What Happens When an Individual Fails to Report Foreign Bank Accounts

By Steven L. Walker

Steven L. Walker examines what happens when an individual fails to report foreign bank accounts.

On July 20, 2012, the Court of Appeals for the Fourth Circuit in *Williams*[1] held that an individual willfully failed to comply with foreign bank account report (FBAR) requirements when he signed a tax return without disclosing foreign accounts.

To briefly provide some background, federal law requires individuals to report annually to the IRS any financial interests they have in any bank, securities or other financial accounts in a foreign country.[2] The report is made by filing a completed Form TD F 90-22.1 with the Department of the Treasury, and the report must be filed on or before June 30 of each calendar year with respect to foreign financial accounts maintained during the previous calendar year.[3]

The Secretary of the Treasury may impose a civil money penalty on any person who fails to timely file the report. In cases where a person "willfully" fails to file the FBAR, the government may impose an increased maximum penalty,[4] up to $100,000 or 50 percent of the balance in the account at the time of the violation.[5]

In the *Williams* case, Bryan Williams opened two Swiss bank accounts in the name of a foreign corporation and deposited more than $7 million into the accounts from 1993 through 2000. Williams completed a tax organizer in January 2001, which his accountant provided to Williams in connection with the preparation of his 2000 federal tax return. In response to the question in the tax organizer regarding whether Williams had "an interest in or a signature or other authority over a bank account, or other financial account in a foreign country," Williams answered "no." In addition, in response to the question in the tax return (line 7a in Part III of Schedule B) regarding whether Williams had an interest in or a signature or other authority over a financial account in a foreign country, Williams answered "no," and he did not file a FBAR by the June 30, 2001, deadline.

In the fall of 2000, the IRS discovered Williams' Swiss accounts and froze them. In June 2003, Williams pled guilty to conspiracy to defraud the IRS and criminal tax evasion. In January 2007, Williams finally filed an FBAR for each year from 1993 through 2000. Thereafter, the IRS assessed two $100,000 civil penalties—one penalty for each foreign account—against Williams, pursuant to 35 U.S.C. §5321(a)(5), for his failure to file an FBAR for tax year 2000. Williams failed to pay these penalties, and the United States brought an enforcement action to collect them. The district court entered judgment in favor of Williams, finding that the government failed to establish that Williams willfully violated 35 U.S.C. §5314.

The government appealed, and the Court of Appeals held that the district court clearly erred in finding that Williams did not willfully violate 35 U.S.C. §5314.

The Court of Appeals found that the taxpayer's signature on his 2000 federal tax return was *prima facie* evidence that he knew the contents of the

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return. The taxpayer made a conscious effort to avoid learning about the reporting requirements, and his false answers on both the tax organizer and his federal tax return evidenced conduct that was meant to conceal or mislead sources of income. At a minimum, the taxpayer's actions established reckless conduct, which satisfied the burden of proof requirements of the civil FBAR penalty for willfulness, according to the court.

McBride Case

In another closely watched case, on November 8, 2012, a federal district court in the Northern District of Utah in *McBride*[6] held that an individual was subject to the civil willfulness penalty because he failed to report his interest in four foreign financial accounts.

Jon McBride was a partner in The Clip Company, a company which sold belt clip accessories for cellular telephones. The company utilized a manufacturer located in Taiwan for the production of its inventory. Anticipating an increase in business revenue, McBride sought a way to reduce his taxes.

McBride contacted a financial management firm, Merrill Scott, to see if it could provide services that would result in avoiding or deferring the recognition of income that McBride expected to receive. Merrill Scott held itself out as a financial management firm that employed strategies that would allow clients to avoid or defer the recognition of income for tax purposes and to shield assets from creditors.

Merrill Scott established offshore entities that were nominally controlled by individuals associated with Merrill Scott. McBride then engineered a scheme whereby The Clip Company would funnel profits to an offshore entity created by Merrill Scott. The foreign entity disbursed the funds to other foreign entities, as well as McBride individually. McBride engaged in other schemes to move profits offshore.

McBride failed to file FBAR reports in 2000 and 2001. McBride also never discussed with his accountant his involvement with Merrill Scott. On McBride's tax returns, McBride checked the box "no" in response to the question on Schedule B whether McBride had an interest in a foreign bank account. McBride also signed the returns under penalty of perjury, declaring that he had examined the returns and believed that the returns were true, correct and complete to the best of McBride's knowledge and belief.

In 2004, the IRS investigated McBride as a result of his involvement with Merrill Scott. In interviews with the IRS, McBride denied that he had utilized the services of Merrill Stock, did not tell the truth, and failed to produce documents in response to the IRS's document requests. Ultimately, the IRS assessed a civil penalty for McBride's willful failure to report his interest in the foreign accounts in 2000 and 2001.

The United States filed suit in federal district court to reduce the assessment to judgment to collect the amounts owed, and the district court upheld the imposition of the FBAR penalties.

The district court held that the government had established that McBride willfully failed to file the FBAR reports for the years 2000 and 2001. The court entered a judgment in favor of the United States for the amount of the FBAR penalties.

In reaching its decision, the district court ruled that the government has the burden of proving that McBride willfully failed to file FBARs by a preponderance of the evidence. A higher burden of proof is not required.

