Lessons from an International Tax Dispute: Three Interrelated Cases, in Three Different Proceedings, Generating Three Separate Liabilities

*By Hale E. Sheppard**

I. Introduction

Attention has been focused recently on conservation easement donations, micro-captive insurance, virtual currency, and other "hot" topics. Although not dominating the news cycle any longer, plenty of taxpayers continue hiding foreign assets, and the Internal Revenue Service ("IRS"), with help from the Department of Justice ("DOJ"), still aggressively pursues them. What is remarkable about these international actions is that they sometimes trigger three interrelated disputes, occurring in three different venues, and generating three potentially large liabilities. What is perhaps more interesting, or disconcerting depending on your perspective, is that many taxpayers and their representatives are clueless as to the special procedures and players involved in these types of enforcement matters. A recent trilogy of court decisions, broadly referred to in this article as the *Flume* cases, provides a teachable moment, an opportunity to see, in real life, what a taxpayer with unreported foreign assets could face if caught.[1]

HALE E. SHEPPARD, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section and Chair of the International Tax Section of Chamberlain Hrdlicka.

II. Overview of Common Duties and Penalties

To appreciate the significance of the three *Flume* cases, one must first have a basic understanding of the obligations triggered by having a direct or indirect interest in a foreign account. U.S. citizens and residents have several duties, the following among them:

- They must check the "yes" box on Schedule B (Interest and Ordinary Dividends) to Form 1040 (*U.S. Individual Income Tax Return*) to disclose the existence of the foreign account.
- They must identify the foreign country in which the account is located, also on Schedule B to Form 1040.
- They must declare all income on Form 1040 before depositing it into the foreign account, along with all passive income later generated by the account, such as interest, dividends, and capital gains.
- They generally must report the account on Form 8938 (*Statement of Specified Foreign Financial Assets*), which is enclosed with Form 1040.
- In situations where taxpayers hold the foreign account indirectly through a foreign corporation, they likely need to file Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).
- In cases where taxpayers hold the foreign account through a foreign trust instead, they normally must file a Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) and/or Form 3520-A (*Annual Information Return of Foreign Trust with a U.S. Owner*).
- They must electronically file a FinCEN Form 114 (*Report of Foreign Bank and Financial Accounts*) ("FBAR").

Failure to meet the preceding duties, without a good justification or excuse, often leads to significant penalties. First, taxpayers omitting income from foreign activities and assets often face large U.S. tax liabilities, as well as significant penalties linked to the tax underpayments. Examples include negligence penalties equal to 20 percent of the tax debt, penalties rising to 40 percent in situations involving undisclosed foreign financial assets, and penalties reaching 75 percent where the IRS can prove civil fraud.[2] Taxpayers are also stuck with large interest charges, on both the tax liabilities and penalties.[3]

Second, if a taxpayer fails to file Form 8938 in a timely manner, then the IRS generally will assert a penalty of $10,000 per violation.[4] The penalty increases to a maximum of $50,000 if the taxpayer does not rectify the problem quickly after contact from the IRS.[5]

Third, holding an interest in a foreign corporation, particularly one categorized as a controlled foreign corporation ("CFC"), triggers more complications. Several categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations ordinarily must file a Form 5471 with the IRS.[6] If a person neglects to do so, then the IRS may assert a penalty of $10,000 per violation, per year.[7] This standard penalty increases at a rate of $10,000 per month, to a maximum of $50,000, if the problem persists after notification by the IRS.[8]

Fourth, additional penalties apply when foreign trusts are involved. Form 3520 must be filed in various circumstances. For instance, a "responsible party" generally must file a Form 3520 within 90 days of certain "reportable events," such as the creation of a foreign trust by a U.S. person, the transfer of money or other property (directly or indirectly or constructively) to a foreign trust by a U.S. person, and the death of a U.S. person, if the decedent was treated as the owner of any portion of the trust under the grantor trust rules, or if any portion was included in the gross estate of the decedent.[9] A U.S. person also must file a Form 3520 if he receives during a year (directly or indirectly or constructively) any distribution from a foreign trust.[10] The penalty for not filing a Form 3520 is $10,000 or 35 percent of the so-called "gross reportable amount," whichever is larger.[11] A Form 3520-A normally must be filed if, at any time during the relevant year, a U.S. person is treated as the owner of any portion of the foreign trust under the grantor trust rules.[12] The normal penalty for Form 3520-A violations is the higher of $10,000 or five percent of the "gross reportable amount."[13]

