Second Court Rejects "Constructive Knowledge" Theory for Willful FBAR Penalties

*By Hale E. Sheppard**

I. Introduction

The longstanding Offshore Voluntary Disclosure Program ("OVDP") ended in late 2018, but many international battles are still raging, particularly those involving large penalties for undisclosed foreign accounts. Simply put, many U.S. individuals did not file FinCEN Forms 114 ("FBARs") to report accounts, did not declare the income they generated, and did not proactively approach the IRS to resolve matters. They hoped to remain undetected, but the IRS eventually audited them and asserted sanctions for "willful" violations.

One theory on which the IRS bases penalties is that the individuals had "constructive knowledge" of their FBAR duties, solely because they signed and dated their annual Forms 1040 (*U.S. Individual Income Tax Return*). This notion seemed farfetched to many at the outset, but several courts accepted it. The ramifications of such judicial decisions were unnerving: Since every U.S. individual must execute his annual Form 1040 in order for it to be valid, every individual must have "constructive knowledge" of potential FBAR duties, such that nobody can avoid willful penalties. Fortunately, two courts have rejected constructive knowledge as a justification for willfulness, much to the relief of U.S. individuals still engaged in foreign account disputes.

This article explains the duties for those holding foreign accounts, summarizes the IRS's position regarding constructive knowledge, analyzes the long list of cases supporting this position, and then highlights the two recent cases rejecting it, including *Schwarzbaum*.[1]

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II. Overview of Duties Related to Foreign Accounts

It is tedious, yet essential, to start with some background on duties for U.S. individuals holding foreign financial accounts.

A. Disclosure of Foreign Accounts and Related Income

The relevant law mandates the filing of an FBAR in situations where (i) a U.S. person, including U.S. citizens and residents, (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.[2] U.S. individuals with foreign accounts have several other duties, in addition to merely filing an FBAR. These include the following:

- They must check the "yes" box in Part III (Foreign Accounts and Trusts) of Schedule B (Interest and Ordinary Dividends) to Form 1040 to disclose the existence of the foreign accounts;
- They must identify the foreign country in which the accounts are located, also in Part III of Schedule B to Form 1040;
- They must declare all income generated by the accounts (such as interest, dividends, and capital gains) on Form 1040; and
- They generally must report the accounts on Form 8938 (*Statement of Specified Foreign Financial Assets*), which is enclosed with Form 1040.[3]

B. Questions and Cross-References on Schedule B

One of the duties listed above is checking "yes" to the foreign-account inquiry found on Schedule B to Form 1040. The IRS has slightly modified and expanded this language over the years, with the materials for 2019 stating the following:

> At any time during 2019, 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.[4]

C. Executing Forms 1040

Taxpayers must execute their Forms 1040 in order for them to be valid. The IRS often uses this sworn declaration against taxpayers after the fact, particularly 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.

D. Increase in FBAR Penalties

Congress enacted the Bank Secrecy Act in 1970.[5] One purpose of this legislation was to require the filing of certain reports, like the FBAR, where doing so would help the U.S. government in conducting criminal, tax, and regulatory investigations.[6]

Congress was concerned about widespread non-compliance with FBAR duties; therefore, it enacted stringent penalties in 2004 as part of the American Jobs Creation Act ("Jobs Act").[7] Under the law in existence *before* the Jobs Act, the IRS could only assert penalties against taxpayers where it could demonstrate that they "willfully" violated the FBAR rules.[8] If the IRS managed to satisfy that high standard, it was limited to imposing a relatively small penalty, ranging from $25,000 to $100,000, regardless of the size of the hidden account.[9]

Thanks to the Jobs Act, the IRS can 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] The Jobs Act calls for higher 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.[12] Given that many unreported accounts have enormous balances, the assessment-period for FBAR penalties is six years (not the standard three years) from the time of the

violation, and the law allows for penalties on a per-unreported-account-per-year basis, sanctions under the Jobs Act can be huge.

