

# Court Bucks the Trend in FBAR Penalty Cases: Merely Signing a Tax Return Does Not Establish Willfulness

By Hale E. Sheppard\*

*Hale E. Sheppard examines two recent cases that fortify taxpayer defenses, Bedrosian, which is well known, and Flume, which is not.*



## Walters Kluwer

### I. Introduction

The U.S. government often trumpets its success in asserting severe penalties for “willful” failures by taxpayers to file FinCEN Form 114 (“FBAR”) to disclose foreign financial accounts. Triumphs for the U.S. government should come as no surprise; things come easier when you have full discretion regarding which taxpayers to pursue, whether to assert non-willful or willful penalties, when to settle a case, *etc.* Taxpayers periodically win, though, despite the many advantages enjoyed by the U.S. government. These victories prove valuable to other taxpayers who find themselves embroiled in international tax battles with the U.S. government, which often involve tax liabilities for omitted foreign income, extended assessment periods for unfiled information returns, and, of course, large penalties for FBAR violations. This article examines two recent cases that fortify taxpayer defenses, *Bedrosian*,<sup>1</sup> which is well known, and *Flume*,<sup>2</sup> which is not.

### II. Duties Related to Foreign Accounts

To understand the significance of *Bedrosian* and *Flume*, one must first have a basic understanding of the obligations triggered by holding an interest in, or having some type of power over, a foreign account.

#### A. Overview of Obligations

The relevant law mandates the filing of an FBAR in situations where (i) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (ii) had a direct

**HALE E. SHEPPARD**, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka and Chair of the International Tax Group.

financial interest in, had an indirect financial interest in, had signature authority over, or had some other type of authority over (iii) one or more financial accounts (iv) located in a foreign country (v) whose aggregate value exceeded \$10,000 (vi) at any point during the relevant year.<sup>3</sup>

*Taxpayers periodically win, though, despite the many advantages enjoyed by the U.S. government.*

U.S. individuals have several duties when they hold a reportable interest in a foreign financial account, including the following:

- checking the “yes” box in Part III (Foreign Accounts and Trusts) of Schedule B (Interest and Ordinary Dividends) to Form 1040 (*U.S. Individual Income Tax Return*) to disclose the existence of the foreign account,
- identifying the foreign country in which the account is located, also in Part III of Schedule B to Form 1040,
- declaring all income generated by the account (such as interest, dividends, and capital gains) on Form 1040,
- reporting the account on Form 8938 (*Statement of Specified Foreign Financial Assets*), which is enclosed with Form 1040, and
- electronically filing an FBAR.<sup>4</sup>

## B. Account Disclosures on Schedule B

Part III of Schedule B to Form 1040 contains an inquiry about foreign accounts. The IRS has slightly modified and expanded this language over the years, with the materials for 2017 stating the following:

At any time during 2017, did you have a financial interest in or a signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? *See instructions.*

If “Yes,” are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? *See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements.*

If you are required to file a FinCEN Form 114, enter the name of the foreign country where the financial account is located.

## C. Penalties for FBAR Violations

Congress enacted new FBAR penalty provisions in 2004.<sup>5</sup> Since that time, the IRS has been able to penalize any U.S. person who fails to file an FBAR when required.<sup>6</sup> In the case of non-willful violations, the maximum penalty is \$10,000, but the IRS will waive such penalty if the violation was due to “reasonable cause.”<sup>7</sup> Higher penalties apply where “willfulness” exists. Specifically, in situations where a taxpayer deliberately fails to file an FBAR, the IRS can assert a penalty equal to \$100,000 or 50 percent of the balance in the account at the time of the violation, whichever amount is larger.<sup>8</sup> Given the large balances in some unreported accounts, FBAR penalties can be enormous.

## D. Unexpected Significance of Executing Form 1040

In addition to the preceding duties, taxpayers must sign and date their Forms 1040 in order for them to be valid. Unless they pay very close attention to the small print, most taxpayers will be unaware that they are making the following broad, sworn statement to the IRS, which often comes back to haunt them:

Under penalties of perjury, I declare that *I have examined this return and accompanying schedules [including Schedule B] and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year.*

## III. Evolving Definition of “Willfulness”

Several courts have examined the issue of what constitutes “willfulness” in the context of civil FBAR penalties.<sup>9</sup> Notable decisions include *Williams* in 2012,<sup>10</sup> *McBride* in 2012,<sup>11</sup> *Bussell* in 2015,<sup>12</sup> *Bohanec* in 2016,<sup>13</sup> *Bedrosian* in 2017,<sup>14</sup> *Kelley-Hunter* in 2017,<sup>15</sup> *Garrity* in 2018,<sup>16</sup> *Markus* in 2018,<sup>17</sup> and, most recently, *Flume* in 2018.<sup>18</sup>

