Constructive Knowledge and FBAR Penalties: Does Merely Filing a Form 1040 Suffice to Establish "Willfulness?"

*By Hale E. Sheppard**

I. Introduction

In fighting the battle against offshore tax avoidance, the U.S. government has raised some creative arguments to establish that a taxpayer "willfully" failed to disclose foreign accounts by filing FinCEN Forms 114 ("FBARs"). These include the concept of "constructive knowledge," whereby the U.S. government contends that, because Schedule B (Interest and Ordinary Dividends) of Form 1040 (*U.S. Individual Income Tax Return*) specifically asks about foreign accounts, because Schedule B directs taxpayers to additional sources of information about foreign account duties, and because taxpayers must sign their Forms 1040 declaring that they have reviewed the entire Form 1040, including all Schedules and Statements attached, *any* FBAR violation must be "willful" and thus subject to the highest possible penalty.

This notion sounded absurd to many in the tax community at the outset, but it has been embraced by several courts. Not all courts have accepted the position, though, giving hope to taxpayers that merely signing a Form 1040 will not be considered tantamount to a willful FBAR violation and the large penalties that come with it. This article examines the major cases that have analyzed the "constructive knowledge" position and what they mean to taxpayers.

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II. Overview of the Law, Enforcement, Duties, and Penalties

Some background on the evolution of the FBAR and the duties generally triggered by holding a foreign account is essential.

A. A Short History

Congress enacted the Bank Secrecy Act in 1970.[1] One purpose of this legislation was to require the filing of certain reports, like the FBAR, where doing so would be helpful to the U.S. government in carrying out criminal, tax, and regulatory investigations.[2]

Concerned with widespread non-compliance, the U.S. government has taken certain actions in recent years. Notably, the Treasury Department transferred authority to enforce FBAR duties to the IRS in 2003.[3] 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.[4]

Congress, for its part, enacted more stringent FBAR penalty provisions in 2004 as part of the American Jobs Creation Act ("Jobs Act").[5] Under the law in existence before the Jobs Act, the government could only assert penalties against taxpayers where it could demonstrate that they "willfully" violated the FBAR rules.[6] If the government managed to satisfy this high standard, it could impose a relatively small FBAR penalty, ranging from $25,000 to $100,000, regardless of the size of the hidden account.[7]

Thanks to the Jobs Act, the IRS may now impose a civil penalty on any person who fails to file an FBAR when required, period.[8] In the case of non-willful violations, the maximum penalty is $10,000.[9] The Jobs Act calls for higher maximum penalties where willfulness exists. Specifically, in situations where a taxpayer willfully fails to file an FBAR, the IRS may assert a penalty equal to $100,000 or 50 percent of the balance in the undisclosed account at the time of the violation, whichever amount is larger.[10] Given the huge balances in some unreported accounts, FBAR penalties under the Jobs Act can be enormous.

B. Disclosure of Accounts, Other Assets, and Income

The relevant law mandates the filing of an FBAR in situations where (i) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (ii) had a direct financial interest in, had an indirect financial interest in, had signature authority over, or had some other type of authority over (iii) one or more financial accounts (iv) located in a foreign country (v) whose aggregate value exceeded $10,000 (vi) at any point during the relevant year.[11]

When it comes to U.S. individuals, they have several linked to holding a reportable interest in a foreign financial account, including the following:

- checking the "yes" box in Part III (Foreign Accounts and Trusts) of Schedule B (Interest and Ordinary Dividends) to Form 1040 (*U.S. Individual Income Tax Return*) to disclose the existence of the foreign account;
- identifying the foreign country in which the account is located, also in Part III of Schedule B to Form 1040;
- declaring all income generated by the account (such as interest, dividends, and capital gains) on Form 1040;
- reporting the account on Form 8938 (*Statement of Specified Foreign Financial Assets*), which is enclosed with Form 1040; and
- electronically filing an FBAR.[12]

III. The Crux of the Issue

To appreciate the importance of the cases cited in this article, one must understand some initial items.

One of the duties listed above is checking "yes" to the foreign-account inquiry found in Part III of Schedule B to Form 1040. The IRS has slightly modified and expanded this language over the years, with the materials for 2017 stating the following:

> At any time during 2017, 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.

Taxpayers must sign and date their Forms 1040 in order for them to be valid. Unless they pay very close attention to the small print, most taxpayers will be unaware that they are making the following broad, sworn statement to the IRS, which often comes back to haunt them in FBAR penalty cases:

> Under penalties of perjury, I declare that *I have examined this return and accompanying schedules [including Schedule B] and statements*, and to the best of my knowledge and belief, they are true, correct, and

accurately list all amounts and sources of income I received during the tax year.