III. IRS's Position About Constructive Knowledge

A number of courts have examined the issue of what constitutes "willfulness" in the context of civil FBAR penalties.[13] Far too many cases exist to analyze them all in this article, but some notable ones include *Williams* in 2012,[14] *McBride* in 2012,[15] *Bussell* in 2015,[16] *Bohanec* in 2016,[17] *Jarnagin* in 2017,[18] *Bedrosian* in 2017,[19] *Kelley-Hunter* in 2017,[20] *Toth* in 2018,[21] *Colliot* in 2018,[22] *Wadhan* in 2018,[23] *Garrity* in 2018,[24] *Markus* in 2018,[25] *Norman* in 2018,[26] *Flume* in 2018,[27] *Kimble* in 2018,[28] *Horowitz* in 2019,[29] and *Rum* in 2019.[30]

Several of the preceding cases center on whether the taxpayer had "constructive knowledge" of his FBAR filing duty. The argument presented by the IRS and Department of Justice ("DOJ") adheres to the following logic:

- The taxpayer signed his Form 1040 under penalties of perjury, thereby representing that he reviewed the entire Form 1040, including Schedule B, and that everything was true, correct, and accurate;
- Schedule B put the taxpayer on notice of his potential FBAR duty;
- To the extent that the taxpayer had questions about the FBAR, Schedule B expressly directed him to the Instructions to Form 1040, the FBAR itself, and the Instructions to the FBAR;
- 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
- 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 still 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. Cases Upholding the Concept of Constructive Knowledge

Many courts initially accepted the notion that (i) certain actions or inactions by a taxpayer constituted constructive knowledge, and (ii) constructive knowledge, by itself, sufficed to uphold willful FBAR penalties. Below is a summary of some relevant cases.

A. *Williams*

Williams was 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 Fourth Circuit indicated that the District Court should not have focused on the taxpayer's motivation for not filing an FBAR. Then, noting various judicial precedents in the *criminal* arena, the Fourth Circuit went on to state what it considered the proper legal standard. It 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. In situations where willfulness is a condition for *civil* liability, the Fourth Circuit indicated that this covers both knowing and reckless violations. 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]."

The Fourth Circuit supported its decision on several grounds, one of which was constructive knowledge. 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, correct, and accurate. The Fourth Circuit 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 Fourth Circuit, the questions and cross-references in Part III of Schedule B to Form 1040 put the taxpayer on inquiry notice of the FBAR duty. The taxpayer in *Williams* testified that he did not review his Form 1040 in general or read the information in Schedule B in particular. The Fourth Circuit interpreted this inaction as conduct designed to conceal financial information, a conscious effort to avoid

learning about reporting duties, and "willful blindness" to the FBAR requirement.

B. *McBride*

The District Court in *McBride* 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." 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. 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.

C. *Jarnagin*

The next case to address the constructive knowledge argument was *Jarnagin*. There, the IRS assessed non-willful FBAR penalties, not willful ones. The issue, therefore, was whether the taxpayers had "reasonable cause" for the violations, such that penalties could be mitigated. As demonstrated below, *Jarnagin* still adds to the debate around constructive knowledge, despite the fact that the penalty standards are different.

The taxpayers bought property in Canada and started operating a ranch there. They split their time between Canada and the United States. The taxpayers opened an account at Canadian Imperial Bank of Commerce, which existed during the years at issue, 2006 through 2010. The balance of the account reached approximately $3.5 million. 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 the taxpayers 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, even though they signed them, thereby attesting that they had examined everything, including the Forms 1040 and Schedules B, and that they were true, correct, and accurate. The DOJ presented this argument, citing *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 the taxpayers had a "particular

obligation" to review Schedule B because the husband was a dual U.S.-Canadian citizen, he had business activities in Canada, and he maintained a Canadian account with millions on deposit. The Court of Federal Claims speculated that, if the taxpayers 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 as follows:

> 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 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, and the parties ultimately conducted a trial whose sole witness was the taxpayer herself.

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, the taxpayer indicated during the trial 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, and her note to UBS instructing it to close the account.

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.

