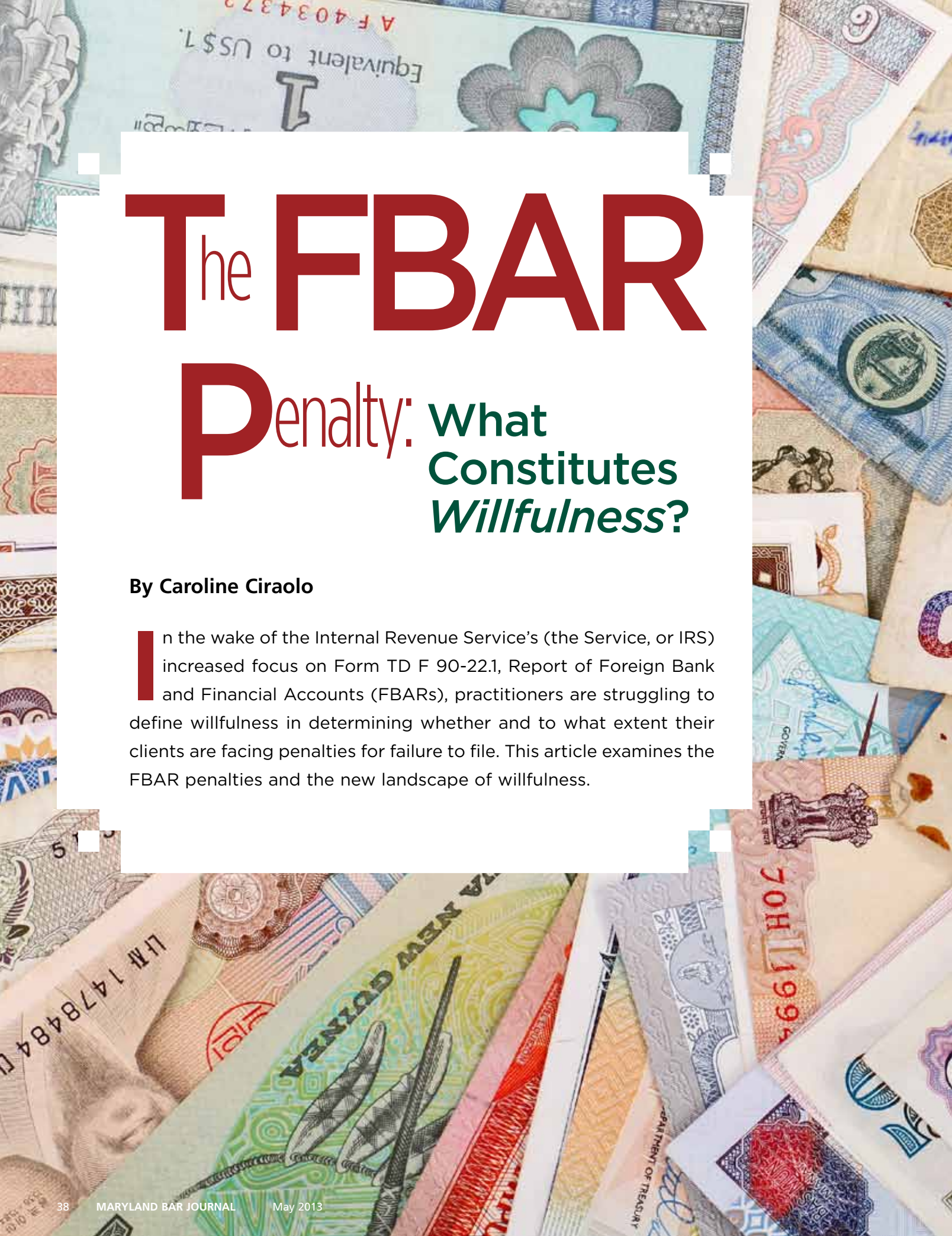

The FBAR Penalty: What Constitutes *Willfulness*?

By Caroline Ciraolo

In the wake of the Internal Revenue Service's (the Service, or IRS) increased focus on Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBARs), practitioners are struggling to define willfulness in determining whether and to what extent their clients are facing penalties for failure to file. This article examines the FBAR penalties and the new landscape of willfulness.