Trying to digest all the data about willfulness in the FBAR context is, well, hard. The rules are complex, the court decisions are not entirely consistent, the IRS and the DOJ take different positions in different cases, *etc.* In an effort to clarify and consolidate matters, below is a summary of critical issues learned from prior FBAR cases:

- The Tax Court lacks jurisdiction over FBAR penalty matters, in both pre-assessment and post-assessment (*i.e.*, collection) cases, so FBAR litigation takes place in District Court or the Court of Federal Claims.

- The standard for asserting maximum FBAR penalties is “willfulness.”
- The government is only required to prove willfulness by a preponderance of the evidence, not by clear and convincing evidence.
- The government can establish willfulness by showing that a taxpayer either knowingly or recklessly violated the FBAR duty.
- Recklessness might exist where a taxpayer fails to inform his accountant about foreign accounts.
- Recklessness might also exist where a taxpayer is “willfully blind” of his FBAR duties, which can occur when the taxpayer executes but does not read and understand every aspect of a Form 1040, including all Schedules attached to the Form 1040 (like Schedule B containing the foreign-account question) and any separate forms referenced in the Schedules (like the FBAR).
- If the taxpayer makes a damaging admission during a criminal trial, the government will use such statement against him in a later civil FBAR penalty action.
- The taxpayer’s motives for not filing an FBAR are irrelevant, because nefarious, specific intent is not necessary to trigger willfulness.
- The government can prove willfulness through circumstantial evidence and inference, including actions by the taxpayer to conceal sources of income or other financial data.
- In determining whether an FBAR violation was willful, courts might consider after-the-fact unprivileged communications between taxpayers and their tax advisors.
- The IRS might adhere to its internal guidance, which limits the total willful FBAR penalty to 50 percent of the highest balance of the unreported accounts, spread over all open years.
- The courts review the question of willfulness on a *de novo* basis, meaning that taxpayers generally cannot offer evidence at trial related to the IRS’s administrative process in conducting the audit, determining whether willfulness existed, *etc.*
- Courts might reject as irrelevant, in an evidentiary sense, reports and testimony from experts who attempt to make a link between general ignorance of FBAR duties by the public and particular ignorance of the taxpayer under attack.
- Depending on the circumstances, the U.S. government might be able to ensnare a taxpayer in three different, stressful, costly, and time-consuming cases at one time, including those for (i) income taxes, and accuracy-related or civil fraud penalties, in Tax Court,

(ii) assessable international information return penalties, in District Court, and (iii) FBAR penalties, in District Court or the Court of Federal Claims.

- Courts might give credence to the argument that age-related mental conditions preclude a finding of willfulness.
- Rooted in *Colliot* and *Wadhan*, courts might cap willful FBAR penalties at \$100,000 per violation, unless and until the regulations are changed to match current law.

## IV. First Victory for Taxpayers

*Bedrosian* was unique in that it constituted the first situation in which a taxpayer, as opposed to the government, prevailed on the willfulness issue.<sup>19</sup>

### A. Description of the Relevant Facts

The taxpayer started working in the pharmaceutical industry and he frequently traveled abroad on business early in his career. He opened an account in Switzerland at some point in the 1970s with the predecessor to UBS in order to facilitate payment of expenses during international trips. The balance started small and grew over the years as a result of three things: (i) periodic deposits of after-tax funds *via* check and wire transfer from the United States, (ii) a supposed loan that the taxpayer received from UBS of approximately \$750,000, and (iii) passive income generated by the accounts.

*Bedrosian was unique in that it constituted the first situation in which a taxpayer, as opposed to the government, prevailed on the willfulness issue.*

The taxpayer, who holds an undergraduate degree and a law degree, was the chief executive officer of a large generic pharmaceutical company. As head of the company, he manages hundreds of people, routinely reviews and signs complex financial statements, approves corporate contracts, analyzes complex industry regulations, *etc.*

When UBS supposedly issued a loan of some \$750,000 to the taxpayer, it apparently opened a subaccount (“Large Account”) under the existing account (“Small Account”), deposited the funds in the Large Account, and began investing them on behalf of the taxpayer. Much of the

case centers on what the taxpayer knew, and when, about the Large Account.

