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Tax Litigation Issues

Expert Analysis

The Next Frontier: Civil Penalties for Undisclosed Offshore Accounts

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The government's current crackdown on undisclosed offshore accounts is approaching its second decade, and the results have been impressive. Notwithstanding the recent high profile acquittal of former Bank Frey executive Stefan Buck (see D. Enrich, "A Swiss Banker Helped Americans Dodge Taxes. Was It a Crime?," New York Times, Jan. 6, 2018), since early 2009, the Department of Justice has successfully prosecuted over 120 taxpayers, lawyers, accountants, bankers and other professionals for criminal offenses relating to undisclosed accounts (see Offshore Charges/Convictions Spreadsheet (7/22/16)). The DOJ has also entered into over 85 Deferred Prosecution or Non-Prosecution Agreements with financial institutions, and over 55,000 taxpayers have resolved their civil and criminal exposure through one of the Internal Revenue Service's Offshore Voluntary Disclosure Programs. *Offshore Voluntary Compliance Efforts Top $10 Billion; More Than 100,000 Taxpayers Come Back into Compliance*, IR-2016-137, Oct. 21, 2016 (noting that participants in the OVDPs have paid over $9.9 billion in taxes, interest and penalties and that an additional 48,000 taxpayers have used the streamlined procedures offered by the IRS to cure prior non-willful omissions, generating approximately $450 million in taxes, interest and penalties).

An often overlooked fourth prong of the government's offshore enforcement efforts is the IRS's pursuit of taxpayers who were fortunate enough to avoid criminal prosecution without making a voluntary disclosure. These individuals are subject to audit and, while clearly preferable to criminal prosecution, they face substantial civil penalties if they are found to have willfully failed to disclose their offshore accounts. Lawyers representing such taxpayers need to be cognizant of the limited avenues available for opposing those penalties.

Civil FBAR Penalties

The Bank Secrecy Act requires taxpayers to disclose foreign accounts by filing Reports of Foreign Bank and Financial Accounts (FBARs) listing any "financial interest in, or signature or other authority over, … bank, securities, or other financial account[s] in a foreign country" with an aggregate value over $10,000 at any time during the year. 31 C.F.R. §1010.350. Revenue agents who discover previously undisclosed accounts during an audit can either refer the taxpayer for criminal investigation or address the matter civilly by assessing unpaid taxes, interest, and civil penalties. While

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non-willful violations are subject to penalties up to $10,000 per violation (31 U.S.C. §5321(a)(5)(B)), if the IRS concludes the taxpayer acted willfully, it can impose civil penalties equal to the greater of $100,000 or 50% of the highest balance in the undisclosed accounts. 31 U.S.C. §5321(a)(5)(C). (Since each year that the account is not disclosed constitutes a separate violation, the penalties for failing to disclose an account for multiple years can potentially exceed the total value of the account. While the

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Internal Revenue Manual suggests that, in most cases, a willful penalty should be capped at 50 percent of the highest value of the undisclosed accounts in a single year, see I.R.M. §4.26.16.6.5.3 (11-06-2015), there is no legal prohibition to the imposition of multiple 50 percent penalties.)

When the taxpayer refuses to pay an assessed penalty, the IRS will bring an enforcement action in federal court. (The increased activity in this area is reflected in the sizeable jump in the number of pending cases: from seven in 2014 to 52 in 2017. See Presentation at the 5th Annual International Tax Enforcement and Controversy, *Continuing Enforcement and Disclosure Issues Regarding Foreign Assets*, Oct. 27, 2017.) The key issue in such cases is whether the government can demonstrate that the defendant's failure to disclose the accounts in question was willful. Four recent cases shed light on the standard required to establish a willful violation.

Determining Willfulness

In *United States v. Williams*, 489 Fed. App'x 655 (4th Cir. 2012), the defendant deposited over $7 million in unreported income into two Swiss bank accounts between 1993 and 2000. The government opened an investigation in the fall of 2000, at which time Williams retained counsel and the Swiss authorities froze his accounts. Despite his knowledge of the government's investigation, Williams neglected to file an FBAR for 2000 and did not disclose the accounts on his income tax return for that year. In January 2002, Williams acknowledged the accounts during an interview with IRS agents, and the following year he pleaded guilty to tax evasion and conspiring to defraud the United States, admitting that he had intentionally concealed his Swiss bank accounts. After the conclusion of the criminal case, the IRS assessed and sought to collect a willful FBAR penalty.

While the district court accepted Williams's argument that his omission was non-willful, the U.S. Court of Appeals for the Fourth Circuit disagreed. Addressing the standard for determining willfulness, the Fourth Circuit relied on *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 57 (2007), for the proposition that "where willfulness is a statutory condition of civil liability" it can be established through reckless as well as knowing violations. The court added that willfulness may be proven through inferences drawn from the taxpayer's conduct, including "a conscious effort to avoid learning about [the] reporting requirement[]."

Measured against this standard, the court had little difficulty concluding that Williams's failure to disclose the accounts was willful. The court rejected Williams's claim that he was unaware of the FBAR filing requirement, noting that his signature on his tax return constituted "prima facie evidence that he knew the contents of the return," including the instructions regarding the filing requirement. The court noted that, at a minimum, the tax return put Williams on inquiry notice regarding his obligation to file FBARs and pointed to Williams's denial of the existence of any offshore accounts on both a "tax organizer" that he completed for his accountant in early 2001 and his tax return as evidence of his intent to conceal the accounts. Finally, almost as an afterthought, the court pointed to Williams's admission during his plea allocution that he had willfully failed to report the accounts as part of his tax evasion scheme. Thus, the Fourth Circuit had found that "Williams's undisputed actions establish reckless conduct," which was sufficient to meet the government's burden.