Lastly, taxpayers often face large sanctions for unfiled FBARs. 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.[14] In the case of non-willful violations, the maximum penalty is $10,000 per incident.[15] Higher penalties apply if willfulness exists. Specifically, when a taxpayer willfully fails to file an FBAR, the IRS may assert a penalty of $100,000 or 50 percent of the balance in the undisclosed account at the time of the violation, whichever amount is larger.[16] Given the multi-million dollar balances in many unreported accounts, given that the IRS can assert a penalty worth 50 percent of the account for every single year that the violation occurs, and given that the IRS can impose both civil and criminal penalties for the same infraction, FBAR penalties can be severe.[17]

The penalties described above can be significant, even when considered separately. They have the potential of becoming untenable, though, when the IRS decides to "stack" the penalties, asserting multiple penalties in connection with the same unreported foreign assets or activities. A District Court recently held that "stacking" certain penalties did not violate applicable law or the constitution.[18]

III. Fighting the U.S. Government on Three Fronts

Many taxpayers, accountants, and attorneys, who are not regularly involved with international issues, are unaware of the filing duties and potential penalties described above. Worse still, many more are completely oblivious to the fact that individual taxpayers caught by the IRS with international non-compliance often find themselves embroiled in a fight with the U.S. government on three different fronts. The following hypothetical shows how this works.

Assume that Wanderlust Wendy personally held foreign accounts during 2017, with an aggregate balance of approximately $2 million, which yielded a total of $100,000 in interest income. Further assume that Wanderlust Wendy did not report the foreign-source income on her 2017 Form 1040, did not disclose the existence of the foreign accounts by checking the "yes" box on Schedule B to Form 1040, did not enclose a Form 8938 with her Form 1040, and did not electronically file an FBAR. Finally, assume that Wanderlust Wendy did not participate in a voluntary disclosure program to rectify her past transgressions, but rather got audited by the IRS.

The IRS likely would issue the following items to Wanderlust Wendy: (i) a Notice of Deficiency proposing increased taxes on the $100,000 of unreported income and tax-related penalties, (ii) an FBAR 30-day letter (*i.e.*, Letter 3709) asserting a penalty of $1 million, which constitutes the maximum sanction of 50 percent of the highest aggregate balance of the unreported accounts, and (iii) a Form 8278 (*Assessment and Abatement of Miscellaneous Civil Penalties*) asserting a penalty of $10,000 for the missing Form 8938.[19]

If Wanderlust Wendy disputes everything, then she will become familiar with at least three different venues. First, Wanderlust Wendy would file a Petition with the Tax Court to dispute the income taxes and tax-related penalties proposed in the Notice of Deficiency.[20]

Second, because the FBAR penalty derives from Title 31 of the U.S. Code (*i.e.*, Money and Finance) as opposed to Title 26 of the U.S. Code (*i.e.*, Internal Revenue Code), it cannot be challenged in Tax Court.[21] Thus, after Wanderlust Wendy exhausts her administrative appeal rights with the IRS, the DOJ would bring an action against her in District Court to collect the FBAR penalty.[22]

Third, because penalties for not filing Form 8938 are unrelated to the income tax deficiency, they cannot initially be challenged in Tax Court in a proceeding triggered by a Notice of Deficiency.[23] Moreover, because the Form 8938 sanction is an "assessable penalty," taxpayers generally find themselves disputing it in one or more of the following manners: (i) Filing a penalty-abatement letter in response to the first notice from the IRS; (ii) Administratively challenging with the Appeals Office any negative decision by the IRS Service Center about the initial penalty-abatement request; (iii) Filing a request for, and participating in, a Collection Due Process ("CDP") hearing with the IRS; and (iv) After receiving an unfavorable Notice of Determination after the CDP hearing, seeking review by the Tax Court.

The preceding illustration centers on the fictional character of Wanderlust Wendy, but this type of multi-venue fighting often occurs in real life. For instance, one deceased taxpayer and his beneficiaries, with unreported foreign income, accounts, and trusts, were engaged in disputes with the IRS and DOJ for several years, in the Tax Court, two District Courts, and a state Probate Court.[24] Another perfect example, and the focus of this article, is the *Flume* trilogy, analyzed below.

