony at trial, "I was prosecuted for failing to disclose income. To the best of my knowledge I wasn't prosecuted for failing to check that box."[29]

Williams III—Court of Appeals Finds Willfulness

The government, dissatisfied with the taxpayer-favorable decision by the district court, filed a notice of appeal in November 2010, followed by its opening brief with the Fourth Circuit.

The Government's Arguments on Appeal. The government raised just two issues in its brief. First, the government asked the appellate court to determine whether the taxpayer, after making various admissions in his prior criminal case, was estopped (judicially, collaterally, or both) from arguing in the subsequent civil case that his failure to file an FBAR for 2000 was not willful. Second, assuming that the taxpayer was not estopped from raising such arguments, the government urged the appellate court to decide that the district court erred in ruling that the taxpayer did not act willfully.[30] Given the nature of its analysis and holding, the Fourth Circuit never addressed the government's first issue. This article follows suit, focusing solely on the "willfulness" issue.

The government's position on appeal was that the district court erred, as a matter of law, in determining which elements must be present to prove "willfulness" in the context of a civil FBAR violation, as opposed to a criminal one.[31] Citing various decisions from the Supreme Court and appellate courts, the government maintained that, where willfulness is a condition of civil liability, (1) the concept of willfulness is broad enough to cover both reckless and knowing violations, (2) it is not necessary to prove that the taxpayer had an improper motive or bad purpose to show willfulness, and (3) evidence of a taxpayer's actions to conceal income, in conjunction with the taxpayer's failure to seek information about foreign account reporting requirements, suffices to show willfulness.[32] The government argued that the District Court arrived at its conclusion that the taxpayer did not willfully violate the FBAR rules because of its belief that the taxpayer lacked "motivation to willfully conceal" the foreign accounts after November 2000, i.e., after the time that the Swiss authorities had interviewed the taxpayer and frozen the ALQI accounts at the request of the U.S. government. According to the government, the issue of whether the taxpayer had an improper motive for not filing a timely FBAR for 2000 is not determinative of the willfulness question, so the District Court erred in basing its findings on the supposed absence of improper motivation.[33]

After suggesting that the district court applied the wrong legal standard, the government attacked the facts on which the district court rendered its decision. The government began by emphasizing that the taxpayer's plea in his earlier criminal case was a strong indication of willfulness on the FBAR matter, which the district court wrongly elected to downplay.[34] The government seized on the following language from the taxpayer's allocution:

> I also knew that I had the obligation to report to the IRS and/or the Department of the Treasury the existence of the Swiss accounts, but not for the calendar year tax returns 1993 through 2000, I chose not to in order to assist in hiding my true income from the IRS and evade taxes thereon, until I filed my 2001 tax return.

The government essentially argued that a Form 1040 goes to the IRS, while an FBAR gets sent to a special office of the Treasury Department. Thus, contended the government, when the taxpayer previously acknowledged in the criminal case that he knew of his obligation to report the existence of the Swiss accounts "to the Department of the Treasury," logic dictates that he was referring to the FBAR.[35]

The government next argued that, even if the taxpayer's motivation were the proper standard in determining willfulness in the civil FBAR context, the district court failed to recognize that the taxpayer had a significant reason for not disclosing the foreign accounts; that is, to hide the millions of pre-tax dollars deposited into the foreign accounts and to hide the passive income generated by such accounts.[36]

Interestingly, the government then suggested that, despite all the public fanfare to the contrary, the IRS may not be all that effective at identifying foreign accountholders. The taxpayer indicated at various stages of the case that he had no reason whatsoever to conceal anything from the IRS after he met with Swiss authorities about the accounts and his accounts were frozen by the Swiss authorities in November 2000 at the insistence of the U.S. government. Stated more colloquially, the taxpayer professed that he had no reason to further hide anything from the IRS once the jig was up. The government, in its opening brief, strained to suggest that (1) because the taxpayer was using a nominee to hold the account, ALQI, "there was no guaranty that the IRS would be able to connect the dots," and (2) there was no specific evidence in the record as to whether the taxpayer admitted to the Swiss authorities in November 2000 that the ALQI accounts belonged to him or

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29 Note 16 *supra* at p. 2010-6154.

30 *Williams*, *supra* note 17, Opening Brief for U.S. Government, filed 2/25/11, at pp 2-3.

31 *Id.*, at p. 33.

32 *Id.*, at pp. 34-35.

33 *Id.*, at pp. 35-36.

34 *Id.*, at p. 36.

35 *Id.*, at pp. 36-37.

36 *Id.*, at p. 38.

whether he continued to distance himself from such accounts.[37]

The government then argued that the district court's conclusion that the taxpayer had no motive to further conceal the foreign accounts after November 2000 cannot be reconciled with his interactions with his accountant. In particular, the government pointed out that, the taxpayer's accountant sent him in January 2001, the tax questionnaire/organizer related to the Form 1040 for 2000 (i.e., two months after the meeting in Switzerland and the freezing of the accounts), yet the taxpayer checked the "no" box in response to the question about foreign accounts. This, argued the government, shows the taxpayer's ongoing intent to hide the accounts.[38]

The taxpayer's high level of sophistication was the next target for the government. It noted that the taxpayer was a well-educated attorney and international businessman, who had practiced law at a prominent New York law firm, worked as a high-level oil executive, and enjoyed multiple opportunities to learn about the duty to file annual FBARs.[39] Against this backdrop, the government suggested that it was "highly improbable" that the taxpayer was unaware of his FBAR duties.[40]

Finally, the government tried to downplay some taxpayer behaviors and highlight others, depending on whether they hurt or helped the government's case. Certain actions by the taxpayer in later years could be viewed as favorable to the taxpayer. These included meeting with IRS representatives, applying for the OVCI, filing Forms 1040X for past years, and ultimately filing FBARs as part of the examination process. The government tried to completely disregard such events, underscoring that the case involved the duty to file an FBAR only as of 6/30/01, and that "disclosures in 2002 and 2003 have no bearing on that question."[41]

Rebuttal by the Taxpayer. The taxpayer was remarkably brief in his rebuttal to the government's main arguments. Regarding the government's contention that the district court erred, as a matter of law, in determining that a taxpayer's motivation is a factor in gauging willfulness, the taxpayer dismissed this as meritless.[42] Citing various legal authorities, the taxpayer reasoned that, while willfulness does not require the taxpayer to have an improper motive, a taxpayer's incentives to conceal or disclose information to the IRS are indeed relevant to determining his subjective intent.[43]

The government's secondary argument was that, even if the district court used the correct legal standard, its decision not to uphold the FBAR penalty was clearly erroneous as a factual matter for various reasons. The taxpayer countered this argument as follows. He first explained that his actions in later years (i.e., hiring reputable attorneys and accountants, meeting with IRS attorneys, applying for the OVCI, filing Forms 1040X, etc.) should factor into the analysis. The taxpayer's attorney framed his argument as a rhetorical question:

> If, as the government postulates, [the taxpayer] knew of the FBAR requirement in June 2001 and willfully failed to comply with it, why did he not backfile FBAR reports in the succeeding two years when he and his advisors executed every other conceivable government disclosure, including an amnesty application? Only one reason makes sense: [The taxpayer] had no knowledge of the FBAR requirement, and his advisors never informed him of it.[44]

Next, the taxpayer suggested that his allocution in the criminal case nearly a decade earlier, in 2003, never specifically mentioned the FBAR filing duty or his knowledge thereof. Consequently, it cannot be, as the government contends, highly probative of his willfulness.[45]

The taxpayer then challenged the notion that his denial of the existence of foreign accounts in the tax questionnaire/organizer given to his accountant in January 2001 constitutes evidence of his willfulness to conceal the accounts, even after the Swiss authorities interviewed him, and even after the U.S. authorities had frozen his Swiss accounts. The taxpayer had already retained new tax attorneys at the time his accountant was preparing the Form 1040 for 2000 and he understood that he should not discuss the foreign account matters with anyone other than the attorneys.[46] The taxpayer also suggested that, at that time, he was already assembling a team to rectify all issues concerning the foreign accounts.[47]

Finally, the taxpayer took issue with the government's assertion that he had some reason for not disclosing the foreign accounts after November 2000. The taxpayer pointed out that (1) the application and other documents related to the accounts for ALQI specifically identified the taxpayer as the beneficial owner of the accounts, (2) the Swiss authorities specifically summoned the taxpayer to Switzerland to discuss the accounts, and (3) if the taxpayer were such an educated and sophisticated person, as the government contends, he certainly would have known that the U.S. government would readily link him to ALQI and the accounts held in its name.[48]

Decision by the Fourth Circuit. The Fourth Circuit began its analysis by criticizing the legal standards on which the district court made its taxpayer-friendly decision. In particular, the Fourth Circuit indicated that the district court should not have focused on the taxpayer's motivation for not filing a timely FBAR for 2000, and, inasmuch as it did, the district court made an impermissible leap:

> In making its determination, the district court emphasized [the taxpayer's] motivation rather than the relevant issue of his intent. To the extent the district court focused on motivation as proof of the

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37 *Id.*, at p. 39.

38 *Id.*, at pp. 39-40.

39 *Id.*, at pp. 42-43.

40 *Id.*, at p. 43.

41 *Id.*, at p. 41.

42 *Williams*, *supra* note 17, Opening Brief for Taxpayer-Appellee, filed 4/28/11, at p. 35.

43 *Id.*

44 *Id.*, at pp. 37-38.

45 *Id.*, at p. 38.

46 *Id.*, at p. 39.

47 *Id.*

48 *Id.*, at p. 40. The taxpayer raised some other minor arguments in his Opening Brief, which are not featured in this article.

> lack of intent, it simply drew an unreasonable inference from the record. In November 2000, Swiss authorities met with [the taxpayer] to discuss the ALQI accounts and thereafter froze them at the request of the United States Government. Although the [U.S.] Government knew of the existence of the accounts, nothing in the record indicates that, when the accounts were frozen, the [U.S.] Government knew the extent, control, or degree of [the taxpayer's] interest in the accounts or the total funds held in the accounts. As [the taxpayer] admitted in his allocution [at the criminal trial], his decision not to report the accounts was part of his tax evasion scheme that continued until he filed his 2001 tax return. Thus, his failure to disclose information about the ALQI accounts on his 2000 tax return in May 2001 was motivated by his desire not to admit his interest in the accounts, even after authorities had been aware of them for over six months. Rarely does a person who knows he is under investigation by the [U.S.] Government immediately disclose his wrongdoing because he is not sure how much the [U.S.] Government knows about his role in that wrongdoing. Thus, without question, when [the taxpayer] filed in May of 2001, he was clearly motivated not to admit his interest in the ALQI accounts.[49]

Then, noting various judicial precedents in the *criminal* arena, the Fourth Circuit went on to explain what it considered the proper legal standard to be applied. It explained that (1) willfulness can be inferred from taxpayer conduct designed to conceal financial information, and (2) willfulness can also be inferred from a taxpayer's conscious effort to avoid learning about reporting requirements, i.e., "willful blindness" exists where a taxpayer knew of a high probability of a tax liability yet intentionally avoided the pertinent facts. When willfulness is a condition for *civil* liability, the Fourth Circuit indicated that this covers both knowing violations and reckless violations of a standard. It then clarified that the taxpayer's actions or inactions in this case constituted, at a minimum, "reckless conduct, which satisfies the proof requirement [for civil FBAR violations under 31 U.S.C. 5314.]"