The DOJ presented 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 could not 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 the following with respect to constructive knowledge:

> 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. Norman willfully violated §5314.

E. *Kimble*

Alice Kimble is a U.S. citizen by birth, as were her late parents. At some point, 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. All three knew about the UBS account. The parents supposedly maintained the account 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," 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, and Alice also met with them at least once by herself in Switzerland.

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

The couple divorced in 2000. 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 her about foreign accounts, and she never pro-actively disclosed them. Moreover, Alice never asked Accountant Weinstein if the investment income generated by the UBS and HSBC accounts needed to be reported on Forms 1040.

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

Alice claimed 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. In 2009, Alice applied for the OVDP, and she was accepted. She filed Forms 1040X and FBARs for the relevant years as part of the OVDP. The IRS presented her a Closing Agreement at the end of the OVDP process, which showed a significant "offshore" penalty. Alice then "opted-out" of the OVDP in order to "take her chances" with the IRS.

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 facts and circumstances: (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 an acceptable justification 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 did not disclose the foreign passive income; and (xii) The income generated by the foreign accounts was significant, constituting more than half of Alice's overall income in certain years.

The IRS assessed a willful FBAR penalty, which Alice fully paid. She then filed a claim for refund; the IRS denied it. Alice filed a Complaint in the Court of Federal Claims seeking a refund of the FBAR penalty. 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.

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."

Deciding that it was not even necessary to conduct a trial, 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."

F. *Horowitz*

The main facts in *Horowitz* are as follows. In 1984, Peter Horowitz and his wife, Susan, moved from the United States to Saudi Arabia for work reasons; he accepted a job with a local hospital. In 1988, Peter and Susan opened a joint account with the Foreign Commerce Bank in Switzerland, which they funded with earnings from Saudi Arabia. A few years later, in 1992, they moved back to the United States, but left the account at Foreign Commerce Bank open.

Peter and Susan decided to head back to Saudi Arabia in 1994, again for professional reasons. They closed the account at Foreign Commerce Bank that same year, using the funds to open a new joint account, also in Switzerland, this time at UBS. This new account was a "hold mail" account whose funds were invested in income-producing assets, such as bonds, certificates of deposit, and investment funds. In 2001, Peter and Susan made the long voyage back to the United States, seemingly for good, but left the UBS account open. Peter apparently monitored the account from afar by calling UBS every year or two.

In 2008, soon after U.S. news sources began reporting that UBS was under investigation, Peter traveled to Switzerland, met with UBS representatives to close the joint account, and transferred the funds from UBS to another Swiss institution, Finter Bank.

The specific reasons are unclear, but, in 2010, the Horowitzes closed the account at Finter Bank, repatriated the funds, and then applied to resolve their past international tax non-compliance through the OVDP. In 2012, likely after learning the size of the proposed "offshore" penalty, the Horowitzes "opted-out" of the OVDP, in hopes of reducing the sanctions during the audit process.

The Horowitzes used the same accounting firm for decades to prepare their annual Forms 1040. The methodology consisted of the following steps. The Horowitzes sent the accounting firm self-prepared summaries of financial and tax-related information (none of which included passive income generated by the foreign accounts), they waited to receive the completed Form 1040, and then they signed and filed it with the IRS without much further thought. Peter, who communicated with the accounting firm, never asked about potential U.S. duties related to foreign accounts. The Horowitzes apparently changed accounting firms, starting with the 2007 Form 1040, but used essentially the same procedure. In addition to omitting the foreign passive income, the Forms 1040 were incorrect in that the "no" box was checked on Schedule B in response to the question about the existence of foreign accounts. Finally, the Horowitzes never filed FBARs during the relevant years.

At the conclusion of the audit triggered by the "opt-out" from the OVDP, the Revenue Agent sent the Horowitzes an Examination Report showing, among other things, proposed FBAR penalties for 2007 and 2008. The Horowitzes filed a Protest Letter disputing the FBAR penalties. The Horowitzes did not reach an acceptable settlement with the Appeals Officer and they did not voluntarily pay the FBAR penalties of approximately $1 million. Therefore, the DOJ started a collection action in District Court.