The argument presented by the IRS and Department of Justice ("DOJ") in *Kimble* and several other cases can be summarized as follows: (i) the taxpayer signed his Form 1040 under penalties of perjury, thereby representing that he reviewed the entire Form 1040, including Schedule B; (ii) Schedule B put the taxpayer on notice of his potential duty to file an FBAR; (iii) to the extent that the taxpayer had questions about the FBAR, Schedule B expressly directed the taxpayer to the Instructions to Form 1040, the FBAR itself, and the Instructions to the FBAR; (iv) if the taxpayer checked the "no" box in response to the foreign-account question on Schedule B, then he filed a false Form 1040, he was aware of the FBAR duty, and his FBAR violation was willful; and (v) if the taxpayer instead left the box blank, answering neither "yes" nor "no" about foreign accounts, and if the taxpayer professes not to have reviewed Form 1040 or Schedule B, then his FBAR violation was willful because he had constructive knowledge of the FBAR duty, he was on inquiry notice, he was "willfully blind," he showed reckless disregard for the rules, or some combination thereof.

IV. Constructive Knowledge—A Review of Prior Cases

Several courts have examined the issue of what constitutes "willfulness" in the context of civil FBAR penalties.[13] Notable decisions include *Williams* in 2012,[14] *McBride* in 2012,[15] *Bussell* in 2015,[16] *Bohanec* in 2016,[17] *Bedrosian* in 2017,[18] *Kelley-Hunter* in 2017,[19] *Toth* in 2017,[20] *Colliot* in 2018,[21] *Wadhan* in 2018,[22] *Garrity* in 2018,[23] *Markus* in 2018,[24] *Norman* in 2018,[25] *Flume* in 2018,[26] and *Kimble* in 2018.[27] A few of these cases discuss the argument, summarized above, that is now being raised by the IRS and DOJ with regularity. They are examined below.

A. *Williams*

The first case concerning "willful" FBAR penalties was *Williams*, a multi-year, multi-issue case, with stops in the Tax Court, District Court, and, ultimately, the Fourth Circuit Court of Appeals. Here, we address only the final decision, by the Fourth Circuit Court of Appeals, because of its focus on the issue of "willfulness."

The Fourth Circuit Court of Appeals began its analysis by criticizing the legal standards on which the District Court made its taxpayer-friendly decision. In particular, the Court of Appeals indicated that the District Court should not have focused on the taxpayer's motivation for not filing an FBAR, and, inasmuch as it did, the District Court made an impermissible leap.[28] Then, noting various judicial precedents in the *criminal* arena, the Court of Appeals went on to state what it considered the proper legal standard. The Court of Appeals explained that (i) willfulness can be inferred from taxpayer conduct designed to conceal financial information, and (ii) 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.[29] In situations where willfulness is a condition for *civil* liability, the Court of Appeals indicated that this covers both knowing and reckless violations.[30] It then clarified that the taxpayer's actions or inactions in *Williams* constituted, at a minimum, "reckless conduct, which satisfies the proof requirement [for civil FBAR violations]."[31]

The Court of Appeals supported its decision on several grounds, including the following. It pointed out that the taxpayer signed the relevant Form 1040 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 of Appeals then explained that taxpayers who execute a Form 1040 are deemed to have constructive knowledge of such Form 1040, and the taxpayer in *Williams* was no exception to that principle. According to the Court of Appeals, the questions and cross-references in Part III of Schedule B to Form 1040 put the taxpayer on inquiry notice of the FBAR duty.[32] The taxpayer testified that he did not review his Form 1040 in general or read the information in Schedule B in particular. The Court of Appeals 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.[33]

B. *McBride*

In *McBride*, the District Court analyzed the taxpayer's level of knowledge of the FBAR filing requirement. Its ultimate conclusion on this issue was remarkably clear, but the District Court's analysis meandered somewhat.

The District 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 District 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 District 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/amounts on the return.

When dealing with the FBAR situation, the District 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."[34] Fortifying its position, the District Court cited and quoted 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.[35] The District 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.[36]

Although not entirely clear, it appears that Mr. McBride argued that he was aware of the FBAR filing requirement, but decided not to comply because of his belief, based in part on the analysis by his accountant, that he did not possess a sufficient interest in the foreign accounts under the peculiar FBAR ownership-attribution rules. As the culmination to its long analysis of the "willfulness" issue, the District Court took an extreme position that, if a taxpayer executes and files his Form 1040, then 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 [that his accountant] 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.[37]

C. *Jarnagin*

The next case to address the constructive knowledge argument was *Jarnagin*.[38] Here, the IRS assessed non-willful FBAR penalties, not willful ones. The issue, therefore, was whether the taxpayers had "reasonable cause" and the lower penalties should thus be mitigated. As demonstrated below, *Jarnagin* still adds to the debate around constructive knowledge, despite the fact that the penalty standards are different.