The taxpayer instructed UBS not to send him any mail. He kept abreast of the financial status by meeting periodically with a UBS representative when he traveled to the United States.

The taxpayer started working in 1972 with an accountant, Seymour Handelman (“Accountant Handelman”). Apparently, Accountant Handelman never specifically asked the taxpayer about foreign accounts, and the taxpayer never unilaterally raised the topic, at least until some point in the 1990s. At that time, Accountant Handelman allegedly advised the taxpayer, incorrectly, that he would not need to report income from the UBS accounts until he repatriated the funds or died. It is unclear whether Accountant Handelman notified the taxpayer of his duty to report the existence of the account on Schedule B of Form 1040 or to file an annual FBAR. What is certain, though, is that these things did not occur until many years later.

*As the U.S. government continues to aggressively pursue FBAR violations, and as it introduces more expansive legal theories for liability, taxpayers will be raising and relying on Bedrosian and Flume with frequency.*

Accountant Handelman prepared Forms 1040 for the taxpayer from 1972 through 2006, after which he died. The taxpayer, in need of new help, hired another accountant, Sheldon Bransky (“Accountant Bransky”). The content of the discussions with, and the type of documents provided to, Accountant Bransky are ambiguous, but there is no dispute that he prepared the following: (i) A timely 2007 Form 1040 that omitted the \$220,000 in passive income generated by the UBS accounts, (ii) a Schedule B to the 2007 Form 1040 answering “yes” to the foreign-account question and identifying “Switzerland” as the location, and (iii) a late 2007 FBAR, filed in October 2008 (instead of by the deadline of June 30, 2008), reporting only the Small Account at UBS and noting that the highest balance in such account ranged from \$100,000 to \$1 million. The taxpayer did not convey to Accountant Bransky the erroneous advice that he had previously received from Accountant Handelman to the effect that he was not required to report passive income from UBS until repatriation or death. Nevertheless, it is evident that the taxpayer continued to

follow this flawed guidance, because the UBS income did not appear on the original 2007 Form 1040.

The taxpayer was notified by UBS at some point in 2008 that he must close his accounts, presumably as a result of the criminal investigation by the U.S. government. Therefore, in November 2008, the taxpayer closed the Large Account, with a balance of about \$2 million, and transferred the funds to another Swiss bank, Hyposwiss. Soon thereafter, in December 2008, the taxpayer sent another letter to UBS, this time closing the Small Account, with a balance of about \$250,000, and domesticating the funds to his Wachovia account.

At some point in 2009, the taxpayer began to question the earlier advice from Accountant Handelman with respect to the UBS accounts. He consulted with his attorney, who, in turn, hired both a forensic accountant, to assist with return preparation, and a Swiss attorney, to obtain all necessary data from UBS. The Swiss attorney learned as part of his project that UBS had already provided data to the IRS about the accounts held by the taxpayer. This did not alter the taxpayer’s existing plan, which was to apply to resolve issues with the IRS through the 2009 Offshore Voluntary Disclosure Program (“OVDP”).

In connection with his proposed participation in the OVDP, the taxpayer filed with the IRS in August 2010 (i) Forms 1040X from 2003 through 2008, reporting the passive income generated by the UBS accounts that was not shown on the original Forms 1040, and (ii) a 2006 FBAR, an amended 2007 FBAR, and a 2008 FBAR, reporting both the Small Account and the Large Account. The IRS rejected the taxpayer’s application for the OVDP because it had already received data directly from UBS about the unreported accounts.

In April 2011, the IRS initiated an audit, starting with 2007. The taxpayer cooperated with the audit, responding to all Information Document Requests (“IDRs”) and participating in an interview with the Revenue Agent. The Revenue Agent determined that the FBAR violations were non-willful and presented this finding to the appropriate “panel” within the IRS.

The Revenue Agent later exited the scene for unexpected medical leave, during which time the case was reassigned to another Revenue Agent. In June 2013, the second Revenue Agent disagreed with the earlier conclusion about the character of the FBAR violation for 2007 and asserted a “willful” penalty. The second Revenue Agent sought the highest sanction, equal to 50 percent of the highest balance of the Large Account. The highest balance in 2007 was \$1,951,578.34, triggering a penalty of \$975,789.19.

The taxpayer administratively disputed the penalty, he lost, he made a partial payment of \$9,757.89 (representing

one percent of the FBAR penalty amount), and then he filed a Suit for Refund in District Court. The U.S. Department of Justice (“DOJ”) filed a counterclaim, contending that the taxpayer was liable for the remaining amount of the penalty.