Regarding the key issue in the case, whether the FBAR violations were "willful," the principal contentions of the parties were as follows. The Horowitzes denied that they knew of their FBAR duty because (i) they had spoken to other expatriates who told them, incorrectly, that income earned in Saudi Arabia was only taxed there, (ii) they did not even know what an FBAR was, and (iii) their accountants did not specifically ask about foreign accounts or explain the foreign-account question on Schedule B to Forms 1040.

The DOJ, on the contrary, argued that the Horowitzes were willful because they executed the Forms 1040, Schedule B contained "simple instructions" and asked a "simple question" about the existence of foreign accounts, and the Horowitzes nonetheless checked "no" in response to the foreign-account inquiry.

In rendering its decision, the District Court looked primarily to the earlier holdings in *Williams* and *McBride*, identifying similarities and differences in the facts and circumstances of each case. Focusing on the Horowitzes, the District Court underscored several points. First, they executed their Forms 1040 declaring, under penalties of perjury, that they had reviewed them and they were true, correct, and accurate. Second, Schedule B on Forms 1040 contained the foreign-account question, followed by a cross-reference to instructions explaining the filing requirements and exceptions for FBARs. Third, while the Horowitzes might have listened to friends who opined, erroneously, about U.S. tax duties for expatriates, the District Court lacked information to determine whether it was reasonable to accept such opinions, and, in all events, the views of friends cannot trump

the "clear instructions" on Schedule B. Fourth, the fact that the Horowitzes discussed international tax matters with friends demonstrates their awareness of potential issues. Fifth, the failure by the Horowitzes to have a similar conversation with their accountants shows "a conscious effort to avoid learning about [FBAR] reporting requirements," from which "willfulness blindness" can be inferred.

G. *Rum*

Mr. Rum is a U.S. citizen who operated several businesses, including a deli, pet supply store, and convenience store. In 1998, he opened an account with UBS in Switzerland, sending $1.1 million from a domestic account. He opened a numbered account with UBS, such that his name did not appear, and he instructed UBS to hold the mail related to the account. Mr. Rum actively communicated with UBS regarding investment strategies. He filed annual Forms 1040 with the IRS, but he omitted the passive income from the UBS account, he checked "no" in response to the foreign-account question on Schedule B, and he did not file any FBARs.

In October 2009, UBS sent Mr. Rum a letter indicating that it planned to disclose his data to the IRS. Shortly thereafter, Mr. Rum filed his first FBAR ever, for 2008. Rum then closed the UBS account and transferred the funds to another foreign institution, Arab Bank, also located in Switzerland.

The IRS, after receiving the information from UBS, started an audit of Mr. Rum. The IRS eventually sent a letter indicating that it was assessing a willful FBAR penalty, in response to which Mr. Rum filed a Protest Letter. The Appeals Officer later sustained not only the FBAR penalty, but also civil fraud penalties from the related income tax audit. Ultimately, the DOJ filed the collection suit against Mr. Rum in District Court to recoup the willful FBAR penalty.

FBAR normally cases contain facts that go both ways, with some favoring the IRS, and others supporting the taxpayer's version of events. This was not so in *Rum*, where nearly all items identified by the District Court supported the IRS's position that the violations were willful. The District Court reviewed the definition of willfulness in the FBAR context, citing to *Williams*, *McBride*, and other cases. It then determined that there was no dispute as to willfulness based on the following facts: (i) Mr. Rum opened a numbered account with UBS; (ii) He instructed UBS to hold all mail; (iii) He gave contradictory answers about the rationale for opening the account in Switzerland; (iv) He actively communicated with UBS regarding investment decisions; (v) He did not report income from the UBS account on his Forms 1040; (vi) He checked the "no" box in response to the foreign account question on Schedule B; (vii) He signed his annual Forms 1040 under penalties of perjury declaring that they were true, correct, and accurate; (viii) He did not file any FBARs until 2009, and then only after UBS informed him that it was revealing his account to the IRS; (ix) He transferred the funds from UBS to Arab Bank, instead of repatriating them; (x) He never mentioned the account at Arab Bank during the audit; (xi) He did not inform his accountant about the UBS account; (xii) He did not participate in a voluntary disclosure program; (xiii) He omitted his UBS account on his federal student aid application, to appear as if he had fewer assets and income, yet he disclosed the UBS account on his mortgage application, to show that he had more assets and income; and (xiv) He claimed that he believed that income from the UBS account would not be taxable until he repatriated it, but, inconsistent with that theory, he did not report any income on his 2009 Form 1040, when he brought the money back.