Larry and Linda Jarnagin had diverse careers and successful business ventures over the years. Larry owned and operated several barber shops, worked as a licensed chiropractor, held multiple agricultural properties, worked as a cattle farmer, and bought, sold, and leased mineral rights. Additionally, Larry and Linda owned and managed various apartment complexes, as well as a nightclub.

The Jarnagins bought property in Canada in the early 1980s and started operating a ranch there. They split their time between Canada and Oklahoma. Because they lived in Canada part of the year and operated a ranch there, Larry and Linda opened an account at Canadian Imperial Bank of Commerce ("CIBC") in 1986. This account remained open during the years at issue, 2006 through 2010. The balance of the account reached approximately $3.5 million during this period. It is unclear from the record whether all the passive income generated by the account was properly reported on the annual Forms 1040, but it is undisputed that (i) the Schedules B to Forms 1040 indicated "no" in response to the foreign-account question, and (ii) the taxpayers never filed an FBAR disclosing the Canadian account.

The DOJ contended that Larry and Linda lacked reasonable cause for their FBAR violations for several reasons. One was that they failed to exercise ordinary care and prudence when they did not review their Forms 1040, despite the fact that they signed them, thereby attesting that they had examined everything, including the Forms 1040 and Schedules B, and they were true, accurate, and complete. The DOJ presented this argument, citing and relying on *Williams* and *McBride*.

The Court of Federal Claims analyzed the concepts of constructive knowledge and "willful blindness." It stated that exercising ordinary care and prudence means, among other things, that taxpayers will "personally read and review their completed tax returns carefully." It also stated that the taxpayers were charged with constructive knowledge of the contents of Forms 1040, including references to the FBAR, by virtue of the fact that they executed Forms 1040. The Court of Federal Claims then explained that Larry and Linda had a "particular obligation" to review Schedule B because Larry was a dual U.S.-Canadian citizen, he has business activities in Canada, and he maintained a Canadian account with millions on deposit. The Court of Federal Claims speculated that, if Larry and Linda had taken the time to review their Forms 1040, then they would have discovered the "obvious error" that their U.S. tax professionals committed by checking the "no" box in response to the foreign-account question on Schedule B, and they would have seen the warning to consult the Instructions for more information about FBAR filing duties. The Court of Federal Claims summarized its thoughts in the following manner:

> A reasonable person, particularly one with the sophistication, investments, and wealth of the Jarnagins, would not have signed their income tax returns without reading them, would have identified the clear error committed by their accountants, and would have sought advice regarding their obligation to file [an FBAR].

D. *Norman*

In *Norman*, the IRS assessed a willful FBAR penalty for 2007 in connection with a Swiss account at UBS, the taxpayer unsuccessfully challenged the sanction with the Appeals Office, the taxpayer fully paid the penalty and filed a refund lawsuit with the Court of Federal Claims, the DOJ tried to dispense with the matter by filing a Motion for Summary Judgment, which was rejected, and the parties ultimately conducted a trial whose sole witness was the taxpayer herself.[39]

Despite the existence of the OVDP, the taxpayer made a "quiet disclosure" by directly filing with the IRS Forms 1040X and FBARs for 2003 through 2008. At trial, the taxpayer's theory was that she did not willfully hide the UBS account. The Court of Federal Claims underscored that the taxpayer presented no evidence whatsoever to support her theory, other than her memory, and it was inconsistent with the written proof offered by the DOJ.

The Court of Federal Claims pointed out that the taxpayer could not remember (i) whether she opened the UBS account or received it through inheritance, (ii) meeting with a UBS representative in Switzerland to open the account, (iii) when she opened the account, and (iv) if she made withdrawals from the account. Moreover, explained the Court of Federal Claims, during the trial, the taxpayer indicated that she did not (i) know the account number, (ii) understand what a numbered account was, or (iii) recognize documents related to the opening and management of the account, the stamped signature of her private banker at UBS, her note to UBS instructing it to close the account, or the invoice from her accountant for assisting her with the "quiet disclosure."

The Court of Federal Claims also indicated that the taxpayer lacked credibility because she made false and/or inconsistent statements regarding the foreign account in her Form 1040 for 2007, her audit interview with the Revenue Agent, her letters to the IRS through her accountant and her attorney, the Complaint to start the refund lawsuit, and her testimony at trial.

In contrast to the "questionable testimony" provided by the taxpayer, the DOJ presented clear evidence that (i) the taxpayer signed documents to open a numbered account, (ii) she instructed UBS not to invest in U.S.

securities, (iii) she personally visited UBS in Switzerland, (iv) she met on a yearly basis with UBS representatives, (v) she withdrew $100,000 from the account, (vi) she was informed by UBS in 2008 that it was working with the U.S. government regarding disclosure of its U.S. clients, and (vii) she then closed her account at UBS and transferred the funds to Wegelin & Co., the first foreign bank to ever plead guilty to U.S. tax law violations.