In *United States v. McBride,* 908 F. Supp.2d 1186 (D. Utah 2012), and *United States v. Bohanec*, 263 F. Supp. 3d 881, 888 (C.D. Cal. 2016), the courts similarly upheld willful civil FBAR penalties. In *McBride,* the taxpayer consulted a financial management firm regarding offshore strategies that could reduce his income tax liability, and then opened several foreign accounts that he did not disclose on FBARs. When he subsequently faced an IRS investigation, McBride repeatedly lied to about the foreign accounts and refused to produce relevant documents.

In *Bohanec*, the taxpayers hid unreported income in undisclosed accounts in Switzerland, Austria, and Mexico. In 2010, the taxpayers participated in the OVDP and filed FBARs disclosing the Swiss account, but not the Austrian and Mexican accounts. The IRS subsequently rejected the taxpayers' voluntary disclosure and imposed a willful FBAR penalty.

Following the Fourth Circuit's decision in *Williams*, the courts in both *McBride* and *Bohanec* declined to apply the standard for criminal liability—the intentional violation of a known legal duty—in the civil FBAR context. Rather, the courts concluded that the IRS need only establish willfulness by a preponderance of the evidence and that it can meet this burden through evidence of either recklessness or "willful blindness."

McBride further noted that the taxpayers' signature on their tax returns established their knowledge of the contents of those returns, including the instructions regarding the FBAR filing requirement. There, the court found the taxpayer had actual knowledge of the reporting obligations based on his review of promotional materials prepared by the financial management firm, but alternatively found evidence that McBride had been both reckless and willfully blind. Specifically, the court noted that, upon hearing the financial management firm's presentation, McBride responded "[t]his is tax evasion," and that he failed to disclose relevant facts to his accountant or to seek advice from professionals. Similarly, in *Bohanec*, the court relied on the taxpayers' sophistication, the fact that they had not given the Swiss bank their home address, their failure to tell their return preparer about their offshore accounts, and their omission of the Mexican and Austrian accounts from their voluntary disclosure. These actions were found to be sufficient to satisfy the government's burden of establishing willfulness by a preponderance of the evidence.

'Bedrosian'

Between the preponderance standard of proof, the ability to establish willfulness through evidence of recklessness and willful blindness, and the inferences to be drawn from the taxpayer's signature on the return itself, *Williams*, *McBride,* and *Bohanec* present a steep hill for taxpayers challenging the imposition of civil FBAR penalties. In *Bedrosian v. United States*, No. Civ. 15-5853, 2017 WL 4946433 (E.D. Pa. Sept. 20, 2017), however, the taxpayer overcame these hurdles.

There, the taxpayer opened a Swiss bank account in the early 1970s in order to have access to funds in connection with extensive overseas business travel. Over the years, however, the taxpayer started using the account for savings and, after the bank was acquired by UBS, he borrowed a substantial amount of money, which funded a second account.

Bedrosian conceded that from the mid-1990s until 2007, he knowingly violated the FBAR requirement. In 2007, however, after the death of his prior accountant, Bedrosian took steps to bring himself into compliance. In doing so, he disclosed one account that contained $240,000, but omitted a second, $2 million account. The IRS subsequently imposed and sought to enforce a willful FBAR penalty predicated on the failure to disclose the latter account.

The court in *Bedrosian* agreed with the *Williams*, *McBride*, and *Bohanec* courts that willful intent is satisfied when a defendant knowingly or recklessly violates the statute, and that acting with willful blindness, or ignoring the "obvious or known consequences of one's actions" is sufficient to demonstrate willfulness. In applying this standard, however, the *Bedrosian* court found that the IRS failed to demonstrate sufficient facts to establish that the taxpayer's omission of the second account was knowing, reckless, or even willfully blind.

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Significantly, the court rejected the government's argument that relative culpability was irrelevant and engaged in a detailed factual analysis, distinguishing Bedrosian's conduct as less egregious than the conduct in *Williams*, *McBride*, and *Bohanec*. In this regard, Bedrosian was aided by the fact that, during the year in question, he had filed an FBAR and the issue before the court was whether he knew it was inaccurate. The court acknowledged that Bedrosian had not given the form the requisite attention, but concluded that mere negligence was not sufficient to establish that he willfully omitted the larger account, especially in light of conflicting testimony about Bedrosian's awareness that he held two separate accounts. The judge also gave significant weight to the fact that Bedrosian had sought legal advice and retained an accounting firm to file amended returns before he learned of the government's investigation, and that he cooperated with the IRS from the outset of its investigation.

Conclusion

Taken together, *Williams*, *McBride*, *Bohanec*, and *Bedrosian* demonstrate the difficulty of overcoming a civil FBAR penalty. Given the government's ability to establish willfulness through evidence of reckless conduct and conscious avoidance, and the presumption that taxpayers are aware of the FBAR filings instructions on their tax returns, it will often be difficult to persuade a judge that a taxpayer's noncompliance was inadvertent. By contrast, while *Bedrosian* turned on the taxpayer's understanding of the accounts in question as opposed to his knowledge of the reporting requirement, that case suggests that courts may be willing to be give the benefit of the doubt to taxpayers who can demonstrate that they tried to comply with their obligations.