Tax Insider™

Is your client the subject of an FBAR examination?

Find out how to avoid having the IRS succeed in imposing the larger penalty for willful behavior.

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Has a client received a letter from the IRS asking to schedule an appointment to examine the client's compliance with the requirement to file FinCEN Report 114, *Report of Foreign Bank and Financial Accounts* (FBAR)? Although an FBAR examination is not an income tax examination, the client may be liable for penalties for failure to comply with 31 U.S.C. Section 5314.

Practitioners should know a few key things about these types of cases. First and foremost, an FBAR battle is being waged in federal courts across the country where taxpayers have been seeking to avoid the imposition of the maximum FBAR willfulness civil penalty. Faced with an adverse result during an IRS civil examination or administrative appeal, taxpayers have turned to litigating the civil penalties in federal court in the hope of a better result.

The Department of Justice has succeeded in several cases where courts have upheld the maximum FBAR willfulness penalty and rejected the taxpayer's argument to apply a "reasonable cause" standard and the lesser FBAR nonwillful penalty. This has galvanized the IRS and the revenue agents working the cases. The FBAR willfulness penalty is the greater of $100,000 or 50% of the balance in the unreported foreign account at the time of the violation, and the maximum penalty for a nonwillful violation is $10,000 (31 U.S.C. §5314). See the following cases:

- *Williams*, 489 F. App'x 655 (4th Cir. 2012) (district court erred in finding that the taxpayer did not willfully violate Section 5314);

- *McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012) (FBAR penalties imposed where conduct was reckless and taxpayer was willfully blind as to the obvious risk of failing to comply with the FBAR requirements);

- *Bohanec*, 263 F. Supp. 3d 881 (C.D. Cal. 2016) (defendants' failure to timely file an FBAR for 2007 was willful; the maximum penalty is therefore increased to the greater of $100,000 or 50% of the balance in the foreign accounts on June 30, 2008); and

- *Bedrosian*, No. 17-3525 (3d Cir. 12/21/18) (to prove a "willful" FBAR violation, the government must satisfy the civil willfulness standard, which includes both knowing and reckless conduct).

The evolving FBAR case law sends a clear message to the public. The government is taking FBAR violations seriously. The case law can adversely affect an unwitting taxpayer seeking to convince an IRS revenue agent during a civil examination that his or her failure to report a foreign bank account was not willful. Representatives handling FBAR cases on behalf of their clients should expect IRS revenue agents not only to be aware of the new case law but also to rely on the cases to support their position.

Now, merely taking the position, "I did not read the tax return" or "I did not know about the foreign bank account reporting obligation," may not be enough to turn the case around. Practitioners also should understand the meaning of "willfulness" and what the government must show to meet its burden of proof.

Also, taxpayers seeking to appeal their cases administratively before the IRS Office of Appeals may find themselves running head-on into a wall. IRS Appeals officers, who are given the task of resolving cases by considering the "hazards of litigation," are finding it challenging to accept mitigating factors or hazards considering the Justice Department's recent wins in federal district courts. IRS Appeals officers are tending to uphold the determination reached by the IRS revenue agent during the civil examination, absent new evidence that was not previously considered by the examining agent. This is a warning to taxpayers seeking to appeal their case in hopes of reaching a better result.

At a minimum, a taxpayer's representative should obtain a copy of the administrative file and carefully review the evidence presented during the civil examination prior to discussing the case with the Appeals office. Additionally, a section in the Internal Revenue Manual (IRM) is devoted to Appeals and FBAR penalties. Practitioners should read the manual and become experts on it (IRM §8.11.6, "FBAR Penalties").

All of this means that it is essential for taxpayers to act proactively and disclose their foreign bank accounts before being contacted by the IRS. At a minimum, persons with unfiled foreign bank account reports or unreported income from offshore accounts should take the following steps:

1. Hire a CPA or enrolled agent to prepare a federal tax return;
2. Disclose the existence of foreign accounts to the CPA or enrolled agent;
3. Ask the CPA or enrolled agent whether the foreign investment income needs to be reported on federal income tax returns; and
4. File the foreign bank account reports.

That way, the tax practitioner knows about the issue and can properly advise the taxpayer on how to handle any foreign accounts. If the IRS does come knocking, a reasonable defense can be mounted. For people with delinquent FBARs, the IRS Delinquent FBAR Submission Procedures should be considered. More information can be found on the IRS website (https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures).

The *Kimble* case

A recent case in the U.S. Court of Federal Claims illustrates just how the government litigates (and wins) an FBAR case in federal district court (*Kimble*, No. 17-421 (Fed. Cl. 12/27/18)). The case is worth reading and handing out as "recommended reading" to any clients who are on the fence about disclosing their foreign bank accounts. The case also provides a useful road map for practitioners seeking to litigate an FBAR case in federal district court because the court's opinion sheds light on which arguments may work and which do not.

On Dec. 27, 2018, the Court of Federal Claims held that an individual had willfully failed to file an FBAR and that the IRS did not abuse its discretion when it asserted a civil penalty against the plaintiff of $697,229, i.e., 50% of the balance in the foreign account in 2007.