Based on the preceding, the Court of Federal Claims explained that, while the taxpayer might lack sophistication in financial matters, it cannot believe that she could manage the account containing a large sum of money for over a decade without once reading any documents or realizing that the account had U.S. tax implications. Citing to *Williams*, the Court of Federal Claims concluded as follows:

> Indeed, at a minimum, Ms. Norman was put on inquiry notice of the FBAR requirement when she signed her tax return for 2007, but she chose not to seek more information about the reporting requirements. Although one of the few consistent pieces of Ms. Norman's testimony was that she did not read her tax return, simply not reading the return does not shield Ms. Norman from the implications of its contents. The Court finds that Ms. Norman acted to conceal her income and financial information, and also that she either recklessly or consciously avoided learning of her reporting requirements. Therefore, the Court finds that Ms. Normal willfully violated §5314.

E. *Flume*

The next case, *Flume*, pleasantly surprised the tax community by rejecting the earlier reasoning by the courts in *Williams*, *McBride*, *Jarnagin*, and *Norman*.[40]

Mr. Flume ("Husband") and Mrs. Flume ("Wife") are U.S. citizens who moved to Mexico in 1993. Soon thereafter, in 1995, Husband and another U.S. individual formed a corporation in Mexico called Franchise Food Service de Mexico S.A. de C.V. ("Franchise Food"). It was created in order to operate Mexican locations of Whataburger and Fanny Ice Cream. In addition to Franchise Food, Husband and Wife formed at least two other foreign corporations while living in Mexico, one of which was Wilshire Holdings, Inc. ("Wilshire Belize").

In 2005, Wilshire Belize opened an account at UBS in Switzerland. The District Court concluded that Husband and Wife had a reportable interest in the account because they opened it using Articles of Association showing Husband and Wife as equal owners of Wilshire Belize, they were listed as the "beneficial owners" of the account, they controlled the investment activity in the account, and they signed the wire-transfer orders in 2008 and 2009, as "Directors" of Wilshire Belize, to empty UBS account and remit all funds to a U.S. account.

In the early 2000s, Husband hired a U.S. return preparer with offices in the United States and Mexico to prepare his Forms 1040. They prepared Forms 1040 for the relevant years, 2007 and 2008, disclosing only the existence of Husband's account in Mexico, but not the larger account at UBS. Moreover, Husband did not file timely FBARs for 2007 or 2008. He filed them late, in June 2010, and even then, he seriously understated the value of the UBS account, missing the mark by approximately $600,000 one year.

There was conflicting testimony about whether, or precisely when, Husband told the accountants about the UBS account, but they all agreed that Husband never supplied any documents regarding such account. The accountants said that they first notified Husband about his FBAR obligation around 2003 or 2004, and sent him an annual letter thereafter reminding him. Husband, on the other hand, claimed that the accountants never informed him of FBAR duties until many years later, in 2010.

Husband acknowledged to the District Court that he was not particularly diligent about his tax considerations. Indeed, he did not read his Form 1040 "word for word" and he did not take the time to read the instructions from the IRS, expressly referenced in Schedule B, about FBAR filing requirements. He simply checked the income amount, which seemed appropriate, signed the Forms 1040, and trusted that the accountants had prepared them accurately.

After an audit and assessment of willful FBAR penalties by the IRS, litigation ensued in District Court. The DOJ filed a Motion for Summary Judgment, asking the District Court to rule that Husband willfully violated his duty to file FBARs for 2007 and 2008, because he (i) knowingly disregarded the FBAR duty, or (ii) recklessly ignored a high probability that he was breaking the law, even if he lacked specific knowledge about his FBAR duty.

The District Court indicated that the definition of "willfulness" in the civil FBAR context was an issue of first impression, and emphasized that only a limited number of cases have thoroughly analyzed the issue. The District Court then went on to examine the concept of "willfulness" under three different legal theories: actual knowledge, constructive knowledge, and reckless disregard. We focus only on the second.

Relying largely on *McBride*, the DOJ argued that Husband at least had constructive knowledge of his FBAR duty, because he signed his Forms 1040, which contained instructions to consult the FBAR filing requirements. The District Court refused to follow *McBride* for three reasons. First, the District Court indicated that the constructive-knowledge theory ignores the distinction that Congress drew between willful and non-willful FBAR violations: "If every taxpayer, merely by signing a tax return, is presumed to know the need to file an FBAR, it is difficult to conceive of how a violation could be non-willful."

Second, the District Court explained that resolving this matter on summary judgement (*i.e.*, without a full trial) would be inappropriate because, while Husband admittedly signed his Form 1040 for 2007 in 2008, and thus might be charged with FBAR awareness as of that time under the constructive-knowledge theory, Husband later testified during a deposition that he was ignorant of the FBAR duty until years later, in 2010. The District Court pointed out that a factfinder, the District Court or the jury, must decide which of these two conflicting items carries more weight.