The District Court made a few specific determinations of interest regarding willfulness. First, citing to a list of previous cases, including *Williams*, *Jarnagin*, *Norman*, and *Kimble*, the District Court held that signing of Form 1040 without reviewing it "in and of itself supports a finding of reckless disregard to report under the FBAR." Second, the District Court explained that, by signing Form 1040, taxpayers are placed on "inquiry notice" of the FBAR obligation and thus have "constructive knowledge" thereof. Finally, the District Court described Mr. Rum's behavior as a "pattern" of non-compliance, because he filed annual Forms 1040, which he self-prepared, and invariably declared "no" to the foreign account question on Schedule B.

V. Cases Rejecting Concept of Constructive Knowledge

Two courts have bucked the trend described above by rejecting the core idea, advanced by the IRS and DOJ, that constructive knowledge, with nothing more, is enough to impose willful FBAR penalties. The two relevant cases are analyzed below.

A. *Flume*

The taxpayers are U.S. citizens who moved to Mexico. They formed a foreign corporation, Wilshire Holdings,

Inc. ("Wilshire"), in 2001, and it then opened an account at UBS in Switzerland in 2005. The IRS audited the taxpayers and then sought back taxes, along with penalties for not filing Forms 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*) to report Wilshire.

For its part, the DOJ initiated a collection action in District Court to recoup willful FBAR penalties for 2007 and 2008. The DOJ later filed a Motion for Summary Judgment, asking the District Court to rule that the husband willfully violated his FBAR duties. The filings and hearing triggered by the Motion for Summary Judgment produced the following facts.

In the early 2000s, the husband hired Leonard Purcell, a U.S. return preparer with offices in the United States and Mexico, and his partner to prepare his Forms 1040 (*Mexican Accountants*). They prepared Forms 1040 for the relevant years, disclosing only the existence of the husband's small account in Mexico, but not the large account at UBS. Moreover, the husband did not file timely FBARs for 2007 or 2008. He filed them late, in 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, the husband told the Mexican Accountants about the UBS account, but they all agreed that he never supplied any documents regarding such account. The 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 Mexican Accountants had prepared them accurately. The husband signed the Form 1040 each year, indicating that he had reviewed it, and it was true, correct, and accurate.

The District Court indicated that the definition of "willfulness" in the civil FBAR context was an issue of first impression in the Fifth Circuit, and emphasized that only a limited number of cases had thoroughly analyzed the issue. The District Court then went on to examine the concept of "willfulness" under various legal theories, including "constructive knowledge."

Relying largely on *McBride*, the DOJ argued that the 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. In rendering its decision about the Motion for Summary Judgment in *Flume*, the District Court refused to follow *McBride* for several reasons, two of which dealt with constructive knowledge. 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 announced that the constructive-knowledge theory is "rooted in faulty policy arguments." The DOJ argued that ruling in favor of the husband would encourage taxpayers to sign Forms 1040 without reading them in hopes of later avoiding 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 ended its comments on this issue 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.