Sparing no punches, the Fourth Circuit stated that "the evidence as a whole leaves us with a definite and firm conviction that the district court clearly erred in finding that [the taxpayer] did not willfully violate [the FBAR rules for 2000]." The court supported its decision on the following grounds.

First, the court pointed out that the taxpayer signed his Form 1040 for 2000 under penalties of perjury, thereby swearing that he had examined the Form 1040, as well as all Schedules and Statements attached to such Form 1040, and that all items were true, accurate, and complete. The court then explained that taxpayers who execute a tax return are deemed to have constructive knowledge of such return, and the taxpayer in this case was no exception to that principle. According to the court, the instructions on Line 7a in Part III of Schedule B to the 2000 Form 1040 (i.e., "see instructions and exceptions and filing requirements for Form TD F 90-22.1") put the taxpayer on inquiry notice of the FBAR duty. The taxpayer testified that he did not review his 2000 Form 1040 in general or read the information in Schedule B in particular. The court interpreted this inaction as conduct designed to conceal financial information, a conscious effort to avoid learning about reporting requirements, and "willful blindness" to the FBAR requirement.

The standards set by the courts can be downright dispiriting to taxpayers with ongoing FBAR problems, as well as to the tax representatives tasked with defending them.

Second, the court held that the taxpayer's allocution at the earlier criminal proceeding further confirms that his failure to file a timely FBAR for 2000 was willful. Seizing on one tiny portion of the taxpayer's allocution back in 2003, the court concluded that the taxpayer admitted his knowledge of the FBAR duty because he used the phrase "Department of the Treasury." This tenuous line of reasoning is as follows:

> During that allocution, [the taxpayer] acknowledged that he willfully failed to report the existence of the ALQI accounts to the IRS or Department of the Treasury as part of his larger scheme of tax evasion. This failure to report the ALQI accounts is an admission of violating [the FBAR rules] because a taxpayer complies with the [FBAR rules] by filing an FBAR with the Department of the Treasury.

Why the *Williams* Trilogy Is Noteworthy

The *Williams* cases were long, fact-intensive, and featured some ambiguous reasoning from the courts. Moreover, as this article demonstrates, *Williams III* turns out to be a groundbreaking case, one in an ever-growing line of victories for the government involving civil FBAR penalties. Given the importance of the *Williams* trilogy, a list of the significant (and often overlooked) issues is provided below.

Tax Court Lacks Jurisdiction over Civil FBAR Matters. In *Williams I*, the taxpayer attempted to dispute not only the tax issues under Title 26 of the U.S. Code (i.e., the federal income taxes, accuracy-related penalties, and civil fraud penalties for 1993 through 2000 identified by the IRS in its Notice of Deficiency), but also the FBAR penalty for 2000 under Title 31 of the U.S. Code. The Tax Court, ruling on this novel issue, held that it lacks authority to hear FBAR issues, both at the assessment stage and the collection stage. Simply put, "[t]he Tax Court has no jurisdiction to review the [IRS's] determination as to [taxpayers'] liability for FBAR penalties."[50]

Appreciating Different Assessment Periods. Although not unduly highlighted in the *Williams* cases, they demonstrate the importance of appreciating differing assessment periods. As explained above, the IRS conducted a civil audit and proposed adjustments to income and various civil

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49 Note 17 *supra*, at footnote 5.

50 Note 15 *supra*.

penalties with respect to 1993 through 2000, including FBAR penalties. In the case of false or fraudulent tax returns, the IRS faces no time constraints on assessment.[51] Where FBAR violations are concerned, however, the IRS must assess the penalty within six years of the violation.[52] Accordingly, while the taxpayer in *Williams* might have "admitted" his non-compliance by filing delinquent FBARs for 1993 through 2000 with the Revenue Agent in 2007, the IRS was able to assert an FBAR penalty for only one year, 2000, because the six-year statute had already expired for the preceding years.

FBAR Penalties in Cases with Sub-Accounts. The taxpayer raised a variety of arguments in its briefs in *Williams II*, one of which concerned the appropriate number of FBAR penalties. In particular, the taxpayer argued that the maximum penalty should be $100,000 instead of $200,000 because he opened only one foreign account, which just happened to have been divided into sub-accounts later by the bank (one for cash and the other for equities) for administrative purposes. The taxpayer, in his words, had only "a single banking relationship." In support of this theory, the taxpayer cited a bank document called "General Conditions," minutes from a meeting of the ALQI board of directors, and an ALQI corporate resolution, each of which expressly mentions one account. Given its decision in *Williams II* that the taxpayer did not act willfully, the district court did not need to address the issue, and the taxpayer did not seem to advance the sub-account issue before the Fourth Circuit during *Williams III*. Thus, the issue of just how many punishable unreported foreign accounts exist in a sub-account scenario was unanswered.

Reasonable Reliance on Qualified Tax Professionals. The reasonable-reliance-on-a-qualified-tax-professional defense was unique in *Williams II*. The government presented evidence that the taxpayer never provided any information whatsoever about the foreign accounts or foreign-source income to his accountant from 1993 through 2000. The government also demonstrated that the accountant sent the taxpayer a questionnaire/organizer each year, which specifically asked whether he had an interest in or authority over a foreign account. The taxpayer completed it for 2000, affirmatively checking the "no" box to the foreign-account inquiry.[53] Distancing himself from this reality, the taxpayer focused on the fact that he hired U.S. tax attorneys with a reputable national firm in early June 2001, and they failed to advise him to file an FBAR before 6/30/01.

The district court did not address the reliance issue in its decision in *Williams II*, centering the discussion instead on the taxpayer's motives and the distinction between not reporting income on Forms 1040 and not reporting foreign accounts on FBARs. The Fourth Circuit, however, made short order of the reliance defense in *Williams III*, underscoring the following:

> [T]o the extent [the taxpayer] asserts he was unaware of the FBAR requirement because his attorneys or accountants never informed him, his ignorance also resulted from his own recklessness. [The taxpayer] concedes that from 1993-2000 he never informed his accountant of the existence of the foreign accounts even after retaining counsel and with the knowledge that authorities were aware of the existence of the accounts.[54]

Questioning the Amount of the FBAR Penalty. The scope of FBAR "collection actions" was examined and clarified in *Williams II*. The parties had divergent opinions on the role of the district court. On one hand, the government argued that the *amount* of the FBAR penalty asserted by the IRS is not subject to judicial review, and that there is no authority for the proposition that a district court, hearing a "collection action" under 31 U.S.C. section 5321(b)(2), can review the IRS's administrative record or the factors considered by the IRS in determining the penalty amount. As summarized by the government on brief, "[a]s this case simply concerns the United States' effort to collect a debt, the Court's review is limited to determining whether or not the FBAR penalty is a valid debt."[55] In other words, the government maintained that the district court's sole job is to determine whether a taxpayer "willfully" failed to file the FBAR.

The taxpayer, on the other hand, repeatedly argued that the court had the authority under the Administrative Procedures Act to review decisions by administrative agencies, such as the IRS, for abuse of discretion and with respect to arbitrary and capricious actions. The taxpayer further suggested that, if the court were to hold that he acted willfully, it should schedule a separate briefing to address the proper amount of the penalty.[56]

Because the district court held that the taxpayer did not "willfully" fail to file the FBAR and no penalties were thus sustained, this issue was not specifically addressed in *Williams II*. Moreover, the taxpayer did not seem to renew this issue in *Williams III*. This issue remains important for the following reasons. Since the IRS was delegated the authority to assert FBAR penalties back in 2003, it has always had discretion about whether a particular taxpayer should be penalized, as the relevant provision expressly states that the IRS "may" (not "shall" or "must") assert an FBAR penalty in certain cases.[57] The IRS's discretion has expanded in recent years, covering both the existence and amount of the penalty. The relevant provision in effect in 2000 penalized only "willful" violations, and the penalty amount was the larger of $25,000 or the highest balance in the unreported account (not to exceed $100,000).[58] Under the Jobs Act, which took effect in October 2004, the IRS may use its discretion in determining the penalty amount in

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51 Sections 6501(c)(1) and (2).

52 31 U.S.C. section 5321(b)(1).

53 *Williams*, *supra* note 16, United States Proposed Findings of Fact and Conclusions of Law filed 4/26/10; United States Post-Trial Brief filed 7/1/10, at p. 10.

54 Note 17 *supra*, at footnote 6.

55 *Williams*, *supra* note 16, United States' Post-Trial Brief, filed 7/1/10, at p. 14.

56 *Williams*, *supra* note 16, Defendant Williams' Response to Government's Post-Trial Brief, filed 7/15/10, at pp. 8-10.

57 31 U.S.C. section 5321(a)(5)(A).

58 31 U.S.C. section 5321(a)(5) (in effect until 10/22/04).

cases of non-willful violations. Lest there be any doubt in this regard, the IRS's own Internal Revenue Manual outlines the following parameters for its agents: "Examiners are expected to exercise discretion, taking into account the facts and circumstances of each case, in determining whether penalties should be asserted and the total amount of penalties to be asserted."[59] This requires the IRS to decide whether the FBAR violation was attributable to "reasonable cause," which lends itself to judicial review.[60]

Assessing the Weight of Unpublished Decisions. *Williams III*, as the first decision by a federal Court of Appeals to wrangle with tricky civil FBAR issues, is important. However, it was issued as an "unpublished" opinion, expressly noting in the decision itself that "[u]npublished opinions are not binding precedent in this circuit." Many taxpayers and practitioners would like nothing better than to ignore or demote the case on this basis, but doing so would be imprudent. This is because the potential use and value of "unpublished" decisions is surprisingly broad.

Federal Rules of Appellate Procedure Rule 32.1(a) generally provides that a court may not prohibit or restrict the citation of federal judicial opinions, orders, judgments, or other written dispositions that have been designated as "unpublished," "not for publication," "non-precedential," "not precedent," or the like. Moreover, the Advisory Committee Notes to Rule 32.1 state the following:

> Rule 32.1 is extremely limited. It does not require any court to issue an unpublished opinion or forbid any court from doing so. It does not dictate the circumstances under which a court may choose to designate an opinion as "unpublished" or specify the procedure that a court must follow in making that determination. It says nothing about what effect a court must give to one of its unpublished opinions or to the unpublished opinions of another court . . . Under Rule 32.1(a), a court of appeals may not prohibit a party from citing an unpublished opinion of a federal court for its persuasive value or for any other reason. In addition, under Rule 32.1(a), a court may not place any restriction on the citation of such opinions. For example, a court may not instruct parties that the citation of unpublished opinions is discouraged, nor may a court forbid parties to cite unpublished opinions when a published opinion addresses the same issue.

The preceding procedural rule and related commentary create ambiguity regarding how much weight *Williams III* will carry in the future. One thing is for sure, though, as the IRS continues to assert large civil FBAR penalties, and as taxpayers keep challenging such penalties, the U.S. government will be citing *Williams III* early and often, as they say.