The two issues in the case were (1) what was the standard for finding a willful violation of the FBAR requirement, which permits the imposition of a larger penalty, and (2) whether the maximum FBAR penalty provided by statute supersedes an earlier regulation that has not been amended. This article discusses the first issue, willfulness. Alice Kimble stipulated that she failed to file an FBAR for 2007 and report her Swiss and French bank accounts but contended that her failure to file the form was not willful.

The meaning of 'willful'

The government asserted that a violation of 31 U.S.C. Section 5321(a)(5) is "willful" where a taxpayer: (1) violates the law "voluntarily rather than accidentally"; (2) is "willfully blind" to the legal duty to report; or (3) engages in conduct that is in "reckless disregard" of the legal duty to report. In the government's view, Kimble's conduct was willful under any of these standards.

According to the government, Kimble's failure to report was voluntary because she signed her federal tax return knowing of the obligation to report her foreign accounts. In addition, she maintained a numbered account (a form of a hidden bank account in Switzerland) and instructed her foreign bank not to send any account-related correspondence to the United States, and Kimble did not inform her accountant about the existence of her foreign accounts.

With respect to the second standard, the government stated that to be "willfully blind," a person "must subjectively believe that there is a high probability that a fact exists and the [person] must take deliberate actions to avoid learning that fact." The government reasoned that Kimble was willfully blind of her duty to comply with the FBAR reporting requirements because:

1. As a matter of law, she was charged with knowledge of the representations made on federal tax returns;
2. She knew of the FBAR requirement posited by Question 7(a) on Schedule B, *Interest and Ordinary Dividends*, of Form 1040, *U.S. Individual Income Tax Return*, of her 2007 income tax return, which asked whether the taxpayer had an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account; and
3. She admitted that she never read her tax returns or any of the documents she signed related to her Swiss bank account.

Under the third standard, the government argued her conduct was willful because she had acted with reckless disregard of her legal duty to file an FBAR, answer Question 7(a) accurately on her 2007 income tax return, and ask her accountant for advice on any reporting requirements or other federal tax issues that might arise in connection with the Swiss account.

Kimble's reply

Kimble countered that that "willfulness" is a "voluntary, intentional violation of a known legal duty" and that the government's interpretation of the requirement would render the term "willful" superfluous because under it every taxpayer who fails to file an FBAR does so willfully. Because she had never read her tax returns and had no knowledge of the FBAR or other federal tax reporting requirements, her failure to report her accounts was not voluntary or intentional, so it was not willful.

The court's resolution

The Court of Federal Claims held that Kimble's failure to report her foreign bank account to the IRS by filing an FBAR was willful and that she was subject to the higher willfulness penalty. The court, citing the Supreme Court, found that willfulness encompassed both knowing and reckless violations of a standard. The relevant acts by Kimble for determining whether her conduct was willful were:

- Kimble did not disclose the existence of her foreign accounts to her accountant until approximately 2010;
- Kimble never asked her accountant how to properly report foreign investment income (income from the foreign accounts);
- Kimble did not review her individual income tax returns for accuracy for tax years 2003 through 2008;
- Kimble answered "No" to Question 7(a) on her 2007 income tax return, falsely representing under penalty of perjury that she had no foreign bank accounts.

The court concluded that the third and fourth acts, evidenced conduct by Kimble, as a co-owner of the foreign accounts, 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 Kimble had no legal duty to disclose information to her accountant or to ask her accountant about IRS reporting requirements, this did not affect the court's determination that her conduct was "willful."

The *Kimble* case is a reminder that the government is pursuing the maximum willful penalty by taking the position that the individual was "willfully blind" to the requirement that he or she file an FBAR or acted "recklessly." A taxpayer's response must be something more than just "I did not read my tax returns" because a taxpayer, according to the government, is charged with constructive knowledge of the content of a signed income tax return.

Observations

Currently, the first course of action in FBAR cases is to try to resolve the case with the IRS revenue agent during the civil examination. A successful presentation before an IRS agent should include at least the following:

- Producing documents to support a finding of nonwillfulness;
- Presenting signed affidavits under penalty of perjury;
- Factually distinguishing the case from the adverse published FBAR cases; and
- Educating the agent as to why the taxpayer's conduct was not willful.

Consider giving the agent a PowerPoint or other presentation that walks through the evidence and shows why the willfulness factors are not present in the case. Those factors can be found in the Internal Revenue Manual (IRM §4.26.16). Remember, the IRS is a document-driven agency, and this means that a taxpayer needs something more than a self-serving and unsubstantiated affidavit to prevail. If the representative is an accountant, it may make sense to retain tax counsel to provide legal assistance in sorting through the nuances of the published cases and mounting a viable legal defense.

Additionally, it is essential to manage the client's expectations about an administrative appeal. The belief that things can be worked out at IRS Appeals may no longer hold true given the current state of the FBAR case law. As additional FBAR cases are litigated in federal court and the law develops further, there will be taxpayer wins that practitioners can rely upon successfully in a civil examination or administrative appeal. Until that happens, taxpayers must continue to push back and fight on. Stay tuned.

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