Third, and most importantly, the District Court announced that the constructive-knowledge theory is "rooted in faulty policy arguments." The DOJ argued that ruling in favor of Husband would encourage taxpayers to sign Forms 1040 without reading them in hopes of later avoiding any negative consequences from inaccuracies and would permit taxpayers to escape liability by simply claiming that they did not read what they were signing. The District Court flatly rejected the DOJ's position, calling it "incorrect," because the IRS can still impose a $10,000 penalty for each non-willful FBAR violation, and the IRS can still pursue taxpayers under a reckless-disregard theory. The District Court concluded as follows:

> [T]here is no policy need to treat constructive knowledge as a substitute for actual knowledge … Accordingly, the Court will not hold that [Husband] had constructive knowledge—and that he owes the Government more than half a million dollars—merely because he signed his tax returns under penalties of perjury. The Government has thus failed to conclusively establish that [Husband] was willful on the ground that he knowingly disregarded his FBAR obligations.

V. Constructive Knowledge—Analyzing the Most Recent Case

The most recent case in the constructive knowledge saga is *Kimble*.

A. Description of the Key Facts

Alice is a U.S. citizen by birth, as were her late parents, Harold and Frances. At some point before 1980, the parents opened an account with UBS in Switzerland, designating Alice as a joint owner. In 1983, Alice married Michael, and they had a son, David, in 1985. Alice, Michael, and David all knew about the UBS account. Harold supposedly told them to keep it a secret because they might need the funds one day to flee the country in the event of religious persecution. In 1998, as joint owner of the UBS account, Alice signed a "numbered account agreement with UBS," instructed UBS to hold all correspondence, and authorized UBS to invest the funds in time-deposits. Alice and Michael met with UBS representatives in the United States at least six times over the years to discuss the account. Alice also met with them at least once in Switzerland.

Around 1998, Alice and Michael opened an account with HSBC in France in order to pay expenses associated with their apartment in Paris.

During their marriage, which lasted from 1983 to 2000, Michael handled the family finances and prepared the Forms 1040. He never reported any income generated by the UBS and HSBC accounts, never checked "yes" in response to the foreign-account question on Schedule B, never identified Switzerland or France as locations of foreign accounts, and never filed an FBAR. These earlier years were not at issue in the FBAR penalty dispute.

In 2000, Alice and Michael divorced. Alice did not disclose the foreign accounts in any documents filed in connection with the divorce. Soon after the divorce, Alice hired Steven Weinstein ("Accountant Weinstein") to prepare her individual Forms 1040 and state tax returns. Accountant Weinstein never asked Alice about foreign accounts, and she never pro-actively disclosed them to Accountant Weinstein. Moreover, Alice never asked Accountant Weinstein if the investment income generated by the UBS and HSBC accounts needed to be reported on Forms 1040.

In 2005, Alice signed three documents related to the UBS account: one confirming her desire for UBS to retain all correspondence related to the account, another addressing her status and potential U.S. tax withholding, and yet another indicating that she was the sole beneficiary of the account, even though her mother, Frances, was also a joint owner at that time.

Alice claims to have first learned of her duty to report foreign accounts in 2008 from reading a newspaper article about issues surrounding UBS. She then hired legal counsel. The balance in the UBS account as of the 2007 FBAR filing deadline (*i.e.*, June 30, 2008) was $1,365,662, while the balance of the HSBC account at the same time was $134,130.

The hope, of course, is that more courts side with Flume, *recognizing that logic lobbies against precedent that taxpayers are presumed to be aware of the FBAR filing duty merely by submitting their annual Forms 1040.*

Alice filed timely Forms 1040 for 2003 through 2008, but she never reported any income from the UB and HSBC accounts, and she answered "no" in response to the foreign-account question on Schedule B. Alice also neglected to file FBARs.

B. OVDP and Opt-Out

In April 2009, Alice applied for the Offshore Voluntary Disclosure Program ("OVDP"), and she was accepted. As part of the OVDP, she filed Forms 1040X and FBARs for 2003 through 2008. The IRS presented her a Closing Agreement at the end of the OVDP process, which showed an "offshore" penalty of $377,309. Alice disliked this figure, so she informed the Revenue Agent in February 2013 that she intended to "opt-out" of the OVDP, to "take her chances" with the IRS.

C. Results of Audit

The IRS started an audit in 2013, at the end of which the Revenue Agent determined that Alice's FBAR violations were "willful." The Revenue Agent based this conclusion on the following: (i) Alice had a direct financial interest in the accounts; (ii) she checked "no" to the foreign-account question on Schedule B to every Form 1040; (iii) she made no efforts to inform herself about any U.S. obligations associated with inheriting a Swiss account exceeding $1 million; (iv) Alice never reported any passive income generated by the accounts on her Forms 1040 for decades; (v) Alice only approached the IRS through the OVDP after UBS notified her that it would be remitting data about all U.S. accountholders to the IRS; (vi) Alice made efforts to conceal the account; (vii) Alice had active management of both foreign accounts; (viii) Alice has no business or family connections with Switzerland, where the UBS account was located; (ix) fear of potential religious persecution is not "reasonable cause" for non-compliance with U.S. law; (x) Alice was non-compliant with U.S. tax law even after entering into, and later opting-out of, the OVDP; (xi) Alice had significant involvement with Accountant Weinstein but chose not to disclose the foreign passive income; and (xii) the passive income generated by the foreign accounts was relatively significant, constituting more than half of Alice's overall income in certain years.