Varying Interpretations of Willfulness. Other cases have previously addressed the concept of "willfulness" in the context of criminal issues, including criminal FBAR violations. Those cases stand for the proposition that willfulness means a "voluntary, intentional violation of a known legal duty."[61] *Williams II* and *III* are important because they are the first in which the courts have interpreted the concept of "willfulness" in the civil FBAR context.

The Fourth Circuit in *Williams III* indicated that the taxpayer's conduct (i.e., checking the "no" box in response to the foreign-account question on Schedule B to his Form 1040 for 2000, not reviewing the Schedule B or its cross-references to the FBAR filing requirement, etc.) constituted "reckless conduct" and "willful blindness" to his FBAR duty. Interestingly, the legal standard applied by the Fourth Circuit in *Williams III* is significantly lower than that previously indicated by the IRS. In other words, even the IRS initially believed that it had to reach a much higher level in order to successfully assert and collect a civil FBAR willful penalty. This is evident from the following IRS materials.[62]

The IRS issued a legal memorandum in 2006, CCA 200603026, in connection with two of its international enforcement programs. One of the issues addressed was the proper interpretation of the "willfulness" standard in the context of civil FBAR penalties. The IRS's directness on this point was remarkable: "The first question is whether the phrase 'willful violation (or willfully causes any violation)' has the same definition and interpretation under 31 U.S.C. § 5321 (the *civil* penalty) and § 5322 (the *criminal* penalty). *The answer is yes.*" Lest any doubt remain, CCA 200603026 goes on to state the following:

> Both Section 5321(a)(5), providing for a civil penalty, and Section 5322(a), providing for criminal penalties, contain a similar "willfulness" requirement . . . The same word, willful, is used in both of these sections. Statutory construction rules would suggest that the same word used in related sections should be consistently construed.

In referring to a dissenting opinion in the Supreme Court case *Ratzlaf*, the IRS then explained the following in CCA 200603026:

> [W]e agree with his conclusion that in the case of the FBAR penalty, in order for there to be a voluntary intentional violation of a known legal duty, the accountholder would just have to have knowledge that he had a duty to file an FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR. *A corollary of this principle is that there is no willfulness if the accountholder has no knowledge of the duty to file the FBAR.*

Similar to CCA 200603026, the IRS acknowledges in its own Internal Revenue Manual that, in the context of willful FBAR penalties, the test is whether "there was a voluntary, intentional violation of a known legal duty" and "willfulness is shown by the person's knowledge of the [FBAR] re-

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59 IRM section 4.26.16.4 (7/1/07).

60 31 U.S.C. section 5321(a)(5) (in effect until 10/22/04); See, e.g., *Kansas City Southern Industr., Inc.*, 98 TC 242 (1992) (holding that "[i]n this case, as in others, the remedy for abuse of discretion is to disregard the consequences of the Commissioner's action or refusal to act, not to order the Commissioner to perform the act.")

61 *Cheek*, 498 U.S. 192 (1991); *Sturman*, 951 F.2d 1466 (CA-6, 1991); *Bishop*, 412 U.S. 346 (1973).

62 A number of articles explain how the legal standard for "willfulness" developed by the Fourth Circuit in *Williams III* would not only conflict with published guidance from the IRS on the civil FBAR issue, but also with various court decisions. See, e.g., Skarlatos and Sardar, "The Fourth Circuit Goes Too Far by Imposing a Willful FBAR Penalty on Reckless Conduct in the *Williams* Case," 14 Journal of Tax Practice & Procedure 15 (August-September 2012); Sardar, "What Constitutes 'Willfulness' for Purposes of the FBAR Failure-to-File Penalty?" 113 JTAX 183 (September 2010).

porting requirements and the person's conscious choice not to comply with the requirements."[63]

SECOND CASE ADDRESSING 'WILLFUL' FBAR CIVIL PENALTIES—*MCBRIDE*

Williams III sparked much controversy and confusion, but the debate over its significance did not last long because the second case addressing civil "willful" FBAR penalties, *McBride*, 908 F. Supp. 2d 1186, 110 AFTR2d 2012-6600 (DC Utah, 2012), was decided less than four months later by a district court in Utah.

The Key Facts[64]

Jon McBride, a U.S. citizen, was a partner in a domestic partnership called the Clip Company, LLC, which sold accessories that allowed people to carry mobile phones on their belts. McBride was in charge of the financial operations of the Clip Company. As with many products nowadays, the phone accessories were not made in the United States; they were produced by an outfit in Tawain ("Taiwanese Manufacturer").

Starting in 1999, the Clip Company entered into various lucrative contracts for the sale of its belt accessories to major mobile phone producers and retailers, including Ericsson, AT&T, Best Buy, and Motorola. McBride anticipated that a significant increase in revenue (approximately $2 million) would result from such contracts, so he began seeking ways to reduce or defer taxes that he, as half-owner of the Clip Company, would normally be required to pay. This effort led him in 1999 to Merrill Scott and Associates (MSA), whose operations he had seen advertised.

MSA portrayed itself as a financial management firm that allowed its clients to achieve two main goals, tax minimization and asset protection. McBride went to the offices of MSA in July 1999, where he was treated to a presentation about a potential strategy. MSA labeled the strategy the "Financial Master Plan." With respect to the goal of tax minimization, the promotional materials from MSA (1) suggested the creation of a "decontrolled" environment, achieved through the use of sophisticated financial instruments, foreign entities, and foreign accounts, (2) stated that certain foreign entities "will be used as vehicles to capture business income offshore and U.S. tax-free," (3) explained that certain funds sent to a foreign manufacturer would be "captured offshore in [a foreign entity] allowing for tax-free growth and accumulation," and (4) claimed that "by redirecting taxable income into various expense centers, you are able to save on net taxes." Apparently, after hearing the pitch about the Financial Master Plan, McBride announced his initial impression that it was tantamount to "tax evasion." The representatives of MSA, of course, refuted his claims and assured him that the Financial Master Plan was legal.

During the meeting in 1999, the MSA representatives gave McBride several pamphlets describing the Financial Master Plan, including how it affected U.S. tax and reporting duties. One of the pamphlets stated the following: "U.S. citizens are subject to specific U.S. reporting requirements for interests in foreign corporations, trusts and bank accounts. U.S. citizens and others filing Internal Revenue Service returns are not immune from requisite declaration of ownership interests in foreign entities." The pamphlet also contained this warning: "As a U.S. taxpayer, the law requires you to report your financial interest in, or signature authority over, any foreign bank account, securities account, or other financial account [and] intentional failure to comply with the foreign account reporting rule is a crime and the IRS has means to discover such unreported assets." In addition to the pamphlets, the folks at MSA also gave McBride a written legal opinion about the Financial Master Plan. The opinion was prepared by the Estate Planning Institute, P.C., which McBride learned within a week of the meeting in July 1999 was an entity controlled by or related to MSA.

McBride entered into a so-called "implementation agreement" with MSA in July 1999, whereby he purchased the Financial Master Plan for $75,000 and obligated himself to pay additional monthly fees for ongoing services from MSA. The memo field of the checks that McBride used to make the initial payment to MSA indicated that the purpose of the payments was "[b]ank account offshore."

In August 1999, Craig Taylor ("Accountant Taylor"), the accountant for McBride's business partner, sent McBride a memo expressing certain concerns about the Financial Master Plan and enclosing a newspaper article explaining that holding foreign bank accounts was often associated with tax evasion and fraudulent activity. This did not dissuade McBride from proceeding.

The Financial Master Plan was convoluted, presumably by design, and the factual findings by the district court left various aspects rather ambiguous. Accordingly, what follows is a good-faith description of the major aspects of the Financial Master Plan, including the main entities and money flow.

Pursuant to the Financial Master Plan, MSA either formed or made available to McBride two foreign entities: Drehpunkt Ltd. ("Foreign Entity One") and Lombard & Associates, Ltd.

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63 IRM section 4.26.16.4.5.3 (7/1/08); IRM section 4.26.16.6.5.1 (11/6/15).

64 The facts, analysis, and holdings were derived primarily from *McBride*, 908 F. Supp. 2d 1186, 110 AFTR2d 2012-6600 (DC Utah, 2012). The author also obtained and reviewed the following materials filed by the parties, which provided additional data: (1) Complaint dated 4/29/09, (2) Answer dated 6/18/09, (3) Plaintiff's Motion for Summary Judgment dated 10/15/100; (4) Defendant's Memorandum in Opposition of Plaintiff's Motion for Summary Judgment; (5) Plaintiff's Reply to Defendant's Opposition to Motion for Summary Judgment; (6) Order Denying Motion for Summary Judgment dated 2/24/11; (7) Notice of Supplemental Authority by Plaintiff dated 5/13/11; (8) Plaintiff's Trial Brief dated 5/14/12; (9) Defendant's Trial Brief dated 5/14/12; (10) Transcript of Bench Trial Volumes I and II dated 7/2/12; (11) Plaintiff's Proposed Findings of Fact dated 7/23/12; and (12) Defendant's Proposed Finding of Facts dated 8/22/12.

65 The materials filed with or issued by the district court in *McBride* indicate that another entity in the Bahamas, Palisades & Associates, Ltd., was formed or made available to McBride. It appears that no foreign accounts were opened under such entity and it was not otherwise pivotal to the case. Accordingly, Palisades & Associates Ltd. is not further addressed in this article.

("Foreign Entity Two").[65] These entities were controlled, at least nominally, by individuals who were either employed by or otherwise associated with MSA. Separate accounts were then opened at the Royal Bank of Scotland, in the Bahamas, for Foreign Entity One and Foreign Entity Two. MSA also established two additional entities, in Canada, at the request of McBride, Phoenix Overseas Advisors, Ltd. ("Foreign Entity Three") and Global Securities Corporation ("Foreign Entity Four"). Foreign brokerage accounts were then opened under each of these two Canadian entities to enable McBride to engage in securities transactions.

Also pursuant to the Financial Master Plan, McBride, through the Clip Company, entered into an agreement with the Tawainese Manufacturer, whereby the Clip Company would pay the Taiwanese Manufacturer an inflated price for the phone accessories. This deliberate overpayment (which the Clip Company likely treated as a component of cost-of-goods-sold) would result in "excess funds" for the Taiwanese Manufacturer, which would normally have been treated as taxable profits to the Clip Company. The Tawainese Manufacturer then sent the "excess funds" by wire transfer to the Bahamanian account of Foreign Entity One. It is unclear whether the Taiwanese Manufacturer received a fee for this accomodation.

A simplified, hypothetical example will show how this might have functioned. Say the Taiwanese Manufacturer produced and sold each phone accessory to the Clip Company for $10, and the Clip Company, in turn, could sell each accessory to the ultimate consumer for $30. This would normally render a taxable profit for the Clip Company of $20 per accessory. However, if the Taiwanese Manufacturer raised its price to $20 per accessory, the Clip Company would show a taxable profit of only $10 per accessory. The key is what happens to the extra $10 per accessory, i.e., the "excess funds" on which the IRS focused.