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The FBAR Penalties

Of the many international penalties, it is the penalty for failing to file the FBAR, or filing false FBARs, that has most clients awake at night. Under 31 U.S.C. § 5321(a)(5)(B), the Service may impose a non-willful penalty of up to $10,000 for each violation of 31 U.S.C. § 5314. Where the violation is willful, the penalty increases up to the greater of $100,000 or 50 percent of the amount in the account at the time of the violation. 31 U.S.C. § 5321(a)(5)(C).

Non-Willful Penalties and Reasonable Cause

The Service is statutorily barred from imposing FBAR penalties if the violation is due to reasonable cause *and* "the amount of the transaction or the balance in the account at the time of the transaction was properly reported." 31 U.S.C. § 5321(a)(5)(B)(ii). While it may appear that the reasonable cause exception does not apply unless an FBAR is timely filed, the reporting requirement under the reasonable cause exception "means that the examiner must receive the delinquent FBARs from the nonfiler in order to avoid application of the non-willfulness penalty." Internal Revenue Manual (I.R.M.) § 4.26.16.4.4 (07-01-2008). Moreover, in guidance issued to the Large & Mid-Sized Business Division on October 31, 2008, the Service stated: "no [FBAR] penalty will be assessed if there is reasonable cause for not filing the FBAR." *LMSB-4-0908-047* (October 31, 2008). "[E]xaminers are to use discretion, taking into account the facts and circumstances of each case, in determining whether a warning letter or penalties that are less than the total amounts provided for in the mitigation guidelines are appropriate." *Id.*; *see also* I.R.M. § 4.26.16-2 (7-1-2008). "The sole purpose for the FBAR penalties is to serve as a tool to promote compliance with respect to the FBAR reporting and recordkeeping requirements." *Id.* The Service recognizes this in Frequently Asked Question (FAQ) 17 of the Offshore Voluntary Disclosure Program (OVDP), where it advises that no penalties will be imposed where taxpayers reported the income from the foreign accounts and simply failed to file the FBARs.

Under I.R.M. § 4.26.16.4.6.1(3) (07-01-2008), the mitigation criteria are:

1. The person has no history of criminal tax or Bank Secrecy Act convictions for the preceding ten years and has no history of prior FBAR penalty assessments;
2. No money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose;
3. The person cooperated during the examination; and
4. IRS did not determine a fraud penalty against the person for an underpayment of income tax for the year in question due to the failure to report income related to any amount in a foreign account.

Where an FBAR violation occurred but no penalty is appropriate, the examiner will issue the FBAR warning letter, Letter 3800. In cases where a penalty is warranted, the Internal Revenue Manual (Manual) directs an examiner to consider the mitigation guidelines to promote uniformity but does not require that the guidelines be strictly applied. I.R.M. § 4.26.16.4.6 (07-01-2008). The examiners are instructed to consider:

1. Whether compliance objectives would be achieved by issuance of a warning letter;
2. Whether the person who committed the violation had been previously issued a warning letter or has been assessed the FBAR penalty;
3. The nature of the violation and the amounts involved; and
4. The cooperation of the taxpayer during the examination.

I.R.M. § 4.26.16.4.7 (07-01-2008). The examiner's work papers must document the mitigating factors, and his or her decision is subject to manager approval. The FBAR penalty mitigation guidelines are set forth at I.R.M. Exhibit 4.26.16-2 (07-01-2008).

Burden of Proof and Willfulness

According to the Supreme Court in *Ratzlaf v. United States*, to establish a willful violation for purposes of the civil FBAR penalty under 31 U.S.C. § 5321, the government must establish "a voluntary intentional violation of a known legal duty." 510 U.S. 135, 141 (1994). The Service takes the same position in the Manual and its Chief Counsel Advisory opinions. *See* I.R.M. 4.26.16.4.5.3 (07-01-2008); IRS CCA 200603026 (Jan. 20, 2006). Until recently, courts have held that the government must prove that the taxpayer was aware of the requirement to file the FBAR and intentionally failed to do so (or filed a false FBAR). *See, e.g., United States v. Dollar Bank Money Market Account*, 980 F.2d 233, 238 n.2 (3d Cir. 1992). The government will rely on circumstantial evidence and infer willfulness based on a course of conduct. *See United States v. Sturman*, 951 F.2d 1466, 1476 (6th Cir. 1991).