## B. Positions by the Parties

The taxpayer and the DOJ presented their positions to the District Court, primarily through cross-motions for summary judgment, which were denied, and then a one-day trial.

### 1. Main Arguments by the Taxpayer

The taxpayer, understandably, focused most of his time and attention on the key issue of whether his failure to report the Large Account on the original 2007 FBAR was willful, negligent, reasonable, or something in between. The taxpayer emphasized a number of points in this regard during the litigation, including the following: (i) He relied on erroneous advice from Accountant Handelman; (ii) He did not closely review the relevant Forms 1040 or FBARs before they were filed; (iii) Schedule B to the 2007 Form 1040 answered “yes” to the foreign-account question and identified “Switzerland” as the relevant country; (iv) At the time of filing the original 2007 FBAR, he was unaware that UBS had created a Small Account and a Large Account, and he simply considered it all to be just one account; (v) he did not have in his possession statements from UBS at the time he filed the original 2007 FBAR; (vi) He did not believe that the supposed loan of approximately \$750,000 would be counted as part of the reportable balance, because that money essentially belonged to UBS, not the taxpayer; (vii) He retained legal counsel, a forensic accountant, and a Swiss attorney as part of an effort to voluntarily become compliant through the OVDI, even though his application was rejected; (viii) He filed Forms 1040X, FBARs, and an amended 2007 FBAR in August 2010, before the IRS started an audit; and (ix) He fully cooperated during the IRS audit.

The taxpayer further maintained that, in the worst case scenario, his FBAR penalty should be reduced in accordance with the “penalty mitigation guidelines.” The Internal Revenue Manual indicates that the IRS might reduce FBAR penalties if the following four “mitigation threshold conditions” are met in a particular case: The taxpayer has no history of criminal tax or Bank Secrecy Act convictions for the preceding 10 years and no history of FBAR penalty assessments; No money passing through any of the foreign accounts associated with the taxpayer was from an illegal source or used to further a criminal purpose; The taxpayer cooperated during the IRS audit;

and The IRS did not determine a fraud penalty against the taxpayer for income tax underpayments related to the foreign account.<sup>20</sup>

### 2. Main Arguments by the DOJ

The DOJ, like the taxpayer, directed most of its energy to the issue of willfulness. It raised a long list of points through the litigation, many of which are summarized here: (i) The taxpayer is an accomplished, intelligent, experienced professional who understood, or should have taken the necessary steps to understand, his tax duties, FBAR duties, and facts related to funds held with UBS; (ii) Because he signed his annual Forms 1040, the taxpayer had at least constructive knowledge of, and was placed on inquiry notice about, his FBAR duties; (iii) The taxpayer cannot claim ignorance of his FBAR duty for 2007, because he actually filed one, even though it was late and incomplete; (iv) The fact that the taxpayer sent two separate letters to UBS to close the Large Account and the Small Account, and the fact that funds from the Large Account were transferred to another Swiss bank, while the funds from the Small Account were repatriated, indicate that the taxpayer knew he had two accounts at UBS, not one; (v) The taxpayer closed the Large Account merely two weeks after filing the original 2007 FBAR, which did not report the Large Account; (vi) The supposed reliance by the taxpayer on erroneous advice from Accountant Handelman is questionable because there is no written evidence or third-party testimony to support it, the advice was limited to income tax issues, not FBAR issues, and the taxpayer did not discuss with his new Accountant Bransky such advice when he took over return preparation starting with 2007; (vii) The taxpayer instructed UBS to hold all mail related to the accounts, and the taxpayer received only oral updates when he met periodically with UBS personnel in the United States; (viii) The taxpayer did not take any steps to voluntarily resolve non-compliance with the IRS until after he learned in 2009 that UBS had already remitted to the U.S. government data about his accounts; (ix) The taxpayer presented no evidence that the \$750,000 deposited into the Large Account constituted a “loan,” and even if it were, a loan amount cannot be excluded when calculating the highest balance for FBAR purposes; and (x) The non-compliance by the taxpayer was significant, lasting for several decades, and resulting in approximately \$375,000 in passive income from 2003 through 2007 alone.