The next step was to get the untaxed "excess funds" back to McBride and/or the Clip Company. This was accomplished in multiple ways, including, but not limited to, the use of a "loan" arrangement. Apparently, funds were transferred from the Bahamanian account of Foreign Entity One to another foreign company controlled by MSA. Then, this company purportedly made a "loan" to the Clip Company in the form of a line-of-credit. According to the district court, this essentially allowed the Clip Company to "borrow" its own (untaxed) money. Whenever the Clip Company reached its credit limit, MSA, through the foreign company, would simply raise the limit and honor all additional requests for funds by McBride. The district court indicated that McBride instructed MSA on how, when, and where to transfer funds.

Once the untaxed funds had been repatriated, either through the "loan" arrangement or otherwise, they were used for a variety of purposes. For example, they were used for payment of regular business expenses for the Clip Company, distributions in the form of "partner draws" to McBride, mortgage payments for McBride's former wife, purchase of Christmas presents for McBride's parents, airline travel, automobile leases, investments in various entities, and satisfaction of outstanding legal fees.

In early 2001, McBride stopped receiving status reports from MSA about the foreign asssets and interest payments made on the line-of-credit. This halt of information triggered concern in McBride about the legitimacy of MSA. Therefore, in an attempt to recoup his funds, McBride persuaded MSA in March 2001 to further increase the line-of-credit for the Clip Company by $665,000 and then immediately withdrew all such funds.

During 2000 and 2001, approximately $2.7 million of otherwise taxable business profits to the Clip Company were ultimately routed to McBride. The highest balances in the unreported foreign accounts are highly relevant, too. The district court, looking to the documentation presented by the U.S. Department of Justice, determined that McBride had a reportable interest in four acccounts in each of 2000 and 2001, whose balances ranged from $10,900 to $736,902.

With respect to his Form 1040 for 2000, McBride worked with Craig Stayner ("Accountant Stayner"), who also served as the accountant for the Clip Company. McBride never discussed with Accountant Stayner his involvement with MSA, never provided him with any documentation related to MSA, and never mentioned that Accountant Taylor might have some information or expertise regarding the Finacial Master Plan and international tax and reporting obligations. Part III to Schedule B of McBride's Form 1040 for 2000 had the "no" box checked in response to the question about the existence of foreign accounts, and McBride did not file an FBAR for 2000 with the Treasury Department by the deadline of June 30, 2001. Of course, McBride signed and dated his Form 1040, thereby declaring under penalties of perjury that he had examined the Form 1040, as well as all accompanying Schedules and Statements, and, to the best of his knowledge, everything was true, correct, and complete.

McBride made a switch the next year, shifting his tax-related work to Accountant Taylor. His representative may have changed, but his actions did not: McBride checked the "no" box in Part III of Schedule B, thereby denying that he had a reportable interest in any foreign account, he neglected to file an FBAR for 2001 with the Treasury Department by 6/30/02, and he signed and dated his Form 1040, again swearing that he had reviewed and approved the entire Form 1040 for 2002, including all Schedules and Statements.

The IRS began examining McBride in 2004 for potential noncompliance issues related to his participation in the Financial Master Plan. He adopted a defensive position, refusing to provide certain documents to the Revenue Agent, denying that he had used the Financial Master Plan, professing ignorance of wire transfers from the foreign accounts of Foreign Entity

One and Foreign Entity Two, claiming that the line-of-credit to the Clip Company was a legitimate loan, and refusing to complete and submit FBARs for 2000 and 2001. The Revenue Agent eventually asserted a civil FBAR penalty for each of 2000 and 2001 "in the amount of $100,000 ($25,000 per account) for his willful failure to report his interest in the foreign accounts."[66] In other words, the Revenue Agent asserted a total "willful" FBAR penalty of $200,000, i.e., $100,000 for each year, which he presumably believed was the maximum penalty allowed under the law applicable to those two years.

Holdings by the District Court

The distrct court made a number of interesting holdings.

Burden of Proof in Civil FBAR Collection Cases. The district court in *McBride* began its analysis by addressing the burden-of-proof issue. It explained that the relevant statute, 31 U.S.C. section 5321(b)(2), simply allows the U.S. government to "commence a civil action to recover a civil penalty assessed" under the relevant FBAR provisions, but does not specify the legal standard that applies. The court then pointed out that only one federal court has directly spoken to this issue, i.e., the district court in *Williams II*. There, it was determined that the burden-of-proof on the U.S. government is "the preponderance of the evidence" on all issues, including the issue of whether a taxpayer's failure to file an FBAR was "willful." Wrapping itself in the logic of *Williams II*, the district court in *McBride* reasoned as follows:

> The preponderance of the evidence standard applied by the district court in [*Williams II*] is the correct standard. As with Government penalty enforcement and collection cases generally, absent a statute that prescribes the burden of proof, imposition of a higher burden of proof is warranted only where 'particularly important individual interests or rights' are at stake. Because the FBAR penalties at issue in this case only involve money, it does not involve 'particularly important individual interests or rights' as that phrase is used in [the relevant cases].[67]

Analysis of Willfulness Issue. With the burden-of-proof issue resolved, the district court turned to the elements that the U.S. government must establish in order to collect a "willful" FBAR penalty. The majority of the elements were undisputed, leaving the focus squarely on the question of whether McBride had "willfully" failed to file FBARs for 2000 and 2001. Indeed, 18 pages of the court's 25-page legal analysis were devoted solely to the "willfulness" issue. Breaking this into digestible pieces is thus required.

Standard for Determining Willfulness in Civil FBAR Cases. Adhering to a line of reasoning presented earlier by the Fourth Circuit in *Williams III*, the district court indicated that "willfulness" in this context includes not only knowing FBAR violations, but also reckless ones. The district court, citing to precedent from the Supreme Court as well as *Williams III*, then explained that "willful blindness" satisfies the willfulness standard in both criminal and civil contexts. Finally, the district court noted that willful intent can be proven by circumstancial evidence, and reasonable inferences can be drawn from the facts because direct proof of a taxpayer's intent is rarely available.

Taxpayer Had Constructive Knowledge of the FBAR Requirement. The district court next turned to McBride's level of knowledge of the FBAR filing requirement. Its ultimate conclusion on this issue is remarkably clear, but the court's analysis meandered somewhat. The court cited the general rule that all taxpayers are charged with knowledge, awareness, and responsibility for all tax returns executed under penalties of perjury and filed with the IRS. The court then underscored that the only case thus far to examine willfulness in the context of civil FBAR penalties is *Williams III* and summarized the government-favorable holdings in that case. The court next recognized that several cases stand for the proposition that the taxpayer's signature on a tax return does not, by itself, prove that the taxpayer had knowledge of the contents of the return. The court distinguished such cases, though, by emphasizing that the language therein about "knowledge of the contents of the return" refers to the taxpayer's awareness about specific figures on the return. When dealing with the FBAR situation, the court pointed out that "knowledge of what instructions are contained within the form is directly inferable from the contents of the form itself, even if it were blank." Fortifying its position, the court went on to cite and quote various criminal cases, including a criminal FBAR case, where the courts attributed to the taxpayer knowledge of the contents of a return based solely on the taxpayer's signature on the tax return. The court, eliminating any ambiguity about its stance on constructive knowledge, rendered the following holding:

> Knowledge of the law, including knowledge of the FBAR requirements, is imputed to McBride. The knowledge of the law regarding the requirement to file an FBAR is sufficient to inform McBride that he had a duty to file [an FBAR] for any foreign account in which he had a financial interest. McBride signed his federal income tax returns for both the tax year 2000 and 2001. Accordingly, McBride is charged with having reviewed his tax return and having understood that the federal income tax return asked if at any time during the tax year he held any financial interest in a foreign bank or financial account. The federal income tax return contained a plain instruction informing individuals that they have the duty to report their interest in any foreign financial or bank accounts held during the taxable year. McBride is therefore charged with having had knowledge of the FBAR requirement to disclose his interest in any foreign financial or bank accounts, as evidenced by his statement at the time he signed the returns, under penalty of perjury, that he read, reviewed, and signed his own federal income tax returns for the tax years 2000 and 2001, as indicated by his signature on the federal income tax returns for both 2000 and 2001. As a result, McBride's willfulness is supported by evidence of his false statements on his tax returns for both the 2000 and the 2001 tax years, and his signature, under penalty of perjury, that those statements were complete and accurate.[68]

Taxpayer Had Actual Knowledge of the FBAR Requirement. More importantly, explained the court, McBride

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66 *McBride*, 908 F. Supp. 2d 1186, 110 AFTR2d 2012-6600 (DC Utah, 2012).

67 Internal citations omitted.

68 Internal citations omitted.

had actual knowledge of the FBAR filing requirement. The court identified four items in support of this determination. First, McBride read the pamphlets and other promotional material provided by MSA, which explained the duty to report an interest in foreign financial accounts. Second, McBride testified at trial that the purpose of adopting the Financial Master Plan was to avoid disclosure of certain assets and the payment of taxes thereon. Third, McBride engaged in an evasive course of conduct with the Revenue Agent during the audit, lying about certain facts and withholding information and documentation. Finally, McBride made statements at trial that contradicted his earlier sworn statements during the discovery phase of the trial.

Taxpayer Acted with Reckless Disregard or Willful Blindness. The court identified a long list of items that, together, supposedly demonstrate that McBride either willfully or recklessly disregarded the obvious risk of tax-related problems (including FBAR violations) because of his participation in the Financial Master Plan. These items included the following: (1) McBride reviewed the memo and enclosed a newspaper article from Accountant Taylor in August 1999 expressing concern about the validity of the Financial Master Plan; (2) McBride was already concerned about MSA in March 2001, well before he filed his Form 1040 for 2000; (3) McBride knew that the purpose of the Financial Master Plan was to avoid taxation and certain reporting requirements; (4) McBride knew the Financial Master Plan involved the use of foreign entities held by nominees; (5) McBride's initial impression of the Financial Master Plan was that it constituted "tax evasion;" (6) McBride did not seek a legal opinion or guidance from outside, independent counsel; (7) Part III of Schedule B to Form 1040 contained a "plain instruction" regarding disclosure of foreign accounts; and (8) McBride did not discuss with or provide information to either of his two accountants regarding the Financial Master Plan.

Why *McBride* Is an Important Case. The obvious reason that *McBride* is noteworthy is that it constitutes only the second case to wrangle with novel legal issues related to the collection of "willful" FBAR penalties. Another apparent reason is that it followed, to a certain degree, the government-favorable holding in *Williams III* that a taxpayer's constructive knowledge of the FBAR filing requirement suffices to prove willfulness. There are a number of more obscure reasons why *McBride* is significant, too. Some of these reasons, which likely went unnoticed by many taxpayers and practitioners, are examined below.

Government Reverses Course on Burden of Proof. As explained above, the district court in *McBride*, adhering to the judicial reasoning in *Williams II*, held that the proper legal standard in FBAR collection cases is preponderance of the evidence, because the relevant statute is silent on the issue and because the civil FBAR penalty involves only money, not "important individual interests or rights." The *McBride* case is noteworthy because it shows (to those who are paying close attention) how the IRS has radically changed its positon on this issue since the courts started rendering unexpected, helpful decisions.