IV. Key Facts for the Three *Flume* Cases

The key facts in the three interrelated *Flume* cases derive from multiple sources.[25]

Mr. Flume ("Husband") and Mrs. Flume ("Wife") are U.S. citizens who moved to Mexico in 1993. Before heading south, Husband worked as an urban planner and real estate developer in the United States. Husband was engaged in the same type of activities in Mexico, operating a real estate company that developed land, sold lots, and built high-end homes.

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"). They started as equals, each owning 50 percent. Husband was also the president. Franchise Food was created in order to operate Mexican locations of Whataburger and Fanny Ice Cream. These establishments were sold in 1998, but Franchise Food remained in existence. Husband claimed that he sold more than half of his shares in Franchise Food in February 2002 to a Mexican citizen. The sale had the effect of reducing Husband's ownership interest to nine percent. Husband engaged in this stock sale to avoid the duty to file Forms 5471 for Franchise Food after 2002; he claimed that he was not required to file Forms 5471 because he had fallen below the applicable ownership threshold of 10 percent.

In addition to Franchise Food, Husband and Wife formed at least two other foreign corporations, one of which was Wilshire Holdings, Inc. ("Wilshire"). This entity was originally formed in the Bahamas in 2000 and then reincorporated in Belize the following year, 2001. Ownership was reflected by two bearer shares. Certificate 1, worth 25,000 shares, was assigned to Husband. Certificate 2, also worth 25,000 shares, pertained to Wife. Husband denied this ownership throughout the tax dispute, alleging that on the same day that Wilshire was formed, "amended" Articles of Association took effect, which changed the original ownership structure such that Husband and Wife owned less than 10 percent. Husband offered no proof of this new ownership structure, other than the "amended" Articles of Association, which he ultimately admitted had been "backdated."

The IRS has offered taxpayers a variety of voluntary disclosure programs since 2009, and a significant number of individuals and entities analyzed their situation and concluded that pro-actively rectifying matters with the IRS was the most prudent course of action.

In 2005, Wilshire opened an account at UBS in Switzerland. A number of documents and communications related to such account undermined Husband's position that he was just a minor owner of Wilshire. For instance, Husband and Wife opened the Swiss account using the original Articles of Association (showing Husband and Wife as 50/50 owners) and not the "amended" Articles of Association described above, Husband and Wife were listed as "beneficial owners" of the account, Husband signed account-related documents in his capacity as "First Director" of Wilshire, Husband and Wife controlled the investment activity in the account, Husband instructed UBS not to invest in U.S. securities, and Husband and Wife signed the wire-transfer orders, as "Directors" of Wilshire, to empty the Swiss account and remit all funds to a U.S. account.

Husband and Wife filed timely Forms 1040 for 2001 through 2009, but they did not report certain income generated by Franchise Food or Wilshire, did not report passive income generated by the UBS account, did not enclose Forms 5471, and did not separately file FBARs.

In the early 2000s, Husband hired return preparers with offices in the United States and Mexico to prepare annual Forms 1040 ("Mexican Accountants"). They prepared the Forms 1040 for the relevant years disclosing only the existence of Husband's account in Mexico, but not the larger account at UBS in Switzerland.

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. Husband attributed these inaccuracies to the fact that, in June 2010, he lacked access to his UBS records and was obligated to "cobble together" estimates from his notes and memory.

There was conflicting testimony about whether, or precisely when, Husband told the Mexican Accountants about the UBS account, but they all agreed that Husband never supplied any documents regarding such account. The Mexican 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 Mexican Accountants never informed him of FBAR duties until many years later, in 2010.

Husband acknowledged that he was not particularly diligent about his tax considerations. Indeed, he did not read his Forms 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 to him, signed Forms 1040, and trusted that the Mexican Accountants had prepared them accurately. Husband signed Form 1040 each year, indicating that he had reviewed it, and that it was true, complete, and accurate.

Husband had a personal account executive at UBS ("Swiss Bank Representative"), with whom he corresponded regularly about the account, and with whom he met at his house in Mexico to discuss the account. In early 2008, Husband instructed the Swiss Bank Representative to send certain funds from UBS to an account in Mexico, before sending the remainder to a Fidelity account in the United States. The notes of the Swiss Bank Representative indicate that Husband's main concerns were the IRS's investigation of UBS and keeping the account confidential.