The DOJ rejected the taxpayer’s argument about entitlement to a reduced FBAR sanction under the “penalty mitigation guidelines” on the following grounds. The DOJ conceded that the taxpayer met the four thresholds described in the Internal Revenue Manual, in that he had

no previous FBAR penalty assessments before 2007, the funds in the UBS accounts were not derived from illegal sources or used for criminal purposes, the taxpayer fully cooperated during the audit, and the IRS did not assert a civil fraud penalty with respect to the unreported income stemming from the UBS accounts. However, the DOJ underscored that the applicable process has two steps. The first is to meet the four threshold criteria, and the second is to check the highest balance of the relevant account. If it exceeds \$1 million, then a taxpayer is still subject to the most severe FBAR penalty; that is, 50 percent of the highest balance in the account. Because the Large Account was not specifically declared on the original 2007 FBAR, and because its balance reached over \$1.9 million, the DOJ argued that the “penalty mitigation guidelines” simply do not help the taxpayer.

### C. Analysis by the District Court

The taxpayer and the DOJ each filed a Motion for Summary Judgment, and the District Court, predictably, rejected them. In doing so, the District Court noted that the “precise contours” of the concept of willfulness in the civil FBAR penalty context “have *not* been clearly established by statute or precedent.” The District Court also stated that the issue of whether the taxpayer in *Bedrosian* willfully failed to file a timely, accurate, and complete FBAR for 2007 is an “inherently factual question” that is inappropriate for resolution through summary judgment. Thus, the case proceeded to trial.

After holding a one-day trial and reviewing the corresponding legal briefs, the District Court rendered a taxpayer-favorable decision, the first of its kind. The main points from the District Court are as follows.

In terms of standards, the District Court held that for civil FBAR purposes (i) “willful intent is satisfied by a finding that the [taxpayer] knowingly or recklessly violated the statute,” (ii) “the government need not prove improper or bad purpose” by the taxpayer, (iii) “willful blindness” by the taxpayer meets the standard, and (iv) the government can prove willfulness through circumstantial evidence and through inference, including the conduct of the taxpayer to conceal or mislead sources of income or other financial data.<sup>21</sup>

The District Court identified some favorable facts for the taxpayer, namely, Schedule B to the 2007 Form 1040 checked the “yes” box in response to the foreign-account question and indicated “Switzerland” as the relevant country, the taxpayer filed an FBAR reporting at least one account whose balance ranged from \$100,000 to \$1 million, and the taxpayer approached his attorney to rectify matters with the IRS before he learned that UBS had

already supplied his account data to the U.S. government and it had started an investigation.<sup>22</sup>

It was not all positive, though. The District Court expressly acknowledged that the taxpayer is an educated and financially literate businessman, he took a “calculated risk” for many years before 2007 by not reporting the UBS accounts or the income they generated (but such years were not at issue during the trial), there is “no question” that the taxpayer could have easily discovered that UBS had split the funds into a Small Account and Large account based on the annual statements and/or periodic meetings with UBS personnel, and the taxpayer filed the questionable 2007 FBAR showing one account just two weeks before sending two separate letters to UBS to close two accounts. Despite all this, the court held that the taxpayer’s actions “were at most negligent” and the omission of the Large Account from the original 2007 FBAR was an “unintentional oversight or a negligent act” because there “is no indication that he did so with the requisite voluntary or intentional state of mind.”<sup>23</sup>

The District Court reached this determination by comparing the facts in *Bedrosian* to those in previous FBAR cases. It stated the following in this regard: “[W]e cannot conclude, based on a comparison of the facts of this case compared with those of cases in which a willful FBAR penalty was imposed, that the government has proved, by a preponderance of the evidence, that [the taxpayer’s] violation of Section 5314 was willful.”<sup>24</sup> In distinguishing the facts in *Bedrosian*, the District Court seemed to focus on the fact that the unreported accounts in the other cases were part of a larger or complex “tax evasion scheme,” the taxpayers made no efforts to voluntarily disclose matters to the IRS, the taxpayers had already been convicted of a crime, and/or the taxpayers lied or otherwise failed to cooperate with the IRS audit.<sup>25</sup>

The District Court synthesized its holding in the following manner:

In summary, the only evidence supporting a finding that *Bedrosian* willfully violated Section 5314 is: (1) the inaccurate [original FBAR for 2007] itself, lacking reference to the [Large Account], (2) the fact that he may have learned of the existence of the [Large Account] at one of his meetings with a UBS representative, which is supported by his having sent two separate letters closing the accounts, (3) *Bedrosian*’s sophistication as a businessman, and (4) [Accountant] *Handelman*’s having told *Bedrosian* in the mid-1990s that he was breaking the law by not reporting the UBS accounts. None of these indicate “conduct meant to conceal or mislead” or a “conscious effort to avoid

learning about reporting requirements,” even if they may show negligence.<sup>26</sup>