The husband's triumph, from having survived the Motion for Summary Judgment filed by the DOJ, was brief. Indeed, after a trial on substantive matters, the District Court determined that the husband had willfully violated his FBAR duties. One of the reasons behind this decision centered on "constructive knowledge." The District Court explained that the husband acted with "extreme recklessness" by failing to review his Forms 1040 before signing them. The District Court acknowledged that leniency might be proper in situations involving unsophisticated taxpayers, but the husband is a businessman with more than 30 years of experience managing complex projects, in the United States and Mexico. Harkening back to *McBride*, the District Court stated the following:

> Schedule B's question about foreign bank accounts is simple and straightforward and requires no financial or legal training to understand. Even the most cursory review of his tax return would have altered [Husband] to the foreign account reporting requirement.

This ruling is interesting because it demonstrates that the District Court walked a thin line, trying to classify the FBAR violations as willful, while not reversing its earlier holding in response to the Motion for Summary Judgment filed by the DOJ. The District Court seemed acutely aware of its predicament, explaining the following in a footnote:

> *McBride* and *Williams* both accepted a "constructive knowledge" theory for proving knowing violations. Under this view, "every taxpayer, merely by singing a tax return, is presumed to know of the need to file an FBAR." The Court rejected this theory in its summary-judgment Order, and the parties did not urge it again at trial … Citations to *McBride* and *Williams* in this Order should not be understood as a reversal of the Court's [earlier] position that "[t]he constructive knowledge theory is unpersuasive" as a justification for penalties based on knowing conduct.

B. *Schwarzbaum*

The most recent case, *Schwarzbaum*, issued March 2020, finally provided *Flume* some company. The relevant facts are as follows.

The taxpayer was born in Germany, and lived in many different countries, namely, Spain, Costa Rica, Switzerland and the United States. His considerable assets were derived from his father, a successful businessman and investor, either by gift (during his life) or bequest (upon his death). The taxpayer's highest academic accomplishment was high school; he has no tax-related skills, education, or training. He became a Green Card holder in 1993 and a U.S. citizen in 2000.

The taxpayer began holding foreign accounts in 2001, and had a reportable interest in 20 accounts, located in Switzerland and Costa Rica, during the relevant years. The taxpayer used a variety of U.S. accountants to prepare his Forms 1040 over the years. In September 2009, UBS sent the taxpayer a letter indicating that the IRS was seeking information about U.S. accountholders, like him. The taxpayer, through a Swiss attorney, unsuccessfully attempted to prevent UBS from disclosing his data. He then applied for the OVDP, opted-out, and faced an IRS audit. The Revenue Agent first imposed FBAR penalties for 2006, 2007, 2008, and 2009 totaling about $35 million, which he later decreased to approximately $14 million under the applicable mitigation standards. The taxpayer refused to pay such penalties, so the DOJ started a collection lawsuit in District Court.

The District Court started its analysis by adopting the viewpoint in *Flume* and rejecting the DOJ's attempt to assess multi-million dollar penalties based on constructive knowledge. It stated the following on this topic:

> As a preliminary matter, the Court notes that in attempting to satisfy its burden in this case, the USA relies heavily on the notion from case law that a taxpayer is charged with knowledge of the information on a tax return by virtue of signing it under penalties of perjury … However, upon review, the Court agrees with the recent decision in [*Flume*] that the theory of constructive knowledge is unpersuasive in this instance. Imputing constructive knowledge of filing requirements to a taxpayer simply by virtue of having signed a tax return would render the distinction between a non-willful and willful violation in the FBAR context meaningless. Because taxpayers are required to sign their tax returns, a violation of the FBAR filing requirements could never be non-willful. Yet, the statute provides for non-willful penalties. Applying the USA's suggested reasoning would lead to a draconian result and one that would preclude a consideration of other evidence presented. Accordingly, the USA cannot satisfy its burden of proof in this case on the issue of willfulness simply by relying on the fact that [the taxpayer] signed his tax returns or neglected to review them as thoroughly as he should have.

The District Court refused to hear about constructive knowledge, but it ultimately held in favor of the DOJ with respect to 2007, 2008 and 2009, on grounds that the taxpayer showed "recklessness" and "willful blindness" regarding his FBAR duties. The District Court waived penalties for 2006, though, because the taxpayer demonstrated that he reasonably relied on an informed U.S. tax professional.