V. First of Three Fights—Form 5471 Penalty Litigation in Tax Court

The first of several fights in which Husband engaged focused on non-disclosure of his interest in the two foreign corporations, Franchise Foods and Wilshire.

A. IRS Audit and CDP Hearing

The IRS started an audit in 2012. The Revenue Agent sought information from Husband and Wife using various tools, including Information Document Requests ("IDRs") and at least one Formal Document Request ("FDR"). Husband and Wife only partially responded to these demands by the Revenue Agent. Therefore, in August 2012, the Revenue Agent sent pre-assessment notices about potential Form 5471 penalties. Then, in October 2012, the Revenue Agent sent a letter warning Husband and Wife that the IRS would impose additional penalties of $10,000 per month until they filed the required Forms 5471. In January 2013, Husband sent the Revenue Agent Forms 5471 for 2001 and 2002 with respect to Franchise Food, but he filed no Forms 5471 for Wilshire. Shortly thereafter, the Revenue Agent assessed a total of $110,000 for missing Forms 5471 from 2001 through 2009.

Husband did not voluntarily pay the Form 5471 penalties, so the IRS eventually sent him a pre-levy notice in December 2013, indicating that the IRS intended to start seizing assets in order to satisfy the penalties and notifying Husband of his right to request a CDP hearing. Husband filed a timely request for a CDP hearing, claiming, among other things, that (i) the Forms 5471 for 2001 and 2002 for Franchise Foods, filed with the Revenue Agent approximately a decade late and only in response to a letter warning of imminent penalties, sufficed, and (ii) Husband was not required to file Forms 5471 for Wilshire for 2001 through 2009 because he had only a nine percent ownership interest, and thus was not a "U.S. shareholder" with a filing duty.

The IRS Settlement Officer conducting the CDP hearing rejected Husband's first argument on grounds that the Forms 5471 for Franchise Food were filed years after the fact and, in all events, were "inaccurate and incomplete." The Settlement Officer rejected Husband's second argument, too, pointing out that the Revenue Agent had obtained "compelling documentation" from UBS showing that Husband and Wife were owners, officers, and directors of Wilshire from 2001 through 2009. The Settlement Officer ultimately issued a Notice of Determination, concluding that the IRS was free to levy Husband's assets.

B. Tax Court Litigation Contesting Result of CDP Hearing

Husband was not willing to go down without a fight; he filed a timely Petition with the Tax Court challenging the conclusions reached by the Settlement Officer in the Notice of Determination. This Petition was brief, completed using the fill-in form available on the Tax Court website. Husband summarized his entire case for the Tax Court in the following manner: "Taxpayer has complied with Form 5471 reporting requirements as required by law and has filed the appropriate tax forms" and "Taxpayer has documents and IRS filings indicating proper filing of tax forms in accordance with ownership of tax reporting entities."

In his post-trial memo, Husband presented to the Tax Court the same arguments that he had previously (and unsuccessfully) raised with Settlement Officer during the CDP hearing. They consisted of the fact that (i) the Forms 5471 for 2001 and 2002 for Franchise Food, filed with the Revenue Agent during the audit, satisfied the filing duty, and (ii) Husband was not required to file Forms 5471 for Wilshire because he had only a nine percent ownership interest. Along with these longstanding arguments, Husband introduced two new ones in his post-trial memo. He contended, in particular, that the Forms 5471 for 2001 and 2002 were "substantially complete" because Franchise Food was "dormant" and thus had a less stringent filing requirement under Rev. Proc. 92-70. Husband also argued that he reasonably relied on the Mexican Accountants.

The IRS, in its own post-trial memo, quickly attacked Husband's new positions. The IRS pointed out that Franchise Food was not dormant after the stock sale in February 2002, as it continued to be involved in a joint real estate venture for many years thereafter. Moreover, from a technical perspective, the IRS underscored that the "dormant" rules only apply if a CFC is dormant during the entire year at issue, and Franchise Food was active. In terms of the reasonable reliance defense, the IRS explained that it was inapplicable because Husband could not demonstrate that the Mexican Accountants were qualified to complete Forms 1040 and give related advice, he admitted that he never had a call or meeting with the Mexican Accountants, and he conceded that he never provided them information about Franchise Food or Wilshire.