In 2005, the IRS issued a legal memorandum on offshore issues, covering several items, including the burden on the IRS in civil FBAR penalties. This was the infamous CCA 200603026. The IRS's position at that time, looking into the proverbial crystal ball, was that the courts would obligate the IRS to reach a tougher threshold, clear and convincing evidence.

> We expect that a court will find the burden in civil FBAR cases to be that of providing "clear and convincing evidence," rather than merely a "preponderance of the evidence." The clear and convincing evidence standard is the same burden the [IRS] must meet with respect to civil tax fraud cases where the [IRS] also has to show the intent of the taxpayer at the time of the violation. Courts have traditionally applied the clear and convincing standard with respect to fraud cases in general, not just to tax fraud cases, because, just as it is difficult to show intent, it is also difficult to show a lack of intent. The higher standard of clear and convincing evidence offers some protection for an individual who may be wrongly accused of fraud . . . Because the FBAR penalty is not a tax or a tax penalty, the presumption of correctness with respect to tax assessments would not apply to an FBAR penalty assessment for a willful violation—another reason we believe that the [IRS] will need to meet the higher standard of clear and convincing evidence.[69]

It is interesting to witness the IRS's shift of position on the burden-of-proof issue during the *McBride* case. The government attorneys, anticipating that counsel for McBride might point to the IRS's legal memorandum cited above, essentially explained to the district court on brief that the IRS's position back in 2005 was, well, wrong, and it should be ignored altogether. The following shows more accurately how the IRS tried to distance itself from its earlier analysis:

> Though McBride may attempt to assert that the applicable burden of proof with respect to the issue of willfulness is the "clear and convincing standard," that assertion is wrong and unsupported by any law. Morever, McBride may not cite to Internal Revenue Service Legal Memorandum [because] 26 U.S.C. § 6110 specifically prohibits Chief Counsel Advice memoranda like the one mentioned by counsel for McBride from being either used or cited as precedent. Therefore, that memorandum has no controlling effect, and moreover should not have any persuasive value . . .[70]

It is equally interesting to see the IRS attempt to put a final spin on the burden-of-proof debate after the IRS-favorable holdings in *Williams II* and *McBride*. High-ranking IRS attorneys at the forefront of all things FBAR stated, in early 2013, that the issue has been resolved, at least from their perspective.

> [T]he IRS office of Chief Counsel initially took a conservative position when it advised field agents on the standard of proof the government must satisfy to show willfulness for the FBAR penalty, in part because the issue had not been litigated. But the courts have since agreed with the IRS that preponderance of the evidence, rather than clear and convincing evidence, is the correct standard to apply in the civil [FBAR] context.[71]

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69 "Service Discusses Foreign Bank and Financial Accounts Report Penalty," 2006 Tax Notes Today 14-14, Doc. 2006-1196 (9/1/05); CCA 200603026.

70 *McBride*, *supra* note 66, Plaintiff's Trial Brief, 5/14/12, pp. 8-9.

71 Coder, "Taxpayers Face Hurdles and Risks When Opting-Out of U.S. Offshore Voluntary Disclosure Program," 2013 Worldwide Tax Daily 12-4 (1/17/13).

Unexpected Penalties and Interest Charges. Most people are familiar with interest charges on tax underpayments and related penalties, but knowledge about interest charges connected to FBAR violations is less common. The *McBride* case presents an opporunity to highlight this obscure, yet important, issue.

This was a long affair; McBride signed up for the Financial Master Plan in 1999, he implemented it in 2000 and 2001, the IRS began the audit in 2004, the Revenue Agent asserted FBAR penalties in Summer 2007, the Department of Justice filed a Complaint in district court in April 2009, and the district court finally issued its decision in November 2012. Many things were occurring during this period, including the accrual of interest on the FBAR penalties.

The relevant law, which is likely to be alien to many tax practioners and their clients, generally provides that the head of an executive, judicial, or legislative agency shall charge interest on an outstanding debt to the U.S. government.[72] In terms of timing, the law states that interest starts to accrue the date on which demand for payment is made.[73] The law further provides that, in addition to interest charges, the government is empowered to assess on a debt that is more than 90 days past due a penalty of up to 6% per year.[74]

In its Complaint filed with the district court, the U.S. government claimed that McBride was liable not only for the FBAR penalties, but also interest charges and another penalty for not paying the FBAR penalties within 90 days of the assessment back in Summer 2007. The district court upheld these claims, tacking on another $74,621.92 to McBride's already sizable bill from Uncle Sam.

Confusion Created About the Reasonable Reliance Defense. Most taxpayers facing tax adjustments and/or penalties often look outward to justify their transgressions, and McBride was no different. He maintained that he reaonably relied on three different persons, such that FBAR penalties should be mitigated.

McBride began by arguing that he reasonably relied on Accountant Stayner with respect to his Form 1040 for 2000. The court quickly dispensed with this argument because McBride did not fully inform Accountant Stayner about his involvement with MSA and the Financial Master Plan. This ruling raises no concerns.

McBride then contended that he relied on MSA and its attorneys, presumably the ones that prepared the legal opinion about the Financial Master Plan. The court also swiftly rejected this position because such advisors lacked the necessary independence. This ruling does not cause any concerns either.

Lastly, McBride maintained that he relied on Accountant Taylor with respect to his Form 1040 for 2001. As explained earlier, the court found that, in August 1999, Accountant Taylor sent McBride a memo expressing concerns about the Financial Master Plan and enclosing an article addressing legal and compliance issues related to foreign bank accounts. The court came to the following conclusion about the supposed dependence on Accountant Taylor:

> Even if [Accountant] Taylor was fully aware of the [MSA] scheme yet failed to properly advise McBride to report his interests in the foreign accounts, this would not excuse McBride. The taxpayer, not the preparer, has the ultimate responsibility to file his or her return and to pay the tax due. This duty generally cannot be avoided by relying on an agent. McBride knew, or at least made himself willfully blind, about the need to report his interests in the foreign accounts when he signed his 2000 return. That [Accountant] Taylor may have further facilitated McBride's willful blindness a year later [in 2001] by failing to dispense proper advice does not render McBride's failure to report his interest in the foreign accounts any less willful.

This holding raises questions for two main reasons. First, the broad opening statement (i.e., that no reasonable cause would exist even if Accountant Taylor were "fully aware" of the offshore issues and failed to properly advise McBride) seems inconsistent with well-established law. The regulations recognize that a taxpayer's reasonable reliance on an independent, informed, qualified tax professional often reaches the level of reasonable cause.[75] For purposes of the reasonable-reliance defense, the regulations also broadly define the concept of "advice" to cover "any communication" from a qualified advisor and clarify that "[a]dvice does not have to be in any particular form."[76] The Supreme Court, for its part, has concluded that the IRS must liberally construe the reliance defense, stating that "[w]hen an accountant or attorney advises a taxpayer on a matter of tax law . . . it is reasonable for the taxpayer to rely on that advice" and further acknowledging that "[m]ost taxpayers are not competent to discern error in the substantive advice of an accountant or attorney."[77]

Second, in stating that McBride could not rely on others to file a return and pay the proper tax, the district court seems to blur the long line of tax cases distinguishing between reliance on tax advice (which can constitute "reasonable cause") and reliance on others to perform non-delegable ministerial tasks (which cannot constitute "reasonable cause").[78] The Tax Court has previously explained this distinction, which seemed to escape the district court in *McBride:*

> In general, a taxpayer's duty to file a return when due is a personal, nondelegable duty. Thus, reliance upon an accountant to file is ordinarily no excuse for filing a return beyond the due date. However, the Supreme Court has distinguished between the case in which a taxpayer reasonably relies on the substantive tax advice of an accountant or attorney that no return need be filed . . . Similarly, this Court has held that reasonable cause . . . can be shown by proof that the taxpayer supplied all relevant information to a competent tax adviser and relied in good faith on the incorrect advice of the adviser that no return was required to be filed.[79]

Edging Toward Strict Liability. The *McBride* case is also interesting because of the district court's broad interpre-

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72 31 U.S.C. section 3717(a)(1).

73 31 U.S.C. section 3717(a)(2).

74 31 U.S.C. section 3717(e)(2).

75 Reg. 1.6664-4(c)(1).

76 Reg. 1.6664-4(c)(2).

77 *Boyle*, 469 U.S. 241, 55 AFTR2d 85-1535 (1985).

78 *McMahan*, 114 F.3d 366, 79 AFTR2d 97-2808 (CA-2, 1997).

tation of "willfulness" in the FBAR context, which seemingly pushes the concept toward one of strict liability. Although not entirely clear, it appears that McBride argued that he was aware of the FBAR filing requirement, but decided not to comply because of his belief, based to a certain extent on the analysis of Accountant Taylor, that he did not possess a sufficient interest in the foreign accounts under the peculiar FBAR attribution rules. As the culimination to its 18-page analysis of the "willfulness" issue, the court effectively concluded that, if a taxpayer executes and files his Form 1040, all failures to file FBARs, regardless of the validity of the taxpayer's rationale for not filing, are willful and vulnerable to maximum sanctions.

> [E]ven if the decision not to disclose McBride's interest in the foreign accounts was based on McBride's belief that he did not hold sufficient interest in those accounts to warrant disclosure, that failure to disclose those interests would constitute willfulness. Because McBride signed his tax returns, he is charged with knowledge of the duty to comply with the FBAR requirements. Whether McBride believed [Accountant] Taylor had determined that a disclosure was not required is irrelevant in light of [the applicable case], which states that the only question is whether the decision not to disclose was voluntary, as opposed to accidental. The government does not dispute that McBride's failure to comply with FBAR [sic.] was the result of his belief that he did not have a reportable financial interest in the foreign accounts. However . . . the FBAR requirements did require that McBride disclose his interest in the foreign accounts during both the 2000 and 2001 tax years. As a result, McBride's failure to do so was willful.[80]

This final ruling by the district court in *McBride* is noteworthy because it seems contrary to the position taken by the IRS, historically and recently. For instance, in the portion of the Internal Revenue Manual discussing the notion of "willful blindness," the IRS indicates that "[t]he mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness."[81] It goes on to explain that, even in situations where a taxpayer admits knowledge about the FBAR question on Schedule B to Form 1040, willfulness exists only when the taxpayer is incapable of providing the IRS a "reasonable explanation" for not properly responding to the question on Schedule B and not filing an FBAR.[82]

THIRD CASE ADDRESSING 'WILLFUL' FBAR CIVIL PENALTIES—*BUSSELL*

The third case involving civil willful FBAR penalties, *Bussell*, 117 AFTR 2d 2016-439 (DC Calif., 2015), features fewer facts and a shorter holding, much to the relief of the readers of this article.