D. FBAR Litigation

In July 2016, the IRS assessed a willful FBAR penalty, which Alice fully paid in August 2016. She then filed a claim for refund in September 2016. In March 2017, Alice filed a Complaint in the Court of Federal Claims seeking a refund of the FBAR penalty that she had paid. Both the DOJ and Alice ultimately each filed a Motion for Summary Judgment, focused on the issue of "willfulness." Alice later conceded the issues related to the HSBC account, such that all attention was on the UBS account.

1. Positions of the DOJ

In its Motion for Summary Judgment, the DOJ basically repeated and expanded on the grounds for willfulness that the Revenue Agent had previously identified during the audit. The DOJ contended that an FBAR violation is willful where a taxpayer (i) violates the law voluntarily rather than accidentally, (ii) is willfully blind to a duty, or (iii) engages in conduct that is in "reckless disregard" of a legal duty. In its normal throw-everything-against-the-wall-and-see-what-sticks fashion, the DOJ argued as follows:

> First, [Alice's] failure to report was voluntary, because she signed her 2007 federal tax return knowing of the obligation to report. [Alice] had actual knowledge of the filing requirement, but decided not to inform the IRS about the UBS account. In addition, [Alice] maintained a numbered account and instructed UBS not to send any account-related

> correspondence to the United States. And, [Alice] did not inform her accountant about the existence of her foreign bank accounts.
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> Second, as a matter of law, a taxpayer is charged with knowledge of the representations made on federal tax returns. [Alice] also had knowledge of the FBAR requirement posited by Question 7(a) on Form 1040 of her 2007 income tax return. In addition, [Alice] was "willfully blind" to the requirement that she file a FBAR … [Alice] admitted that she never read her tax returns or any of the documents she signed related to the UBS account. Therefore, [Alice] was "willfully blind" of her duty to comply with IRS reporting requirements.
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> In sum, [Alice] engaged in reckless disregard of the statutory duty to: file a FBAR; answer Question 7(a) accurately on her 2007 income tax return; and ask her accountant for advice on any reporting requirements or other federal tax issues that might arise in connection with the UBS account. Therefore, [Alice's] conduct was "willful."

2. Positions of Taxpayer

Alice disagreed with the DOJ, of course. Her main defenses can be summarized as follows. The DOJ's interpretation of "willful" is so broad that every taxpayer who fails to file an FBAR does so willfully, which is contrary to the multi-tiered system of penalties designed by Congress. She never read her Forms 1040 and had no actual knowledge of the FBAR filing duty until 2008, so she could not have made a conscious choice not to comply. All cases cited by the DOJ involve taxpayers involved in significantly more egregious behavior than her. Finally, Congress created the large FBAR penalty in the Jobs Act for willful violations in order to punish "bad actors," and she is not one of those; she did not use the UBS account for any illegal activities.

3. Analysis by the Court of Federal Claims

The Court of Federal Claims reduced the case to its essence, identifying just four facts as "relevant" to the determination: (i) Alice did not disclose the UBS account to Accountant Weinstein; (ii) Alice never asked Accountant Weinstein how to properly report the passive income generated by the UBS account; (iii) Alice did not review her Forms 1040 for accuracy during the relevant years; and (iv) Alice answered "no" in response to the foreign-account question on Schedule B to Form 1040, thereby "falsely representing under penalties of perjury that she had no foreign bank accounts."

The Court of Federal Claims found that Alice had acted willfully, resuscitating the earlier judicial reasoning about constructive knowledge, willful blindness, and reckless disregard. Deciding that it was not even necessary to conduct a trial to fully develop and clarify the facts, the Court of Federal Claims granted the Motion for Summary Judgment filed by the DOJ, ruling as follows:

> In the court's judgment, [the fact that Alice did not review her Forms 1040 for accuracy, she answered "no" in response to the foreign-account question on Schedule B to Form 1040, and she signed Form 1040 under penalties of perjury] evidence conduct by [Alice], as a co-owner of the UBS account, that exhibited a "reckless disregard" of the legal duty under federal tax law to report foreign bank accounts to the IRS by filing a FBAR. Although [Alice] had no legal duty to disclose information to her accountant or to ask her accountant about IRS reporting requirements, these additional undisputed facts do not affect the court's determination that [Alice's] conduct in this case was "willful." For these reasons, the court has determined, viewing the evidence in the light most favorable to [Alice], that there is no genuine issue of material fact that [Alice] violated 31 U.S.C. §5314 and that her conduct was "willful."