The Tax Court reduced this case to its essence. With respect to Franchise Food, the Tax Court concluded that (i) Husband was obligated to file a Form 5471 each year, and (ii) the argument that the Forms 5471, filed years after the deadline and solely as a part of the audit, should be given "retroactive effect" lacked merit. Regarding Wilshire, the Tax Court noted that Husband had a constant Form 5471 filing obligation, and Husband "merely provided self-serving testimony and a backdated document to support his claim that he maintained only a 9% ownership interest during the tax years in issue." Finally, the Tax Court rejected the notion that Husband should be relieved of penalties under a reasonable reliance theory because Husband was unable to demonstrate that the Mexican Accountants had sufficient qualifications and expertise, and Husband never gave them relevant data.

VI. Second of Three Fights—FBAR Penalty Litigation in District Court

While the IRS was seeking Form 5471 penalties in Tax Court, the DOJ attorneys were busy initiating a collection action in District Court to recoup "willful" FBAR penalties for 2007 and 2008. The FBAR penalty litigation consists of two main parts: The summary judgment decision before trial, and the final decision after trial, both of which are examined below.

A. Analysis Triggered by Motion for Summary Judgment

The DOJ filed a Motion for Summary Judgment, asking the District Court to rule that Husband willfully violated his duty to file FBARs because he (i) knowingly disregarded the FBAR duty, or (ii) recklessly ignored a high probability that he was breaking the law.

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 at that time. The District Court then went on to examine the concept of "willfulness" under the following three legal theories.

1. Actual Knowledge—First Legal Theory

The District Court identified several pieces of evidence tending to show that Husband tried to hide his UBS account: (i) He only disclosed the Mexican account, and not the Swiss account, on Schedule B to his Forms 1040; (ii) The Mexican Accountants testified that Husband never disclosed the UBS account to them and never supplied any account statements to them; (iii) The Swiss Bank Representative explained that Husband's main worries during their meetings in Mexico consisted of maintaining the account confidential and the IRS's investigation of UBS; (iv) The Swiss Bank Representative told Husband of the importance of disclosing the Swiss account on Schedule B to his Form 1040; (v) Husband instructed UBS not to invest any funds in U.S. securities; (vi) Husband opened the account under the name of a foreign corporation, Wilshire; and (vii) When Husband filed the late FBARs, he seriously understated the value of the UBS account.

All this evidence notwithstanding, the District Court found that a reasonable factfinder could still conclude Husband did not have actual knowledge of his FBAR duty. The District Court first focused on the testimony of Husband during pre-trial depositions. Husband claimed that he informed the Mexican Accountants about his UBS account soon after it was opened in 2005, he did not learn of his FBAR duty until 2010, he never saw Schedule B of Forms 1040 because he only did a cursory review, he never expressed concern about keeping the UBS account confidential during his meeting in Mexico with the Swiss Bank Representative, he opted not to invest funds from the UBS account in U.S. securities because he was concerned about bank failure in the United States, and he opened the account in the name of Wilshire solely to "legally postpone" payment of income taxes. The District Court explained that, even though the statements by Husband were "self-serving," it was prohibited from making credibility determinations when ruling on a Motion for Summary Judgment.

The District Court went on to explain that, even if it were to ignore the testimony of Husband, a genuine dispute of fact about Husband's actual knowledge about the FBAR duty would still exist for several reasons. First, a factfinder might infer that Husband was ignorant of the FBAR duty because he did not file an FBAR for the Mexican account either. Second, a factfinder might discredit the testimony of the Mexican Accountants because admitting that they failed to notify Husband of his FBAR duties could expose them to malpractice claims. Third, the fact that Husband transferred the funds in the UBS account to a Fidelity account in the United States might be considered evidence that he was not attempting to hide the account from the IRS. Finally, a factfinder might conclude that Husband did not learn about the FBAR obligation until 2010 from the fact that he filed the late FBARs in June 2010.

Based on the preceding, the District Court ruled that there was a genuine fact as to Husband's actual knowledge of his FBAR reporting duty.

2. Constructive Knowledge—Second Legal Theory

Relying largely on *McBride*, the DOJ argued in its Motion for Summary Judgment 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.[26] The District Court refused to follow *McBride* for several reasons, the following among them.