Key Facts

The taxpayer is a dermatologist from Beverly Hills, California with long-standing legal problems. For instance, she was convicted of bankruptcy fraud and tax evasion, and the Tax Court upheld civil fraud penalties against her in another matter. Before the taxpayer claimed bankruptcy in 1995, she and her late-husband organized her medical practice in order to conceal her ownership interest. They then "funneled" about $1.1 million in profits to a foreign account held in the name of a foreign entity. In 1996, the taxpayer transferred the funds to a personal account at a different foreign bank, a predecessor to UBS, in Switzerland. In 1997, the taxpayer and her late-husband opened a second account at UBS ("Subject Account"), adding their son as a signatory. The taxpayer did not report the income generated by the Subject Account on her Form 1040 for 2006 and did not file an FBAR for 2006. The highest balance during that year was just over $2.2 million. In October 2007, one week after filing the Form 1040 for 2006, the son, using his signature authority over the Subject Account, sent a letter to UBS asking it to liquidate the Subject Account and another account at UBS and transfer the funds to accounts at another Swiss financial institution, Finter Bank.

In June 2013, the IRS assessed an FBAR penalty of approximately $1.1 million for willfully not reporting the Subject Account on an FBAR for 2006. In March 2015, within the relevant two-year period, the government filed a collection action in district court, seeking a judgment ordering the taxpayer to pay the FBAR penalty, along with a penalty for failure to pay the assessment within 90 days of demand, and interest.

Holding by District Court Regarding Willfulness

The district court determined that the U.S. government was entitled to summary judgment on the issue of the taxpayer's willfulness, as she stipulated and agreed not to dispute the contentions that she willfully failed to file an FBAR reporting the Subject Account for 2006 and she willfully failed to report the existence of the Subject Account in Part III of Schedule B of Form 1040 for 2006. As if the concession by the taxpayer were insufficient, the district court proceeded to explain that the evidence in this case also confirms willfulness and that, in the context of civil FBAR penalties, the concept of willfulness encompasses "reckless disregard of a statutory duty:"

> Moreover, the record demonstrates that Defendant was willful in failing to report her financial interest in the Subject Account. Although § 5321(a)(5) does not define willfulness, courts adjudicating civil tax matters have held that an individual is willful where he/she exhibits a reckless disregard of a statutory duty. *See Safeco Ins. Co. of Am. v. Burr,* 551 U.S. 47, 57 (2007). Here, Defendant clearly acted with reckless disregard. Defendant has been convicted of bankruptcy fraud and tax fraud for her failure to disclose offshore accounts, and Defendant has been subjected to civil penalties for her failure to disclose offshore bank accounts. Defendant is aware of her statutory duty to report offshore accounts. Nevertheless, Defendant filed her 2006 tax return without reporting the Subject Account, and with-

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79 *Zabolotny*, 97 TC 385 (1991) (internal citations omitted) (holding that reasonable cause existed where two certified public accountants, fully informed of the facts, led the taxpayer to believe that no taxable event was created by the relevant transactions for which any federal excise tax returns would be required to be filed).

80 Internal citations omitted.

81 IRM section 4.26.16.4.5.3 (7/1/08); IRM section 4.26.16.6.5.1 (11/6/15).

82 *Id.*

out filing an FBAR Form. Instead of reporting the Subject Account, Defendant liquidated the Subject Account shortly after filing her tax returns [and moved them to yet another undisclosed foreign bank]. Accordingly, the Government's Motion is granted to the extent that Defendant willfully failed to report her interest in the Subject Account for 2006.

FOURTH CASE ADDRESSING 'WILLFUL' FBAR CIVIL PENALTIES—*BOHANEC*

This brings us to the most recent case involving willful civil FBAR penalties, *Bohanec*, which was decided in December 2016. The facts of the case, as well as the positions of the parties, have been cobbled together using various sources.[83]

Key Facts

August Bohanec was born in Slovenia in 1933. He attended public school in Slovenia, but was forced to miss his last three years because of World War II. He later trained as a tool-and-die maker in Slovenia. He came to the United States in the 1960s and eventually became a U.S. citizen. He is over 80 years old now. Maria Bohanec, his wife, was born in Mexico in 1943. Her highest level of formal education was sixth grade, in Mexico. She also came to the United States in the 1960s and later became a U.S. citizen. She is currently over 70 years old. August and Maria have been married approximately 45 years.

In the 1970s, the Bohanecs bought a camera shop in California ("Camera Shop"). At some point, they became a dealer of Leica cameras, a German brand. The Bohanecs initially got their product from the exclusive Leica distributor for the United States, who was located in New Jersey. Other camera retailers complained about the deals that the Bohanecs were receiving, so the exclusive U.S. distributor began restricting supply to them. The Bohanecs solved that problem by starting to buy inventory from Leitz Canada, a subsidiary of Leica. The Bohanecs were able to do this because they had previously met the president of Leitz Canada, Walter Kluck, through dealings with the Camera Shop.

The Camera Shop gained a worldwide reputation over time for selling, repairing, and refurbishing Leica camera parts. It sold and shipped to customers around the globe, including those in the Philippines, England, South Korea, and Hong Kong.

Presumably in return for the earlier favor by Kluck, the Bohanecs, in the 1980s, sales brokered transactions between Leitz Canada and various camera retailers around the world. They received commissions for such sales, which they deposited into a joint account that they held at UBS in Switzerland. In addition to depositing the sales commissions, the Bohanecs also instructed their foreign clients on occasion to send payments directly to the UBS account in Switzerland, instead of to the Camera Shop in California.

Kluck apparently opened the account for the Bohanecs and managed it while he was alive; UBS took over thereafter. From 1997 to 2007, the highest balance in the UBS account was about $1.1 million.

The Bohanecs did not provide their U.S. address to UBS, did not tell anyone about the foreign account (other than their two children), did not keep any records or use a bookkeeper, did not discuss the potential implications of the UBS account with an accountant, attorney, or banker, did not file Forms 1040 after 1998, and did not file FBARs declaring the UBS account or any other foreign account.

The Bohanecs closed the Camera Shop in the late 1980s, but they continued to sell Lecia cameras and parts on eBay, at least through 2009.

The money in the UBS account did not sit untouched. The Bohanecs made various withdrawals from the account, including, but not limited to (1) a transfer of $10,000 to their daughter, (2) transfers starting in 2003 to a joint account in Austria, (3) transfers starting in 2006 to an account in Mexico related to their construction of a home there, and (4) transfers to their domestic account in California. Transfers continued until 2010.

The only item at issue in *Bohanec* was the civil FBAR penalty for 2007. The balance of the unreported foreign accounts as of the date of the violation (i.e., 6/30/08) was $643,662.

On 1/6/10, the Bohanecs filed an application to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP). Among other things, they stated on their application, under penalties of perjury, that all funds deposited into the UBS account consisted of after-tax earnings from the camera business. The IRS issued the "preliminary acceptance letter" shortly thereafter, on 1/19/10. After what seems to be a significant delay, the Bohanecs filed with the IRS on 5/19/11, Forms 1040 for 2003 through 2008 and FBARs for 2003 through 2008. The submissions by the Bohanecs pursuant to the OVDP had some problems, namely, (1) the statement about the funds in the UBS account all being after-tax amounts was untrue, (2) the Forms 1040 were inaccurate in that they did not include the income earned by the Bohanecs through their eBay business or the passive income generated by all foreign accounts, and (3) the FBARs were inaccurate in that they reported only the UBS account, not the Austrian account and the Mexican account. As a result, the IRS ultimately rejected the Bohanecs from the 2009 OVDP and initiated a standard audit.

The results of the audit were predictable. First, the IRS issued a Notice of Deficiency, asserting additional income taxes, delinquency penalties, and large civil fraud penalties for 2003 through 2010. The Bohanecs never filed a Petition with the Tax Court challenging any aspect of the Notice

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83 Complaint by U.S. Government to Reduce FBAR Penalty to Judgment, filed 6/9/15; Answer by Taxpayers to Complaint to Reduce FBAR Penalty to Judgment, filed 7/27/15; Memorandum of Contentions of Fact and Law by U.S. Government, filed 10/3/16; Memorandum of Contentions of Fact and Law by Taxpayers, filed 10/3/16; Trial Brief by U.S. Government, filed 10/25/16; Proposed Findings of Fact and Conclusions of Law by U.S. Government, filed 10/25/16; Exhibit and Witness List by U.S. Government, filed 11/1/16; Proposed Findings of Fact and Conclusions of Law by Taxpayers, filed 11/7/16; Supplemental Proposed Findings of Fact and Conclusions of Law by U.S. Government, filed 11/7/16; and *Bohanec*, 118 AFTR 2d 2016-5537 (DC Calif., 2016).

of Deficiency. Accordingly, the IRS assessed these figures and presumably started collection actions. The liability had reached $492,164 by September 2016. Second, the IRS asserted a willful FBAR penalty for 2007 against each of August and Maria, seeking the maximum penalty, i.e., 50% of the balance of the foreign accounts at the time of the violation.

Positions Advanced by the Parties

The legal/tax positions advanced by the Bohanecs and the U.S. government did not contain any surprises, largely adhering to the arguments previously advanced in *Williams* and *McBride*. For example, counsel for the Bohanecs highlighted the following points: (1) The taxpayers are elderly and have little formal education; (2) They had never even heard of the FBAR filing requirement by 6/30/08; (3) Based primarily on CCA 200603026, the relevant portion of the IRS's own Internal Revenue Manual, and *Sturman*, the U.S. government must prove, by clear and convincing evidence, and not by merely the preponderance of the evidence, that the Bohanecs committed a "voluntary, intentional violation of a known legal duty;" (4) Because the Bohanecs never filed any Forms 1040 after 1998 until they started participating in the OVDP more than a decade later, they did not affirmatively and inaccurately check the "no" box in response to the foreign-account question in Part III of Schedule B of the annual Form 1040, and they were not placed on some type of constructive or inquiry notice by way of the cross-reference in Part III of Schedule B to the FBAR; (5) *Williams III* and *McBride* were wrongly decided with respect to the proper scope of "willfulness" in the context of civil FBAR penalties; and (6) The Bohanecs did not "willfully" violate their FBAR duty for 2007.

The district court largely accepted the line of reasoning presented by the U.S. government, which is described below. It appears that the U.S. government seemed to appreciate that the evidence tending to show that the Bohanecs acted willfully regarding the FBAR duty for 2007 was considerably weaker than the proof of the improprieties of the taxpayers in *Williams*, *McBride*, and *Bussell*. Likely for this reason, the U.S. government did not attempt to argue that the Bohanecs had actual knowledge of the FBAR duty and deliberately chose to ignore it. The government argued, instead, that the Bohanecs were "reckless" and "willfully blind" about FBARs, stating that they "consciously avoided learning of the obligations of U.S. citizens concerning foreign accounts" and "[i]f the Bohanecs did not understand their obligations under the Bank Secrecy Act of 1970, it is because they chose not to inquire about them and preferred to remain in ignorance in circumstances in which non-reckless individuals would have at least inquired as to the obligations of a U.S. citizen regarding foreign accounts."

Decision by the District Court

The district court first recited the applicable statutes and regulations mandating FBAR filing in certain circumstances. It then underscored that the relevant authorities do not contain a definition of "willfulness," such that one must look to court precedent and other sources. Next, the court quickly dispensed with the position advanced by the Bohanecs that willfulness encompasses only intentional violations of known legal duties, because no court has adopted this argument in the civil FBAR penalty context, and because the Bohanecs cited in support of their position only criminal cases (not civil penalty cases) wherein the defendants must have so-called "specific intent" to be convicted. Referencing *Williams III*, *McBride*, and *Bussell*, as well as the Supreme Court decision in *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47 (2007), the district court determined that the concept of "willfulness" for civil FBAR penalty purposes extends to reckless disregard of a statutory duty. The court, in arriving at this standard, indicated that two items containing language favorable to taxpayers, CCA 200603026 and the Internal Revenue Manual, did not have any precedential value.