VI. Conclusion

This article demonstrates that some degree of disagreement exists between the courts regarding the applicability of the constructive knowledge theory to FBARs. Given that taxpayers with foreign accounts generally must file Forms 1040, and given that willful FBAR penalties can reach 50 percent of the highest balance in the unreported foreign accounts, taxpayers and their advisors will continue to closely watch this issue. The hope, of course, is that more courts side with *Flume*, recognizing that logic lobbies against precedent that taxpayers are presumed to be aware of the FBAR filing duty merely by submitting their annual Forms 1040.

ENDNOTES

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1 The Bank Secrecy Act, P.L. 91-508, Title I and Title II (Oct. 26, 1970).

2 P.L. 91-508, Title I and Title II (Oct. 26, 1970) at §202.

3 68 FR 26489 (May 16, 2003).

4 31 CFR §103.56(g), 68 FR 26489 (May 16, 2003).

5 The American Jobs Creation Act, P.L. 108-357 (Oct. 22, 2004).

6 31 USC §5321(a)(5)(A) (as in effect before Oct. 22, 2004).

7 31 USC §5321(a)(5)(B)(ii) (as in effect before Oct. 22, 2004).

8 31 USC §5321(a)(5)(A).

9 31 USC §5321(a)(5)(B)(i). This penalty cannot be asserted if the taxpayer was "non-willful" and there was "reasonable cause" for the violation. *See* 31 USC §5321(a)(5)(B)(ii).

10 31 USC §5321(a)(5)(C)(i).

11 31 USC §5314; 31 CFR §1010.350(a).

12 For a detailed analysis of the Form 8938 filing requirement, *see* Hale E. Sheppard, *The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance*, Int'l Tax J., 2012, at 11; Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules After IRS Issues Final Regulations*, Int'l Tax J., 2015, at 25; Hale E. Sheppard, *Specified Domestic Entities Must Now File Form 8938: Section 6038D, New Regulations in 2016, and Expanded Foreign Financial Asset Reporting*, Int'l Tax J., 2016, at 5; Hale E. Sheppard, *Canadian Retirement Plans: What Does Revenue Procedure 2014-55 Mean for U.S. Tax Deferral, Form 8891, Form 8938, and the FBAR?* Int'l Tax J., 2016, at 25; and Hale E. Sheppard, *Unlimited Assessment-Period for Form 8938 Violations: Ruling Shows IRS's Intent to Attack Multiple Tax Returns*, Taxes, 2017, at 31.

13 For more detailed information about the recent court battles regarding "willful" FBAR penalties, please see the following articles by the same author: Hale E. Sheppard, *What Constitutes a "Willful" FBAR Violation? Comprehensive Guidance Based on Eight Important Cases*, 129 J. Taxation 24 (2018); Hale E. Sheppard, *Court Bucks the Trend in Willful FBAR Penalty Cases: Merely Signing Tax Returns Does Not Establish Willfulness*, Taxes, 2019, at 29; Hale E. Sheppard, *Court Holds that Pervasive Ignorance Is No Defense to Willful FBAR Penalties: This and Other Lessons from United States v. Garrity*, Int'l Tax J., 2018, at 51; Hale E. Sheppard, *Willful FBAR Penalty Case Shows Importance of Protecting Privileged Communications: What Kelley-Hunter Adds to the Foreign Account Defense Discussion*, Int'l Tax J., 2018, at 15; *Hale E. Sheppard, Analysis of the Reasonable Cause Defense in Non-Willful FBAR Penalty Case: Teachings from Jarnagin*, 128 J. Taxation 6 (2018); Hale E. Sheppard, *First Taxpayer Victory in a Willful FBAR Penalty Case: Analyzing the Significance of Bedrosian for Future Foreign Account Disputes (Part 1)*, 128 J. Taxation 12 (2018); Hale E. Sheppard, *First Taxpayer Victory in a Willful FBAR Penalty Case: Analyzing the Significance of Bedrosian for Future Foreign Account Disputes (Part 2)*, 128 J. Taxation 14 (2018); Hale E. Sheppard, *Can Recent "Willful" FBAR Penalty Cases Against Taxpayers Help Tax Firms Fend Off Malpractice Actions?* Int'l Tax J., 2017, at 33; Hale E. Sheppard, *Government Wins Fourth Straight FBAR Penalty Case: Analyzing Bohanec and the Evolution of "Willfulness,"* 126 J. Taxation 110 (2017); Hale E. Shepard, *Government Wins Second Willful FBAR Penalty Case: Analyzing What McBride Really Means to Taxpayers*, 118 J. Taxation 187 (2013); Hale E. Sheppard, *Third Time's the Charm: Government Finally Collects "Willful" FBAR Penalty in Williams Case*, 117 J. Taxation 319 (2012); Hale E. Sheppard, *District Court Rules That Where There's (No) Will, There's a Way to Avoid FBAR Penalties*, 113 J. Taxation 293 (2010).

