FEDERAL NEWS & ANALYSIS

- Tax Notes Today

SEPTEMBER 8, 2010

News Analysis: Government Position on FBAR Penalties Called Into Question

by Jeremiah Coder

Full Text Published by taxanalysts®

A September 1 court decision finding that a taxpayer had not willfully failed to report interests in offshore bank accounts has left practitioners optimistic that courts will hold the government to a high standard of proof in seeking civil penalties. It could also pave the way for taxpayers with sympathetic cases to avoid penalty liability by opting out of unforgiving voluntary disclosure penalty computation rules.

The U.S. District Court for the Eastern District of Virginia held that the federal government could not recover civil penalties from J. Bryan Williams for his failure to report his interest in two Swiss bank accounts because his action was not willful. The government claimed Williams was liable for penalties under 31 U.S.C. section 5321 as a result of his not filing a foreign bank account report on his 2000 tax return. (For *United States v. J. Bryan Williams*, No. 1:09-cv-00437, see *Doc 2010-19385* or *2010 TNT 171-8*.)

The court employed a *de novo* standard of review, concluding that that standard was appropriate given that "no adjudicatory hearing" is available before the government assesses an FBAR penalty. The

court noted that in similar situations, such as Tax Court proceedings and enforcement actions under the Securities Exchange Act, *de novo* review is proper when the government must prove its case by a preponderance of the evidence.

While it was clear that Williams held foreign financial accounts that were not timely reported, the court did not believe he had willfully violated the FBAR reporting regime. The government argued that Williams's signature on his Form 1040, which included checking no on Schedule B, was prima facie evidence of his knowledge that the return was false and part of concealing the accounts. But the court held that Williams's interaction with Swiss and U.S. authorities showed that he "lacked any motivation to willfully conceal the accounts from authorities."

Although Williams pleaded guilty to one count of tax evasion, the court did not view that admission as relevant in establishing the applicability of the FBAR penalty. The failure to report income on the account "is a separate matter" from FBAR reporting, the court said. The court faulted the government for not being able to "differentiate tax evasion from failing to check the box admitting the existence of a foreign account." Williams's reliance on tax advisers in completing his Form 1040 "constituted an understandable omission" rather than an intentional or "deliberate disregard for the law," the court held.

At various times, federal government officials have made public statements that checking the Schedule B foreign financial account box no when a taxpayer has offshore accounts is evidence in and of itself of punishable conduct. But that view is challenged by the court's decision in this case.

"I think the case illustrates the difficulty the government will have in establishing willfulness for the truly draconian FBAR penalty," said Jack Townsend of Townsend & Jones LLP. A possible outcome of the decision is that some taxpayers will be encouraged to opt out of the voluntary disclosure initiative and take their chances with the normal FBAR penalty regime, said Townsend, author of the Federal Tax Crimes blog. "Assuming that the government cannot meet the high standard in proving a willful failure, the penalty costs could be a whole let less than the program requires," he said.

Bryan C. Skarlatos of Kostelanetz & Fink LLP said the court decision reinforced the notion that checking the Schedule B box is different from failing to report income. However, the court's reliance on the specific facts of the taxpayer -- such as the frozen account and particular involvement of Williams with government authorities -- may make the opinion distinguishable from future cases, he said.

The court's determinations that signing the tax return does not equate to knowledge of all of its contents, that relying on professionals can negate willfulness, and that making a "noisy" voluntary disclosure is evidence of nonwillfulness, all create important rationales that taxpayers can assert in similar cases, Skarlatos said. Those grounds are significant because the IRS's current penalty approach to unfiled FBARs is "based on the presumption that they can show willfulness in every case and can impose crippling penalties on all cases, especially those that occur after the October 15 special disclosure initiative ended," he said.

"The lesson here is that no one factor is sufficient; taxpayers, the government, and courts have to conduct a reasoned analysis of all relevant factors," Skarlatos said. The case also presents a middle-of-the-road approach between the government's position that all unreported Swiss accounts are willful acts and taxpayers' claims of ignorance of reporting requirements, he said.