With respect to the burden of proof, the district court, deferring to earlier decisions by the Supreme Court, indicated that the higher level (i.e., clear and convincing evidence) applies only in civil matters involving important individual interests or rights, such as parental rights, involuntary commitment, and deportation, while the lower level (i.e., preponderance of the evidence) generally applies, even in cases involving severe civil sanctions. As the district court succinctly put it, the "monetary sanctions at issue here do not rise to the level of 'particularly important individual interests or rights.' Accordingly, the preponderance of the evidence standard applies."

The court ultimately concluded that the U.S. government had proved, by a preponderance of the evidence, that the Bohanecs were "at least recklessly indifferent to a statutory duty" for the following reasons:

- They were reasonably sophisticated business people, as evidenced by the fact that they negotiated highly favorable deals with the exclusive U.S. distributor of Leica products, they circumvented Leica's supply limitations by making an arrangement with Leitz Canada, they developed a worldwide reputation and conducted business with customers all over the globe, they always used a return preparer to complete the U.S. tax returns for the Camera Shop, they secured two patents without professional assistance, and they managed the construction of a home in Mexico.
- They were at least reckless, if not willfully blind, about their reporting obligations related to the UBS account, as demonstrated by the fact that they did not provide UBS with their home address in the United States, never told anyone about the account (other than their children), never consulted an attorney, accountant, or banker about potential requirements related to the UBS account, and never used a bookkeeper or otherwise kept

organized books once the UBS account had been opened.

- Their claims that they were unaware of or misunderstood their FBAR duties lacked credibility, because Part III of Schedule B of their Form 1040 from 1998 put them on notice that they needed to file an FBAR, they deposited pre-tax sales commissions into the UBS account and directed certain foreign customers to do the same, and they made several transfers of funds from the UBS account to other foreign and domestic accounts.
- The Bohanecs made several misrepresentations to the IRS in connection with the 2009 OVDP, including stating that all funds in the UBS account were comprised of after-tax amounts, filing "false" Forms 1040 for 2003 through 2008 that omitted income from eBay sales, and filing FBARs for 2003 through 2008 that did not declare foreign accounts in Austria and/or Mexico.

Based on the preceding, the court held that the FBAR violation for 2007 was "willful," such that the maximum penalty, equal to the larger of $100,000 or 50% of the highest aggregate balance in the unreported foreign accounts as of 6/30/08, should apply.

Reasons Why *Bohanec* Is Interesting

Like the other cases analyzed in this article, *Bohanec* is interesting for a number of reasons, many of which are not overt. These reasons are discussed below.

Burden of Proof and Definition of Willfulness. Given the importance of the issues and the relative scarcity of precedent, *Bohanec* probably will be best known for its holdings about the burden of proof that the U.S. government must meet and the definition of "willfulness" for civil FBAR penalty purposes. The district court in *Bohanec*, largely following the earlier standards established in *Williams*, *McBride*, and *Bussell*, held that the U.S. government needs to demonstrate its case by only a preponderance of the evidence, and that the definition of "willfulness," at least in the context of civil FBAR penalties, is sufficiently broad to cover "reckless disregard" of a legal duty.

Two points are particularly interesting in this regard. First, few may notice the leap that the IRS has made, and apparently the courts have accepted, in terms of demonstrating constructive knowledge of the FBAR filing requirement. In both *Williams* and *McBride*, the taxpayers filed annual Forms 1040 for the years in dispute, and Schedule B to such Forms 1040 specifically asked the foreign-account question and cross-referenced the FBAR and its instructions. This, explained the courts, sufficed to place the taxpayers on constructive or inquiry notice about the FBAR. Compare those earlier cases to *Bohanec*, in which the IRS was pressing an FBAR penalty for 2007, but the taxpayers had not filed a Form 1040 since 1998. The U.S. government suggested to the district court that "[t]he Bohanecs were put on notice of the FBAR requirement [for 2007] through the filing of their 1998 federal income tax return."[84]

Second, the IRS has essentially tried to retract its statement that the clear and convincing evidence standard should apply to civil FBAR willful cases ever since it was published, a decade ago, in CCA 200603026. The attempted retraction and recharacterization by the IRS continued in *Bohanec*, when the IRS maintained that its previous analysis about the proper burden of proof was nothing more than an "overly cautious prediction," with no precedential value, which has been disproven by *Williams* and *McBride*.[85] The district court in *Bohanec* agreed, at least with respect to the comment about lacking precedential value.

Fighting the U.S. Government on Multiple Fronts Simultaneously. The Bohanecs found themselves fighting the U.S. government on two fronts at nearly the same time. They were battling the IRS in an audit, initiated after the IRS jettisoned the Bohanecs from the OVDP. The audit focused on federal income tax issues and tax-related penalties, including delinquency penalties under Section 6651 and civil fraud penalties under Section 6663. This struggle was abnormally short because the Bohanecs simply folded; they did not file a Petition challenging the IRS after it issued a Notice of Deficiency seeking more than $400,000. In many instances, this conflict will endure for many years, with taxpayers engaging in protracted Tax Court litigation. The second front on which the Bohanecs were skirmishing involved the FBAR penalty for 2007 and the related collection lawsuit filed by the U.S. government in district court.

Absurd though it may sound, some would argue that the Bohanecs had it easy in that they were busy with the IRS in only two ways, not three or four. Taxpayers with undeclared foreign accounts and unreported foreign income often find themselves engaged in a multi-faceted war of attrition against a rival, the U.S. government, with seemingly limitless resources. A simple example shows how this frequently works.

Assume that Steve Scofflaw held foreign accounts during 2011, with an aggregate balance of approximately $2 million, which yielded a total of $100,000 in interest income annually. Further assume that Steve Scofflaw did not report the foreign-source income on his Form 1040 for 2011, did not disclose the existence of the foreign accounts by checking the "yes" box on Part III of Schedule B of the Form 1040, did not enclose a Form 8938 with his Form 1040, and did not file a separate FBAR by the deadline of 6/30/12. After conducting an audit of 2011, the IRS might issue the following items to Steve Scofflaw: (1) a Notice of Deficiency proposing increased taxes on the $100,000 of unreported income, a 40% accuracy-related penalty under Section 6662(b)(7) or civil fraud penalties under Section 6663, and interest charges, (2) an FBAR 30-day letter (i.e., Letter 3709) and an FBAR Agreement to Assessment and Collection (i.e., Letter 13449)

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84 *Bohanec supra* note 1, Supplemental Proposed Findings of Fact and Conclusions of Law by Government, filed 11/7/16.

85 *Bohanec supra* note 1, Trial Brief by Government, filed 10/25/16.

asserting a penalty of $1 million, which constitutes the maximum sanction of 50% of the highest aggregate balance of the unreported foreign accounts,[86] and (3) a Notice Letter (i.e., Letter 4618) and/or Form 8278 (Assessment and Abatement of Miscellaneous Civil Penalties) asserting a penalty of $10,000 for failure to file a Form 8938 and warning of increased penalties of up to $50,000 for continued non-compliance.[87]

If Steve Scofflaw disputes all the proposed taxes and civil penalties, he will become familiar with three different venues, as well as the costs of fighting in each. First, Steve Scofflaw may file a Petition with the Tax Court to dispute the income taxes and tax-related penalties proposed in the Notice of Deficiency.[88] This could have occurred in *Bohanec*, but the taxpayers opted not to dispute the proposed adjustments in the Notice of Deficiency issued by the IRS concerning 2003 through 2008.

Second, because the FBAR penalty derives from Title 31 of the U.S. Code (i.e., Money and Finance) as opposed to Title 26 of the U.S. Code (i.e., Internal Revenue Code), it cannot be challenged in Tax Court.[89] Thus, after Steve Scofflaw exhausts his administrative appeal rights with the IRS, the U.S. government will bring a civil collection against him in U.S. district court.[90] This is precisely what happened in *Bohanec.*

Third, given that penalties for not filing Form 8938 are not related to a tax deficiency, the IRS takes the position that they are not challengeable in Tax Court. Specifically, the IRS's internal guidance states that "[d]eficiency procedures under Subchapter B of Chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) do *not* apply to penalties discussed in this section."[91] This guidance is consistent with the CCA 201226028, which explains the following:

> The Section 6038D penalty is not itself part of a deficiency, so it cannot be subject to deficiency procedures on that ground . . . [and] the Section 6038D penalty is not calculated on the basis of a tax that is itself subject to deficiency procedures; instead, the penalty is in specific amounts set forth in the statute. As a result, the Section 6038D penalty is assessable by the [IRS] without following deficiency procedures first.

Because the Form 8938 sanction is an "assessable" penalty, taxpayers generally find themselves challenging it in one or more of the following manners: (1) Filing a protest letter, essentially a request for penalty abatement, in response to the first notice from the IRS; (2) Administratively appealing any negative decision by the IRS Service Center of the penalty-abatement request; (3) Filing a request for, and participating in, a CDP hearing with the IRS, after the IRS issues its notice threatening imminent levies of taxpayer property to satisfy the penalty; and/or (4) Paying the penalty under protest and then initiating a refund action with the IRS. None of this occurred in *Bohanec* because that case solely focused on an FBAR violation for 2007; the requirement to file Form 8938 was not introduced until 2011.

The IRS Seems to Go Lightly on FBAR Penalties. There is some apparent incongruity in *Bohanec* in that, on one hand, the IRS is seeking the maximum FBAR penalty for 2007 based on the theory that the taxpayers "willfully" violated the law, while on the other hand, the IRS seems to exhibit some leniency.

For instance, the balance of the account at the time of the violation (i.e., 6/30/08) was at least $643,662. The accounts were jointly held, such that August and Maria each had a duty to file an FBAR. However, instead of assessing a penalty equal to 50% of the balance against each, thereby entirely draining the accounts, the IRS assessed a 25% penalty against only each of August and Maria, for a total of 50%. Specifically, the IRS sought $160,916 from each member of the couple. This is interesting because the IRS has typically adopted a fairly harsh stance on this issue, stating that "FBAR penalties are determined *per account, not per unfiled FBAR*, *for each person required to file* [and] penalties apply for each year of each violation."[92] The IRS followed this policy in *Williams*, asserting two maximum penalties of $100,000 per account. By contrast, the IRS seems to be taking a more tempered approach in *Bohanec*, presumably based on the portion of the Internal Revenue Manual that explains that (1) if an account is co-owned by more than one person, then a penalty determination must be made separately for each co-owner, (2) the penalty against each co-owner will be based on his/her percentage of ownership of the account, and (3) if the IRS cannot determine each owner's percentage of ownership, the highest balance will be divided equally among each of the co-owners.[93]

It is also noteworthy that the IRS penalized only the UBS account, despite the fact that the U.S. government proved at trial that other unreported foreign accounts existed during the relevant years, in Austria and Mexico.

