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TAX LITIGATION ISSUES

Expert Analysis

Civil FBAR Penalty Litigation: No Reprieve for Taxpayers

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On Feb. 18, 2009, the Department of Justice entered into a Deferred Prosecution Agreement with UBS AG. Since that time, the government has aggressively pursued taxpayers who maintained undisclosed offshore accounts. While tens of thousands of taxpayers have cured their historical non-compliance through Offshore Voluntary Disclosure Programs or Initiatives offered by the IRS, approximately 100 taxpayers who failed to make timely voluntary disclosures were subject to criminal investigation and prosecution, with the associated exposure to loss of liberty and financial penalties. A second, more fortunate, subset of the non-compliant taxpayers who did not participate in a voluntary disclosure program were subjected to IRS audits, which carried the potential for substantial civil penalties without the risk of incarceration.

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By statute, the maximum civil penalty for taxpayers who willfully fail to file Reports of Foreign Bank and Financial Accounts (FBARs) is the greater of $100,000 or 50% of the balance in the undisclosed account(s) at the time of the violation. This column has previously addressed both the difficulty taxpayers face in arguing that their failure to disclose offshore accounts was non-willful, see Jeremy H. Temkin, *The Next Frontier: Civil Penalties for Undisclosed Offshore Accounts*, N.Y.L.J. (Jan. 18, 2018), and the potential for capping penalties substantially below the statutory maximum, see Jeremy H. Temkin, *FBAR Penalties: Relief for Taxpayers?*, N.Y.L.J. (Jan. 17, 2019). Recent decisions have reflected continued judicial antagonism to taxpayers' attempts to avoid civil penalties and the rejection of attempts to cap such penalties.

'Willful' FBAR Penalties And Recklessness

If a taxpayer disputes the IRS's assessment of a willful FBAR penalty, the issue is litigated in federal court where the government bears the burden of establishing that the taxpayer had the requisite mental state. Courts have allowed the government to meet this burden by establishing that the taxpayer acted recklessly or through willful blindness. In practice, this has not proved to be a difficult

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threshold for the government to meet. For example, in *United States v. Williams*, 489 Fed. App'x 655 (4th Cir. 2012), the court reversed a post-bench trial verdict in favor of a taxpayer, noting that he had failed to disclose his offshore accounts on a "tax organizer" he had completed for his accountant and that had indicated that he did not have any reportable accounts on Schedule B to his tax return. In finding that the taxpayer had acted recklessly, the court found that his signature constituted "prima facie evidence that he knew the contents of [his tax] return" and that, at a minimum, the taxpayer was on inquiry notice regarding his obligation to file FBARs.

More recently, in *Bedrosian v. United States*, 912 F.3d 144, 152-54 (3d Cir. 2018), the Third Circuit also reversed a post-bench trial verdict in favor of the taxpayer. Applying an objective standard of recklessness, the appellate court held that "a person commits a reckless violation of the FBAR statute by engaging in conduct … entailing an unjustifiably high risk of harm that is either known or so obvious that it should have been known." Because the district court had applied a subjective test—comparing the taxpayer's conduct to conduct found to be willful in other cases—the court remanded the case for consideration of whether the taxpayer "(1) clearly ought to have known that (2) there was a grave risk that an accurate FBAR was not being filed and if (3) he was in a position to find out for certain very easily."

Last December, the Senior U.S. District Court Judge Michael M. Baylson of the Eastern District of Pennsylvania found that Bedrosian's conduct met this objective standard of recklessness. Significantly, Bedrosian was a sophisticated and successful businessman who had filed an FBAR that omitted the larger of two Swiss bank accounts. The court rejected the taxpayer's claim that the omission was an error based on the substantial balance in the undisclosed account and the presumption that the taxpayer had reviewed his return before signing it under penalties of perjury. Thus, the court concluded that the taxpayer had demonstrated a reckless disregard of the risk that the FBAR he had filed was inaccurate.

> The IRS continues to recognize the possibility of non-willful FBAR violations and offers Streamlined Offshore Procedures for taxpayers who unwittingly violated their reporting obligations.

Bedrosian v. United States, No. 15-cv-5853, 2020 WL 7129303 (E.D. Pa. Dec. 4, 2020).