The district court held that McBride's failure to report his interest in the foreign accounts was willful. Willfulness in the civil context covers not only knowing violations of a standard, but reckless ones as well. Willfulness may be satisfied by establishing the individual's reckless disregard of a statutory duty, as opposed to acts that are known to violate the statutory duty at issue, according to the court.

Acting with willful blindness to the obvious or known consequences of one's action also satisfies a willfulness requirement in both civil and criminal contexts, according to the district court. Under the willful blindness standard, a willfully blind defendant is one who takes deliberate actions to avoid confirming a high probability of wrongdoing and who can almost be said to have actually known the critical facts. The court ruled that where a taxpayer makes a conscious effort to avoid learning about reporting requirements, evidence of such willful blindness is a sufficient basis to establish willfulness.

The court found that McBride's conduct was reckless. A responsible person is reckless, the court ruled, if he knew or should have known of a risk that the taxes were not being paid, had a reasonable opportunity to discover and remedy the problem, and yet failed to undertake reasonable efforts to ensure payment. Because McBride acted in reckless disregard of the known or obvious risks created by his involvement with Merrill Scott, the district court found that subjective knowledge was not required for McBride to have willfully failed to comply with the FBAR requirements.

The court further found that McBride was willfully blind to the obvious risks of failing to comply with the FBAR reporting requirements. The court ruled that for 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.

The fact that McBride did not discuss his financial strategies, involving millions of dollars, with his accountant was significant evidence of willfulness or at least recklessness and willful blindness, according to the court

Observations

A few general observations can be made from the *McBride* and *Williams* cases:

- The government can establish that an individual was willful in failing to comply with the FBAR requirements by showing reckless conduct or blind willfulness.
- A responsible person is reckless, if he knew or should have known of a risk that the taxes were not being paid, had a reasonable opportunity to discover and remedy the problem, and yet failed to undertake reasonable efforts to ensure payment.
- Willful blindness may be inferred where an individual was subjectively aware of a high probability of the existence of a tax liability and purposefully avoided learning the facts that point to such liability.
- The government's burden of proof is a preponderance of the evidence (51 percent), as opposed to clear and convincing evidence.
- The IRS can reach out and bring an individual's accountant into the case as a fact witness.

The *McBride* and *Williams* cases are factually distinguishable from most cases, where an individual has delinquent FBARs. *McBride* involved an individual who engaged in a scheme to siphon profits offshore through the use of nominee entities. *Williams* deposited more than $7 million in offshore accounts, plead guilty to tax evasion, provided false information on a tax organizer, and falsely checked the box "no" on Schedule B.

Whether an individual is liable for willfully failing to report the existence of foreign accounts ultimately depends on the facts and circumstances of the particular case. The Internal Revenue Manual provides that penalties should be asserted only to promote compliance with the FBAR reporting and recordkeeping requirements.[7] In exercising their discretion, the Manual provides that IRS agents should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future. The Manual also provides for mitigation provisions that can reduce the dollar amount of the civil penalties.[8] For nonwillful violations, the amount of any civil penalty shall not exceed $10,000, and there is a reasonable cause exception.[9]

How the IRS Factually Develops a Case

The *Williams* and *McBride* cases are instructive in the sense that they show how the IRS factually develops a case to determine whether a civil FBAR penalty should apply. The IRS's investigation may probe the following areas:

- Why the individual failed to file the FBAR reports; when the person first learned of the FBAR reporting requirements; and whether the individual read the information supplied by the government in the tax forms
- What the individual's reasonable cause defense is for failing to report the foreign accounts under 35 U.S.C. §5321(a)(5)(B)(ii) (nonwillfulness civil penalty)
- Why the individual answered "no" in response to Question 7a, Part IV of Schedule B, if that is the case
- What person's level of education and sophistication is, particularly in the field of business and accounting
- Whether the individual engaged in any activity with respect to the funds overseas (*i.e.*, transferring money overseas, buying and selling securities, or making investments) or whether the account is a "passive account"
- Whether the individual knew that the funds deposited into the foreign financial account were taxable, and why the person failed to report the offshore income, if that is the case

The IRS may seek to interview the individual to obtain answers to its questions. Also, if an accountant or enrolled agent prepared the tax returns at issue, the IRS may interview the return preparer to determine what, if anything, the taxpayer told the accountant about the undisclosed bank accounts. The IRS may want a copy of any tax organizer to see whether the person disclosed the foreign accounts to the return preparer.

The Bottom Line

Individuals who fail to report their interest in foreign financial accounts run the risk of substantial civil penalties and possibly a criminal investigation by the IRS. Persons with unfiled foreign bank account reports or unreported income from offshore accounts would be wise to seek the advice of competent tax counsel, who can evaluate the case, explain the options, and develop a defensible strategy.

Endnotes

1 *J.B. Williams*, CA-4, 2012-2 USTC ¶50,475 (2012).
2 31 U.S.C. §5314(a).
3 31 CFR §1010.350.
4 31 U.S.C. §5321(a)(5)(A).
5 31 U.S.C. §5321(a)(5)(C).
6 *J. McBride,* DC-UT, 2012-2 USTC ¶50,666 (2012).
7 *See* IRM 4.26.16.4 (FBAR Penalties).
8 *See* IRM 4.26.16.4.6.1 (Mitigation Threshold Conditions).
9 35 U.S.C. §5321(a)(5)(B).