Caroline Ciraolo of Rosenberg Martin Greenberg LLP told Tax Analysts that the decision brought much-needed guidance to civil FBAR penalty prosecutions. "This is the first judicial guidance we have received with respect to the Service's attempt to collect the FBAR penalty since the offshore program was announced, and the court analyzed the issue well," she said. As more cases involving civil penalties -- particularly those resulting from the IRS's special offshore voluntary disclosure program -- come to the point of resolving the amount of any applicable penalty, "I'm hoping this case causes the IRS to reconsider its current position on willfulness and become more reasonable," she said.

Ciraolo said that most taxpayers are so focused on the numerical calculations on a tax return that they are unaware of the box on Schedule B regarding foreign accounts, and that before the recent

media attention, most were unaware of the duty to disclose offshore accounts. Moreover, accountants often do not ask their clients if they have a reportable interest in a foreign account.

"Even now, with clients in the offshore voluntary disclosure program, accountants preparing amended returns are reporting the income but failing to check the box on Schedule B and failing to advise clients to file the FBARs by June 30. This is a continuing problem." Ciraolo said.

But the *Williams* opinion "goes directly to the point that a taxpayer's failure to check the box yes on Schedule B and file an FBAR does not, in and of itself, establish willful failure to file within the meaning of 31 U.S.C. 5314," Ciraolo said.

"*Williams* also stands for the point that a conviction for tax evasion does not estop the defendant from challenging a civil penalty for failure to file an FBAR," because proving a willful failure to file an FBAR requires a different threshold in establishing the elements of a violation, Ciraolo said. "The government has to prove its case without using a title 26 conviction as a back door," she added.

Josh O. Ungerman of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP said that had the government's position been upheld, it "would have imputed knowledge of the 'no' answer to the foreign account question to a taxpayer regardless of whether the taxpayer had any knowledge of the question on the tax return." He agreed that "many taxpayers with undisclosed offshore accounts had no idea that their tax returns included a question regarding the existence of an offshore account."

The court may have misstated the applicable willfulness standard. Tax professionals are quite familiar with *Cheek v. United States*, 498 U.S. 192 (1991), *Doc 91*-225, *91 TNT 7*-10, which defines willfulness in the criminal context as a "voluntary, intentional violation of a known legal duty." The *Williams* court did not refer to *Cheek*, instead citing a lower willful standard used in civil liability cases that includes reckless conduct. But even the lower threshold did not yield proof that Williams had willfully violated the FBAR statute.

Yet Skarlatos said the same standard outlined in *Cheek* should apply to both civil and criminal FBAR penalties. Ciraolo said that even though a discussion of *Cheek* was omitted from the opinion, "the court followed the spirit of *Cheek* in looking at all the facts and circumstances -- its presence is there -- and determined that in failing to file his FBAR, Williams did not intentionally violate a known legal duty."

The court's decision relied on the statute as it existed before amendments in the American Jobs Creation Act of 2004 that introduced a smaller penalty for nonwillful violations, while imposing much stronger penalties in cases of willful conduct. But despite the statutory changes, the penalty framework still benefits from the court's analysis. "Courts will hold the government to the more onerous standard to get the higher penalties," said Townsend. Ungerman noted that the court took pains to point out that the simple failure to file an FBAR was insufficient to trigger the willful FBAR penalty under the old statute, as evidenced by Congress's amendments adding a nonwillful penalty to the FBAR statute to expand the coverage of the statute.

Taxpayers trying to avoid criminal and civil liability for unreported offshore accounts by filing quiet disclosures will find little in the case to give comfort, as the court seemed swayed by the high level of disclosure and cooperation with authorities demonstrated by Williams. However, taxpayers who decided to come in under the special offshore program but are facing large penalties simply because they don't qualify for the discounted 5 percent penalty may get some relief now if their liability under the statutory regime is less than under the program rules. (For frequently asked questions on the voluntary disclosure program, see *Doc 2009-14388* or *2009 TNT 120-8*.)

Tax Analysts Information

Code Sections: Section 7401 -- Authorization of Civil Actions
Section 6703 -- Abusive Shelter, etc. Penalties
Jurisdiction: United States
Subject Areas: Information reporting
Tax avoidance and evasion
Penalties
Author: Coder, Jeremiah

Institutional Author: Tax Analysts
Tax Analysts Document Number: Doc 2010-19581
Tax Analysts Electronic Citation: 2010 TNT 173-2

Bookmark or link to this document Comment on this story