14 *J.B. Williams III*, 131 TC 54, Dec. 57,547 (2008); *Williams*, No. 1:09-cv-437, 2010 WL 347221 (E.D. Va. 2010); *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655.

15 *J. McBride*, DC-UT, 2012-2 ustc ¶50,666, 908 FSupp2d 1186.

16 *Bussell*, 117 AFTR 2d 2016-439 (D.C. C.D. Cal. 2015).

17 *Bohanec*, 118 AFTR 2d 2016-5537 (D.C. C.D. Cal. 2016).

18 *Bedrosian*, 120 AFTR 2d 2017-5671 (D.C. Pa. 2017).

19 *Kelley-Hunter*, 120 AFTR 2d 2017-5566 (D.C. Dist. Col. 2017).

20 *Toth*, 122 AFTR 2d 2018-6280 (D.C. Mass. 2018).

21 *Colliot*, 121 AFTR 2d 2018-1834 (D.C. Tx. 2018).

22 *Wadhan*, 122 AFTR 2d 2018-5208 (D.C. Co. 2018).

23 *Garrity*, Case No. 3:15-cv-243 (D.C. Conn. 2018).

24 *Markus*, 122 AFTR 2d 2018-5166 (D.C. N.J. 2018).

25 *Norman*, 138 FedCl 189 (2018), 122 AFTR 2d 2018-5334.

26 *Flume*, 122 AFTR 2d 2018-5641 (D.C. S.D. Tex. 2018).

27 *Kimble*, Case No. 17421, Memorandum Opinion and Final Order Granting Defendant's Motion for Summary Judgment, Court of Federal Claims, Dec. 27, 2018.

28 *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655, at footnote 5.

29 *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655.

30 *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655.

31 *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655.

32 *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655.

33 *Williams*, CA-4, 2012-2 ustc ¶50,475, 489 FedAppx 655.

34 *McBride* Slip Opinion, at 36–37.

35 *McBride* Slip Opinion, at 37–38.

36 *McBride* Slip Opinion, at 38–39 (internal citations omitted).

37 *McBride* Slip Opinion, at 48–49 (internal citations omitted).

38 *L.D. Jarnagin*, FedCl, 2017-2 ustc ¶50,426, 134 FedCl 368; 120 AFTR 2d 2017-6683 (Ct. Fed. Cl., Nov. 30, 2017). The author obtained and reviewed the following documents related to *Jarnagin*: Complaint filed December 16, 2015; Answer filed April 18, 2016; Motion and Brief of the United States for Summary Judgment filed March 24, 2017; Opposition to Defendant's Motion for Summary Judgment and Cross-Motion for Summary Judgment for Plaintiffs filed May 10, 2017; Response Brief in Opposition to Plaintiffs' Cross-Motion for Summary Judgment and Reply Brief in Further Support of the United States' Motion for Summary Judgment filed June 16, 2017; Reply to Government's Opposition to Plaintiffs' Motion for Summary Judgment filed June 20, 2017; Opinion and Order filed November 30, 2017.

39 The author obtained and reviewed the following documents related to *Norman*: Complaint filed August 3, 2015; Answer filed April 21, 2016; Memorandum of Law in Support of Defendant's Motion for Summary Judgment filed November 9, 2017; Memorandum in Opposition filed February 7, 2018; Order Denying Motion for Summary Judgment issued February 14, 2018; Defendant's Reply in Support of its Motion for Summary Judgment regarding Legal Issues to Be Addressed at Trial filed March 16, 2018; Opinion and Order issued July 31, 2018.

40 The author derived the key facts by reviewing the following documents related to *E.S. Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21: Petition filed July 7, 2014 (enclosing Notice of Determination); Answer by IRS filed August 27, 2014; First Stipulation of Facts filed September 30, 2015; First Supplemental Stipulation of Facts filed September 30, 2015; Pre-Trial Memorandum by Taxpayer filed September 11, 2015; Pre-Trial Memorandum by IRS filed September 30, 2015; Opening Brief by IRS filed January 15, 2016; Answering Brief by Taxpayer filed March 9, 2016; and Reply Brief by IRS filed April 8, 2016. The author also reviewed the Memorandum and Order issued by the U.S. District Court (S.D. Texas) dated August 22, 2018 (Civil Action No. 516-CV-73) related to the Motions for Summary Judgment focused on FBAR penalties. Finally, the author reviewed the decision from the related FBAR penalty case, *Flume*, Civil Action No. 516-CV-73 (S.D. Texas Aug. 22, 2018), Memorandum and Order.