On July 20, 2012, the Fourth Circuit Court of Appeals issued an unpublished opinion in *United States v.*

Williams reversing the district court's decision and holding that reckless conduct can satisfy the proof requirement for willfulness under 31 U.S.C. § 5321(a)(5)(C). 489 Fed.Appx. 655, 656–60 (4th Cir. 2012). Quoting *Sturman*, the court stated that, "[w]illfulness may be proven through inference from conduct meant to conceal or mislead sources of income or other financial information," and it "can be inferred from a conscious effort to avoid learning about reporting requirements."*Id.* at 658. The court further noted that,

> "willful blindness" may be inferred where "a defendant was subjectively aware of a high probability of the existence of a tax liability, and purposefully avoided learning the facts point to such liability." *United States v. Poole*, 640 F.3d 114, 122 (4th Cir. 2011) (affirming criminal conviction for willful tax fraud where tax preparer "closed his eyes to" large accounting discrepancies). Importantly, in cases "where willfulness is a statutory condition of civil liability, [courts] have generally taken it to cover not only knowing violations of a standard, but *reckless* ones as well." *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 57 (2007) (emphasis added).

Id. In finding "willful blindness," the Fourth Circuit relied on the following:

> Williams signed his 2000 federal tax return, thereby declaring under penalty of perjury that he had examined this return and accompanying schedules and statements and that, to the best of his knowledge, the return was true, accurate, and complete. A taxpayer who signs a tax return will not be heard to claim innocence for not having actually read the return, as he or she is charged with constructive knowledge of its contents.
>
> Williams' signature is prima facie evidence that he knew the contents of the return.
>
> At a minimum, line 7a's directions to see instructions for exceptions and filing requirements for Form TD F 90–22.1 put Williams on inquiry notice of the FBAR requirement.
>
> Williams never consulted Form TD F 90–22.1 or its instructions, did not read line 7a, and never paid any attention to any of the written words on his federal tax return. Thus, Williams made a conscious effort to avoid learning about reporting requirements, and his false answers on both the tax organizer and his federal tax return evidence conduct

> that was meant to conceal or mislead sources of income or other financial information.
>
> *Id.* at 659–60.

The standard of willfulness applied by the court is contrary to both established precedent and the Service's guidance. Moreover, it appears to eviscerate the government's burden to prove that a taxpayer have actual knowledge of the obligation to file an FBAR. Thus, the court ignored the reasonable cause exception and nonwillful penalty regime by taking the position that, if a defendant signed the return, he is charged with the knowledge of the contents of the return and the FBAR requirement and thus acts willfully when he fails to file the FBAR.

Practitioners recovered a bit with the case of *James v. United States*, 2012 WL 3522610, (M.D.Fla. Aug. 14, 2012), where the taxpayer sought a refund of penalties assessed for failure to file Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) on the grounds that he acted with reasonable cause and without willful neglect. The government argued that he could not establish reasonable cause as a matter of law because he was on notice of the filing requirement.

Noting that IRS has not issued regulations defining reasonable cause for failure to file Form 3520, the court looked to the Manual:

> In general, reasonable cause exists when a taxpayer exercises ordinary care and prudence in determining his tax obligations despite his failure to comply. *See* I.R.M. 20.1.1.3.2 (11–25–2011). Whether reasonable cause exists depends upon all of the facts and circumstances of the case, including the taxpayer's reason for failing to properly file, and the extent of his efforts to comply. *Id.* Moreover, the [Manual] provides that ignorance of the law may provide reasonable cause if: "A. A reasonable and good faith effort was made to comply with the law, or B. The taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement." I.R.M. 20.1.1.3.2.2.6 (11–25–2011).