In between the Third Circuit's opinion and Judge Baylson's decision on remand, the Fourth Circuit decided *United States v. Horowitz*, 978 F.3d 80 (4th Cir. 2020). There, the taxpayers were highly educated U.S. professionals who moved to Saudi Arabia in 1984. While residing abroad, the taxpayers opened a Swiss bank account. By 2001, when the Horowitzes returned to the United States, their Swiss account—now at UBS—had grown to approximately $1.6 million. Thereafter, the Horowitzes neglected to give UBS their new mailing address, opting to monitor the account through periodic calls to the bank. In 2008, Mr. Horowitz traveled to Switzerland and transferred the balance of the UBS account (now almost $2 million) to a newly opened, numbered account at Finter Bank. The Finter Bank account had a "hold mail" directive, meaning that the bank would not send correspondence to the Horowitzes in the United States.

Ultimately, the Horowitzes consulted a tax attorney and entered the Offshore Voluntary Disclosure Program. In 2012, however, the Horowitzes opted out of the OVDP in the hopes of reducing their penalty. That maneuver backfired when the IRS assessed willful FBAR penalties totaling almost $750,000. When the Horowitzes refused to pay the assessed penalties, the government commenced an action in the District of Maryland. After discovery, the court granted the government's motion for summary judgment and the Horowitzes appealed.

In affirming the district court's opinion, the Fourth Circuit adopted the test applied by the Third Circuit in *Bedrosian* and concluded that the government had met its burden of establishing willfulness based on recklessness. Specifically, the court concluded the Horowitzes could not have reasonably believed that foreign interest income was exempt from U.S. taxation in light of their awareness that the salaries they earned in Saudi Arabia were subject to U.S. income taxes and their inclusion of the interest income they earned on their domestic accounts in the information they gave to their accountant. Rather, the court determined that, at a minimum, the taxpayers should have asked their accountant about the tax implications of their Swiss accounts. The court also cited both the Horowitzes' use of the numbered account and hold mail options offered by Finter Bank and their denial of the existence of reportable offshore accounts on their tax returns as further support for the conclusion that they had acted recklessly. All told, the Fourth Circuit had little difficulty finding that "the record indisputably establishes not only that the Horowitzes 'clearly ought to have known' that they were failing to satisfy their obligation to disclose their Swiss accounts, but also that they were in a 'position to find out for certain very easily.'"

Uncapped Penalties for Willful FBAR Violations

In addition to scienter-based defenses, taxpayers seeking to avoid significant civil penalties have also argued that a 1987 regulation caps the maximum penalty at $100,000 per account. At the time that regulation was promulgated, the statutory maximum civil penalty for an FBAR violation was the greater of $25,000 or "an amount (not to exceed $100,000) equal to the balance of the account at the time of the violation," and while Congress increased the statutory maximum penalty in 2004, the Treasury Department never adjusted the regulation to mirror the new statute.

In 2018, two courts concluded that, notwithstanding the increased penalties available under the amended statute, the regulation continued to fix the maximum penalty. See *United States v. Wadhan*, 325 F. Supp. 3d 1136 (D. Colo. 2018); *United States v. Colliot*, No. 16-cv-1281, 2018 WL 2271381 (W.D. Tex. May 16, 2018). By contrast, the Federal Court of Claims reached the opposite conclusion. See *Norman v. United States*, 138 Fed. Cl. 189 (Fed. Cl. 2018); *Kimble v. United States*, No. 17-cv-421, 2018 WL 6816546 (Fed. Cl. 2018).

More recently, however, multiple Circuit Courts of Appeals, including the Fourth Circuit in *Horowitz*, and at least 10 district courts have closed the door on this potential avenue of relief, concluding that the 2004 statutory directive that "the maximum penalty … *shall* be the greater of" $100,000 or 50% of the account bars application of the lower penalties fixed in the outdated regulations. See, e.g., *United States v. Collins*, No. 18-cv-1069, 2021 WL 456962, at *8 (W.D. Pa. Feb. 8, 2021); *United States v. Cohen*, No. 17-cv-1652, 2019 WL 4605709, at *3-5 (C.D. Cal. Aug. 6, 2019) (collecting cases).

Conclusion

The factors that *Bedrosian* and *Horowitz* relied on to find that the taxpayers had engaged in willful FBAR violations—the size of the accounts at issue, the use of numbered accounts and a "hold mail" directive, and especially the perjurious denial of the existence of offshore accounts on the tax returns—are prevalent in most cases in which the IRS seeks to impose willful FBAR penalties. Thus, those decisions create a heavy burden for taxpayers seeking to avoid willful FBAR penalties.

This is not to say that all FBAR violations are willful. Indeed, the IRS continues to recognize the possibility of non-willful FBAR violations and offers Streamlined Offshore Procedures for taxpayers who unwittingly violated their reporting obligations. Practitioners, however, need to be attentive to the wide range of factors that can weigh in favor of a finding of willfulness as well as the growing body of case law rejecting reliance on regulations to avoid the full range of penalties that Congress has made available to the IRS.