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." On a related note, 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 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.

3. Reckless Disregard of Duty—Third Legal Theory

The DOJ argued that, even if Husband did not have actual knowledge of his FBAR duty, and even if he did not have constructive knowledge of the same, he still deserved a willful penalty because he "recklessly disregarded" the risk that he was violating the law.

The District Court first explained that, when dealing with civil FBAR penalty cases, recklessness means conduct that creates an unjustifiably high risk of violating the law, which is either known by the taxpayer or so obvious that it should have been known, and it is substantially greater than "merely careless" behavior by the taxpayer. The District Court then pointed out that the most factually similar case to *Flume* is *Bedrosian*, which set a "high bar" in terms of what actions or inactions by a taxpayer constitute recklessness.[27] The DOJ also argued that Husband actively tried to hide the UBS account, which equates to awareness of a significant risk that he was breaking the law. The DOJ further suggested that Husband's "conscious decision" not to consult the FBAR instructions, even though Schedule B on Form 1040 directs taxpayers to do so, constituted recklessness.

The DOJ's arguments fell flat. First, the District Court explained that there was a genuine factual dispute about whether Husband attempted to hide the UBS account from the IRS. Second, because Husband hired the Mexican Accountants, the District Court explained that it might not have been reckless for him not to read the FBAR instructions. Indeed, Husband testified that he relied on the competence of the Mexican Accountants, and if this were true, then it is not clear that Husband was taking an "unjustifiably high risk" in not reading everything closely. Moreover, the District Court explained that the warning on Schedule B to consult the separate FBAR instructions explicitly states that exceptions exist, and Husband might "understandably have reasoned" that he had no FBAR filing duty because the Mexican Accountants had already determined that an exception applied to him. Finally, the District Court emphasized that Line 7b of Schedule B to Form 1040, which was drafted by the IRS, creates ambiguity because it instructs taxpayers to write the name of the "foreign country" not the "foreign countries" in which taxpayers have an account. As a result, Husband "might reasonably have thought that he was not required to list both Mexico and Switzerland."[28] The District Court thus concluded that a reasonable factfinder might determine that Husband did not recklessly disregard his FBAR duties, such that a genuine factual dispute remained.

B. Ultimate Decision by District Court After Trial

Husband's euphoria from surviving the Motion for Summary Judgment was brief. Indeed, after a two-day trial, the District Court changed course, determining that Husband had willfully violated his FBAR duties and upholding the large penalties for the following reasons.

First, the District Court indicated that Husband's testimony was "not credible," contained "numerous contradictions," and "raised serious doubts about his veracity." Several examples were provided to support this skepticism. The District Court explained that Husband's supposed rationale for opening the UBS account in 2005 was to avoid bank failures in the United States. The problem with this, emphasized the District Court, is that no U.S. banks collapsed until later, in 2007 and 2008. The District Court also noted that, despite his supposed concern over the U.S. financial system, Husband had personal bank accounts, investments accounts, and a trust account in the United States throughout the relevant years. The District Court also underscored that Husband changed his story several times about when, exactly, he learned about his FBAR duty. Finally, the District Court challenged Husband's excuse for seriously underreporting the values of the UBS account on his late FBARs. Husband initially indicated that he was forced to rely on incomplete records and his memory, yet he admitted at trial later that he had electronic access to all UBS statements and the general ledgers for Wilshire, which showed the correct balances.

Second, the District Court characterized the financial structure used by Husband as a "sophisticated tax evasion scheme." It pointed to the fact that he successfully operated businesses in Mexico for nearly three decades, he instructed UBS not to invest in U.S. securities, he transferred Wilshire from the Bahamas to Belize in an effort to avoid government oversight, and he did not file tax returns in Mexico for Franchise Foods or himself.

Third, the Mexican Accountants sent Husband an annual reminder of his FBAR duties.

Fourth, the fact that Husband disclosed the existence of a Mexican account on Schedule B to his Forms 1040 shows that he was aware of the requirement and "made a conscious choice" not to similarly disclose the UBS account.

Fifth, the records from UBS, combined with Husband's testimony, show that Husband learned of the IRS's investigation into UBS by mid-2008, but opted not to file any FBARs until after UBS announced that it planned to turn over its records to the IRS. According to the District Court, "[t]his timing strongly suggests that [Husband] knew he was breaking the law but continued to believe that he could get away with it until it became clear that the U.S. authorities would learn of his Swiss account."