Id. at *2. The court recognized established authority that "a taxpayer may reasonably rely on an expert's advice that no return is required; thus, if an expert erroneously advises him that no return is required, or erroneously advises him that it can be filed beyond the due date, reasonable cause may be found." *Id.* (*citing Estate of La Meres v. Commissioner*, 98 T.C. 294, 316–17 (1992) (noting reasonable cause for failing to meet a filing deadline where taxpayer made full disclosure to

expert, relied on his advice, and did not otherwise know that the return was due)).

The court denied the government's motion for summary judgment, noting that James provided his accountant with all trust forms and relied on him for trust advice; and, since the accountant prepared the return, the negative response to the question "did you [James] receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If 'yes,' you may have to file Form 3520," could be construed as advice that no Form 3520 was needed. *Id.* at *3.

Unlike the Fourth Circuit Court of Appeals in *Williams*, the court in *James* found that, where a taxpayer provides the necessary information to his accountant and the return nevertheless erroneously reports no obligation to file Form 3520, the taxpayer is entitled to argue reasonable cause, having done all that ordinary business care and prudence can reasonably demand. *Id.* (*citing Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769, 771 (2d Cir. 1950)).

The pendulum swung back sharply in *United States v. McBride*, 2012 WL 5464955, (D.Utah. Nov. 8, 2012). McBride engaged in a scheme to avoid reporting corporate income and paying tax thereon by using offshore shell entities and foreign financial accounts in the name of such entities. The record strongly supports McBride's intent to evade tax and conceal the foreign financial accounts. The court could have sustained the FBAR penalties based on the facts and circumstances under the clear and convincing standard; but, instead, it went much further and, in doing so, laid waste to years of precedent.

The court began by concurring with *Williams* that the proper standard of proof in determining willfulness for the FBAR penalty is a preponderance of the evidence, not clear and convincing evidence. It recognized that a higher standard is warranted where particularly important individual interests or rights are at stake but found that no such interest or rights are present in FBAR cases because they "only involve money." *Id.* at *14 (citations omitted).

The court further agreed that willfulness includes reckless conduct as well as "willful blindness" to the "obvious known consequences of one actions." *Id.* The court declared that "[c]onduct that evidences 'reckless disregard of a known or obvious risk' or a 'failure to investigate . . . after being notified [of the violation]' also satisfies the civil standard for willfulness in such contexts." *Id.* at 18 (citations omitted).

At this point, the court took the *Williams* reasoning one step further, finding that taxpayers who sign returns have constructive knowledge of all instructions contained in the return, *id.* at *21 (citing *Sturman*, 951 F.2d at 1477 ("'It is reasonable to assume that a person who has foreign bank accounts would read the information specified by the government in tax forms,' including the reference on Schedule B to the FBAR")), and that, "[f]or an individual to have acted "willfully," an individual need not have been subjectively aware of the FBAR reporting requirement or else an individual would be able to defeat liability by deliberately avoiding learning of his or her legal duties," *id.* at *23. The court deemed irrelevant that McBride "may have believed he was legally justified in withholding such information[,] [t]he only question that remains is whether the law required its disclosure." *Id.* at *27 (quoting *Lefcourt v. United States*, 125 F.3d 79, 83 (2d Cir. 1997)). Because the law required that McBride disclose his interests in the foreign accounts on an FBAR, the court found McBride's conduct willful. *Id.*

Conclusion

McBride may be a classic example of bad facts making bad law. Still, we now have a published decision essentially imposing strict liability for the willful FBAR penalty on anyone who signs a federal tax return with a Schedule B attached and fails to file a required FBAR. Like the Fourth Circuit Court of Appeals in *Williams*, the *McBride* court failed to reconcile its holding with the statutory exception for reasonable cause or the non-willful FBAR penalty. It remains to be seen whether the Service still views its burden in establishing a willful FBAR violation as the same "clear and convincing evidence" standard applied to a civil fraud penalty. *See* IRS CCA 200603026.

For now, practitioners should continue to advocate for their clients at the earliest stages of an audit and prepare detailed narratives in support of reasonable cause and non-willfulness. In light of the foregoing developments, the best opportunity to avoid the willful FBAR penalty may be prior to litigation. *See* National Taxpayer Advocate's 2012 Annual Report to Congress (reporting an average FBAR penalty of $15,737 in cases where the taxpayer opted out of the 2009 OVDP).

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