Finally, it is interesting that the IRS decided to limit the number of years for FBAR penalties. The IRS asserted an FBAR penalty for only 2007, but one would assume that it could have done so for other years, too, because (1) the district court noted that the foreign accounts (in Switzerland, Austria, and Mexico) remained open until 2010, and (2) under the OVDP, which covered 2003 through 2008, participating taxpayers are required to supply the IRS with Form 872 extending the assessment-periods for

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86 IRM section 4.26.17.3 (1/1/07).

87 IRM section 20.1.9.2 (4/22/11); IRM section 20.1.9.2.1 (4/22/11); IRM section 20.1.9.22 (4/22/11). Aside from these three civil lines of attack, the IRS might, depending on the facts and circumstances, bring some type of criminal charge, such as filing a false Form 1040, engaging in U.S. tax evasion, etc. The IRS often begins the process with criminal charges and then proceeds to the related civil matters.

88 Section 6213(a).

89 See Sheppard, "Two More Blows to Foreign Account Holders: Tax Court Lacks FBAR Jurisdiction and Bankruptcy Offers No Relief from FBAR Penalties," 11 Journal of Tax Practice & Procedure 27 (February-March 2009).

90 31 U.S.C. section 5321(b)(2). The government must initiate this lawsuit within two years of assessing the FBAR penalty.

91 IRM section 20.1.9.2 (4/22/11) (emphasis added); IRM Exhibit 20.1.9-4.

92 IRM section 4.26.16.4 (7/1/08) (emphasis added).

93 IRM section 4.26.16.6.5.3 (11/6/15).

income taxes, as well as a so-called "Consent to Extend the Time to Assess Civil Penalties Provided by 31 U.S.C. § 5321 for FBAR Violations." In summary, one would assume that the IRS could have asserted FBAR penalties for years before 2007 (because they were open as a result of the mandatory extension granted by the Bohanecs as part of the OVDP) and for years after 2007 (because they remained open under the normal six-year assessment-period).

A Cautionary Tale—The Truth Would Have Been Cheaper. The Bohanecs first approached the IRS through the 2009 OVDP, under which they could have resolved all international tax non-compliance matters by, among other things, filing accurate Forms 1040 for 2003 through 2008, paying the taxes, delinquency penalties, and interest charges related to Forms 1040, filing FBARs for 2003 through 2008, and paying an "offshore" penalty equal to 20% of the highest aggregate value of the non-compliant foreign financial assets during the OVDP period. Moreover, the Bohanecs could have cited to the Frequently Asked Questions (FAQs) issued by the IRS in connection with the OVDP to potentially reduce the "offshore" penalty, eliminating any accounts that were non-income-producing, dividing the account balances evenly between co-owners, avoiding duplication of penalties on the same funds by excluding inter-account transfers, etc. Thus, if the Bohanecs had simply complied with the rules and requirements of the OVDP, they could have capped their tax and penalty liabilities.

It is interesting to note that their failure to provide accurate Forms 1040 and accurate FBARs as part of the OVDP, which resulted in them getting removed from the OVDP, and which triggered the IRS audit, ultimately proved costly to the Bohanecs. In particular, instead of paying a delinquency penalty under Section 6651 maxing out at 25% of the tax liability shown on the Forms 1040 for 2003 through 2008, the Bohanecs ended up paying civil fraud penalties under Section 6663, which are equal to 75% of the tax liability. Additionally, instead of paying a one-time "offshore" penalty equal to 20%, they ended up paying 50% of the account balance in 2007, plus interest, additional penalties, and costs since the time that the FBAR penalty was assessed, approximately three years before the decision by the district court.

Impact on Current Voluntary Disclosure Programs. The recent taxpayer losses in *Williams III*, *McBride*, *Bussell*, and *Bohanec* will trigger additional uncertainty for taxpayers who are participating in the OVDP and entertaining the idea of "opting-out" to seek reduced penalties, participating in the OVDP and considering applying to transition to the Streamline Foreign Offshore Procedure (SFOP) or the Streamline Domestic Offshore Procedure (SDOP), or evaluating whether to initially approach the IRS through the SFOP or SDOP.

OVDP Opt-Out Standards. Generally speaking, taxpayers participating in the 2014 OVDP must (1) file Forms 1040 or 1040X for the last eight years, (2) pay back taxes, 25% delinquency penalties or 20% accuracy penalties (as applicable), and interest charges with respect to the Forms 1040 or 1040X, (3) file all appropriate international information returns, including FBARs, for the last eight years, and (4) pay a catch-all "offshore" penalty equal to 27.5% of the highest aggregate value of the non-compliant foreign financial assets during the eight-year period. The standard "offshore" penalty increases from 27.5% to 50% if any of the non-compliant foreign financial accounts are held in one of the many "tainted" banks identified by the IRS.

The IRS released a series of FAQs to clarify common issues related to the OVDP. FAQ #51 addresses options available to taxpayers who are dissatisfied with the proposed "offshore" penalty. The main path for frustrated taxpayers is to "opt-out" of the OVDP in order to seek reduced penalties, applying the normal standards, on grounds that the taxpayers not only did not willfully violate U.S. tax laws, but they also had "reasonable cause" for any missteps. Among the risks associated with "opting-out" of the OVDP are facing a full-blown audit for all relevant years and the assessment of FBAR penalties higher than the general "offshore" penalty offered within the OVDP.

SFOP and SDOP Standards. When the IRS announced the 2014 OVDP in June 2014, it also introduced the SFOP and SDOP. Below is a high-level summary of these two programs.

In order to be eligible to participate in the SFOP, a taxpayer (who is a U.S. citizen or Green Card holder) must meet the following criteria: (1) the taxpayer was physically outside the United States for at least 330 days in one or more of the past three years; (2) the taxpayer did not have an "abode" in the United States during the relevant year or years; (3) the taxpayer either failed to file annual Forms 1040 with the IRS or filed annual Forms 1040 that did not properly report all income from everywhere in the world; (4) the taxpayer might have also failed to file with the IRS the proper international information returns; (5) the failure to report all income to the IRS, as well as the failure to file all proper international information returns, was the result of "non-willful" conduct by the taxpayer; (6) neither the IRS nor the U.S. Department of Justice has initiated a civil examination or criminal investigation of the taxpayer or a related party; and (7) the taxpayer is an individual (or the estate of an individual) because the SFOP is not open to business entities.

The eligibility requirements for the SDOP are quite similar, with the biggest differences being that the taxpayer must have been living in the United States during the past three years (i.e., the taxpayer does not meet the foreign-residency requirement for the SFOP) and the taxpayer previously filed timely, but inaccurate, Forms 1040 with the IRS for the past three years (i.e., the SDOP is not available for serial non-filers).

Under both the SFOP and the SDOP, taxpayers are required to file U.S. income tax returns for only the past three years, U.S. international information returns (other than FBARs) for only the past three years, and FBARs for only the past six years. The IRS does not impose any penalties whatsoever on those taxpayers who successfully participate in the SFOP. However, the IRS asserts an "offshore" penalty on SDOP participants in the amount of 5% of the highest aggregate balance of the non-compliant foreign financial assets during the past six years.

As indicated above, one key eligibility requirement for the SFOP and SDOP is that the taxpayer can demonstrate to the IRS that his violations were "non-willful." This, like many things in life, is often easier said than done. Taxpayers applying for the SFOP must complete and file a Form 14653 (Certification by U.S. Person Residing Outside the United States for Streamlined Domestic Offshore Procedures), while those seeking refuge in the SDOP are obligated to provide a Form 14654 (Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures). Each of these documents contains a few passages that should be of serious interest to taxpayers, particularly those whose facts and circumstances are not terribly strong:

> My failure to report all income, pay all tax, and submit all required information returns, including FBARs, was due to non-willful conduct. I understand that non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.
>
> I recognize that if the Internal Revenue Service receives or discovers evidence of willfulness, fraud, or criminal conduct, it may open an examination or investigation that could lead to civil fraud penalties, FBAR penalties, information return penalties, or even referral to Criminal Investigation.
>
> Under penalties of perjury, I declare that I have examined this certification and all accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Effect of Recent FBAR Cases. After the taxpayer victory in *Williams II*, people speculated that many taxpayers would be emboldened to "opt-out" of the OVDP and roll the proverbial dice with the IRS's Examination Division and Appeals Office. As one article put it, a possible outcome of *Williams II* was that "some taxpayers will be encouraged to opt out of the voluntary disclosure initiative and take their chances with the normal FBAR penalty regime."[94] However, the government victories in *Williams III*, *McBride*, *Bussell*, and *Bohanec* likely will change this attitude, causing taxpayers to be more cautious, as well as better prepared, before opting-out of the OVDP or applying for the SFOP or SDOP. Indeed, with each governmental victory in FBAR penalty cases, and with the passage of many years since the first OVDP was announced back in 2009, one would anticipate that the IRS will become less inclined to find instances of "non-willfulness" and "reasonable cause."

CONCLUSION

What is the true status of "willfulness" in the context of civil FBAR penalties? There are at least two sides to every story.

Some inevitably will conclude that *Williams III*, *McBride*, *Bussell*, and *Bohanec* stand for the general proposition that (1) the standard for asserting the highest civil FBAR penalties is willfulness, (2) the U.S. government is required to prove willfulness by only a preponderance of the evidence, (3) the government can establish willfulness by showing that a taxpayer either knowingly or recklessly violated the FBAR duty, (4) recklessness might exist when a taxpayer fails to inform his accountant, return preparer, or other tax advisor about foreign accounts, (5) recklessness might also exist when a taxpayer is "willfully blind," which occurs when the taxpayer does not read and understand every aspect of a Form 1040, including all Schedules attached to the Form 1040 (including Schedule B containing the foreign-account question) and any separate forms referenced in the Schedules (including the FBAR), (6) 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, and (7) the fact that the IRS previously took the position in published documents, such as CCA 200603026 and the Internal Revenue Manual, that the IRS must prove willfulness by clear and convincing evidence (instead of by merely a preponderance of the evidence) and willfulness requires "a voluntary, intentional violation of a known legal duty," is not relevant and not binding on the IRS now.

Others likely will take the position that it is still challenging for the IRS to successfully assert and collect a willful FBAR penalty because each case is determined based on individual facts in each case, the decisions in *Williams III*, *McBride*, *Bussell*, and *Bohanec* are not representative situations because they concern taxpayers involved in egregious behavior with abnormally strong signs of intentional wrongdoing, and the U.S. government is reluctant to litigate any FBAR penalty case that it could lose, as this could seriously undermine its international tax enforcement efforts and voluntary disclosure programs.

What is clear is that this issue is far from resolved. As a case in point, the same day that the district court rendered the decision upholding the willful FBAR penalty in *Bohanec*, counsel for the taxpayers announced that they intended to appeal.[95] This dispute will be followed by countless others in the coming years. ●

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94 Coder, "U.S. Government Position on FBAR Penalties Called into Question," 2010 Worldwide Tax Daily 174-4 (9/9/10).

95 Richman, "U.S. Court Decision on FBAR Willfulness Standard Set for Appeal," Tax Notes Doc. 2016-24192 (12/8/16).