Sixth, 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 Husband was 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 that "Schedule B's question about foreign bank accounts is simple and straightforward and requires no financial or legal training to understand [and] even the most cursory review of his tax return would have alerted [Husband] to the foreign account reporting requirement."

Finally, the District Court claimed that it was "reckless" for Husband to place total reliance on the Mexican Accountants, particularly because he did not conduct any research on their credentials. The District Court concluded that, taking into account his large international holdings and complex business arrangements, Husband was reckless by "failing to investigate the credentials of the people he claims to have entrusted with his tax liability."

VII. Third of Three Fights—Federal Income Tax Litigation in Tax Court

As one would expect in a situation involving expatriates, operating a business in Mexico, forming various entities, and holding foreign accounts, income tax issues also arose in *Flume*. These matters were addressed in separate litigation with the Tax Court, centered on alleged federal income tax deficiencies.[29]

Among other things, the IRS claimed that Husband and Wife, as sole owners of Wilshire, had unreported Subpart F income stemming from income earned by the UBS account held in the name of Wilshire.[30] Perhaps most interesting was the IRS's lenient penalty proposal. In its Notice of Deficiency, the IRS took the position that (i) Husband and Wife understated the actual income and deemed income from their foreign entities, (ii) failed to report passive investment income earned by the UBS account, (iii) utilized Wilshire, formed in a "tax haven country," to operate a business and make investments "in order to avoid paying U.S. income taxes on their worldwide income," (iv) "intentionally sought to disguise their true ownership" of Wilshire and Franchise Food by creating documents indicating that foreign individuals were the majority owners, (v) "purposely" opened the UBS account in the name of Wilshire when they were the true owners, and (vi) instructed UBS not to invest in

U.S. securities in an effort to avoid detection. Despite this long list of allegations, the IRS asserted the lowest penalties, for mere negligence or, alternatively, substantial understatement of the correct tax liability.[31]

The Tax Court generally held in favor of the IRS on both the tax and penalty issues.[32] With respect to the latter, the Tax Court determined that the Revenue Agent had secured the necessary approval from her supervisors under Code Sec. 6751(b) before proposing penalties and that Husband lacked "reasonable cause" for the errors and omissions. Specifically, the Tax Court declined to entertain Husband's claim of reasonable reliance because he did not know whether the Mexican Accountants possessed sufficient international expertise and he failed to provide them with the necessary information about the foreign entities and accounts. The Tax Court concluded that these shortcomings illustrate that Husband did not rely on the "judgment" of the Mexican Accountants, much less reasonably rely on it.

VIII. Conclusion

The IRS has offered taxpayers a variety of voluntary disclosure programs since 2009, and a significant number of individuals and entities analyzed their situation and concluded that pro-actively rectifying matters with the IRS was the most prudent course of action. Others, with a higher risk tolerance or a fuzzy understanding of the true downsides, adopted the more aggressive wait-and-see approach. The three *Flume* cases provide an eye-opening look into the obscure procedural realties of international tax disputes, as well as potential outcomes. Those taxpayers with ongoing international non-compliance issues should consider these cases, in deciding whether to approach the IRS, in calculating their potential tax and penalty exposure, and in identifying experienced legal counsel to defend them.

ENDNOTES

* Hale specializes in tax audits, tax appeals, tax litigation, and international tax compliance. You can reach Hale by phone at (404) 658-5441 or by email at *hale.sheppard@chamberlainlaw.com*.

1 The *Flume* cases consist of the following: *E.S. Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21 (Tax Court case focused on civil penalties for unfiled Forms 5471 to disclose ownership of foreign corporations); *Flume*, 122 AFTR 2d 2018-5641 (S.D. Texas 2018) (Order by District Court in response to Motion for Summary Judgment filed by the U.S. government regarding FBAR penalties) and *Flume*, 123 AFTR 2d 2019-2211 (S.D. Texas 2019) (Verdict by District Court regarding FBAR penalties); *Flume*, 119 TCM 1545, Dec. 61,692(M), TC Memo. 2020-80 (Tax Court case focused on federal income taxes and tax-related penalties).