VI. Conclusion

It is too early to call it a trend, but the recent decisions in *Flume* and *Schwarzbaum* give taxpayers hope that other courts will start to snub "constructive knowledge" as grounds for the IRS to assert willful FBAR penalties. Taxpayers and their advisors will be watching for further support as IRS international enforcement efforts intensify, and countries around the world increase collaboration and information sharing.

ENDNOTES

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1 *Schwarzbaum*, 125 AFTR 2d 2020-XXXX (D.C. FL 3/20/2020).

2 31 USC §5314; 31 CFR §1010.350(a).

3 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; Hale E. Sheppard, *Extended Assessment Periods and International Tax Enforcement: Rafizadeh v. Commissioner, Unreported Foreign Assets, and Use of FATCA Weapons*, Taxes, 2018, at 35 and 44 J. Int'l Taxation 25 (2018).

4 Schedule B (Form 1040 or 1040-SR) (2019).

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

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

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

8 31 USC §5321(a)(5)(A) (as in effect before Oct. 22, 2004).

9 31 USC §5321(a)(5)(B)(ii) (as in effect before Oct. 22, 2004).

10 31 USC §5321(a)(5)(A).

11 31 USC §5321(a)(5)(B)(i). The IRS cannot assert this penalty if the taxpayer was "non-willful" and there was "reasonable cause" for the violation. *See* 31 USC §5321(a)(5)(B)(ii).

12 31 USC §5321(a)(5)(C)(i).

13 For more detailed information about court battles regarding "willful" FBAR penalties, *see* Hale E. Sheppard, *Flume, Boyd, and Cohen: Three Recent FBAR Cases Yielding Important New Lessons*, Int'l Tax J., 2019, at 31; Hale E. Sheppard, *More FBAR Penalty Losses and Lessons: The Significance of Rum and Ott*, Int'l Tax J., 2019, at 17; Hale E. Sheppard, *Constructive Knowledge and FBAR Penalties: Does Merely Filing a Form 1040 Suffice to Establish Willfulness?* Int'l Tax J., 2019, at 35 and Taxes, 2019, at 47; Hale E. Sheppard, *Appellate Court Jeopardizes First Holding of Non-Willfulness in FBAR Penalty Case: Round Three of the Bedrosian Battle*, __ J. Int'l Taxation ___ (2019) and ___ J. Taxation ___ (2019); Hale E. Sheppard, *Courts Hold That U.S. Government Can Pursue Executors, Representatives, Fiduciaries, Beneficiaries, Distributees, and Others for FBAR Penalties Assessed Against Deceased Taxpayers*, __ J. Int'l Taxation ___ (2019) and ___ J. Taxation ___ (2019); 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 23; 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. Sheppard, *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 *Williams*, 131 TC 54, Dec. 57,547 (2008); *Williams*, No. 1:09-cv-437, 2010 WL 347221 (E.D. Va. 2010); *Williams*, CA-4, 489 FedAppx 655 (2012).

15 *McBride*, 908 FSupp2d 1186 (D.C. Utah 2012).

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 *Jarnagin*, FedCl, 134 FedCl 368 (2017); 120 AFTR 2d 2017-6683 (11/30/2017).

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

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

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

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

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

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

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

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

27 *Flume*, TC Memo. 2017-21 (Case focused on civil penalties for unfiled Forms 5471 to disclose ownership of foreign corporations); *Flume*, Civil Action No. 516-CV-73 (S.D. TX 8/22/2018) (Order in response to Motion for Summary Judgment filed by the U.S. government); *Flume*, 123 AFTR 2d 2019-XXXX (S.D. TX 6/1/2019) (Verdict by District Court regarding FBAR penalties).

28 *Kimble*, Case No. 17421, 122 AFTR 2d 2018-XXXX (Ct. Fed. Cl. Dec. 27, 2018).

29 *Horowitz*, 123 AFTR 2d 2019-XXXX (D.C. MD 1/18/2019).

30 *Rum*, 124 AFTR 2d 2019-XXXX (M.D. FL 8/2/2019).