2 Code Sec. 6662; Code Sec. 6663.

3 Code Sec. 6621.

4 Code Sec. 6038D(d)(1); Reg. §1.6038D-8(a).

5 Code Sec. 6038D(d)(2); Reg. §1.6038D-8(c).

6 Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471.

7 Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §1.6046-1(k).

8 Code Sec. 6038(b)(2); Reg. §1.6038-2(k)(1)(ii); Code Sec. 6046(f); Reg. §1.6046-1(k).

9 Code Sec. 6048(a)(1); Code Sec. 6048(a)(4).

10 Code Sec. 6048(c)(1).

11 Code Sec. 6677(a).

12 Code Sec. 6048(b)(1). The grantor trust rules are located in Code Secs. 671 to 679.

13 Code Sec. 6677(b).

14 31 USC §5314; 31 CFR §1010.350(a).

15 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).

16 31 USC §5321(a)(5)(C)(i).

17 31 USC §5321(d) ("A civil penalty may be imposed under [31 U.S.C. § 5321(a)] with respect to any violation of this subchapter notwithstanding the fact that a criminal penalty is imposed with respect to the same violation.")

18 Hale E. Sheppard, *What Garrity Teaches About FBARs, Foreign Trusts, "Stacking" of International Penalties, and Simultaneously Fighting the U.S. Government on Multiple Fronts*, J. TAX PRACTICE & PROCEDURE, 2019, at 27.

19 IRM §4.26.17.3 (01-01-2007); IRM §20.1.9.2 (04-22-2011); IRM §20.1.9.2.1 (04-22-2011); IRM §20.1.9.22 (04-22-2011).

20 Code Sec. 6213(a).

21 Hale E. Sheppard, *Two More Blows to Foreign Account Holders: Tax Court Lacks FBAR Jurisdiction and Bankruptcy Offers No Relief from FBAR Penalties*, J. TAX PRACTICE & PROCEDURE, 2009, at 27.

22 31 USC §5321(b)(2).

23 IRM §20.1.9.2 (04-22-11) (emphasis added); IRM Exhibit 20.1.9-4; *see also* CCA 201226028.

24 Hale E. Sheppard, *What Garrity Teaches About FBARs, Foreign Trusts, "Stacking" of International Penalties, and Simultaneously Fighting the U.S. Government on Multiple Fronts*, J. TAX PRACTICE & PROCEDURE, 2019, at 27.

25 *Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21; *Flume*, 122 AFTR 2d 2018-5641 (S.D. Texas 2018); *Flume*, 123 AFTR 2d 2019-2211 (S.D. Texas 2019); *Flume*, 119 TCM 1545, Dec. 61,692(M), TC Memo. 2020-80.

26 *McBride*, 110 AFTR 2d 2012-6600 (Nov. 8, 2012); *McBride*, 908 FSupp2d 1186 (D. Utah 2012).

27 *Bedrosian*, 119 AFTR 2d 2017-1545 (DC Penn. 2017); *Bedrosian*, 120 AFTR 2d 2017-5671 (DC Penn. 2017); *Bedrosian*, 120 AFTR 2017-5832 (DC Penn. 2017); *Bedrosian*, CA-3, 912 F3d 144 (2018).

28 *Flume*, Civil Action No. 516-CV-73 (S.D. Texas Aug. 22, 2018), Memorandum and Order, Footnote 17.

29 *See Flume*, Tax Court Docket No. 31162-14 (covering 2006, 2007, and 2008); *Flume*, Tax Court Docket No. 9126-14 (covering 2009); *Flume*, 119 TCM 1545, Dec. 61,692(M), TC Memo. 2020-80.

30 *Flume*, Tax Court Docket No. 31162-14, Petition (with copy of Notice of Deficiency attached) filed December 31, 2014.

31 *Flume*, Tax Court Docket No. 31162-14, Petition (with copy of Notice of Deficiency attached) filed December 31, 2014.

32 The Tax Court held in favor of Husband with respect to the 2008 federal income tax issues, only, because of erroneous calculations by the Revenue Agent and certain timing matters regarding Subpart F income. However, the Tax Court expressly noted that "the Subpart F income for 2008 that was not includable in [the taxpayer's] gross income is subject to recapture in a future year." *Flume*, 119 TCM 1545, Dec. 61,692(M), TC Memo. 2020-80, Footnote 17.