## V. Second Victory for Taxpayers

A more recent case, *Flume*, constitutes another win for taxpayers. It is premature to label the case a total victory, because the District Court has not yet ruled on the issue of willfulness, but the holding by the District Court in response to a Motion for Summary Judgment filed by the DOJ fortifies defensive positions for taxpayers. As explained above, many international tax disputes, including *Flume*, obligate taxpayers to fight the government on several different fronts at one time, as the applicable taxes and penalties are assessed and collected in unique ways. Thus, before we get to the positive result in the FBAR aspect of *Flume*, we first must address the negative outcome in the earlier case, which focused on whether the taxpayers should be penalized for not filing Forms 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*) to report certain foreign entities.<sup>27</sup>

### A. First Case—Unreported Foreign Corporations

#### 1. Overview of Form 5471 Duties and Definitions

Four categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations must file an annual Form 5471 with the IRS to report their relationships with the corporations.<sup>28</sup> These categories are summarized below.

- A Category 2 filer is a U.S. individual, who is either an officer or director of a foreign corporation, in which a U.S. person has acquired during the year (i) 10 percent or more of the stock of the corporation, or (ii) an additional 10 percent or more of the stock of the foreign corporation.
- A Category 3 filer includes several types of persons, including any U.S. person who acquires stock in a foreign corporation, and when such stock is added to any stock that the U.S. person already owns, the U.S. person owns 10 percent or more of the stock of the corporation.
- A Category 4 filer is a U.S. person who had “control” of a foreign corporation for an uninterrupted period of 30 days during the year, which means that such U.S. person held more than 50 percent of the stock of the foreign corporation, applying special ownership-attribution rules.

- A Category 5 filer is a “U.S. shareholder” who/that owns stock in a foreign corporation, that is considered to be a controlled foreign corporation (“CFC”), for at least 30 uninterrupted days during the year and who/that held the stock on the last day of the relevant year. For these purposes, (i) a “U.S. shareholder” is any U.S. person who/that owns (directly, indirectly, or constructively) 10 percent or more of the foreign corporation, and (ii) a “CFC” is a foreign corporation that has “U.S. shareholders” who/that own (directly, indirectly, or constructively) more than 50 percent of the foreign corporation on any day of the year.

Form 5471 is filed as an attachment to the U.S. person’s federal income tax return.<sup>29</sup> If a person fails to file a Form 5471, files a late Form 5471, or files a timely but “substantially incomplete” Form 5471, then the IRS can assert a penalty of \$10,000 per violation, per year.<sup>30</sup> This standard penalty increases at a rate of \$10,000 per month, to a maximum of \$50,000, if the problem persists after notification by the IRS.<sup>31</sup> The IRS will not impose penalties if there was “reasonable cause” for the Form 5471 violations.<sup>32</sup>

#### 2. Key Facts of the Case

Mr. Flume (“Husband”) and Mrs. Flume (“Wife”) are U.S. citizens who moved to Mexico in 1993. Before heading south, Husband worked as an urban planner and real estate developer in the United States. Husband was engaged in the same type of activities in Mexico, operating a real estate company that developed land, sold lots, and built high-end homes.<sup>33</sup>

In 1995, Husband and another U.S. individual formed a corporation in Mexico called Franchise Food Service de Mexico S.A. de C.V. (“Franchise Food”). They started as equals, each owning 50 percent, *i.e.*, 25,000 of the 50,000 total shares. Husband was also the president. Franchise Food was created in order to operate Mexican locations of Whataburger and Fanny Ice Cream. These two establishments were sold in 1998, but Franchise Food remained in existence. Husband claimed that he sold 20,500 of his shares in February 2002 to a Mexican citizen and resident. The sale had the effect of reducing Husband’s ownership in Franchise Foods to 4,500 shares, which was nine percent. Husband presumably engaged in this stock sale in an attempt to alleviate the duty to file Forms 5471 for Franchise Food after 2002; he likely took the position that he was not a Category 5 filer because he was not a “U.S. shareholder” because he did not own 10 percent or more of Franchise Food.

In addition to Franchise Food, Husband and Wife formed at least two other foreign corporations, one of which was Wilshire Holdings, Inc. (“Wilshire Belize”). This

entity was formed in 2001, in Belize, with just two bearer shares. Certificate 1, worth 25,000 shares, was assigned to Husband. Certificate 2, also worth 25,000 shares, pertained to Wife. Husband denied this ownership throughout the tax dispute, alleging that on the same day that Wilshire Belize was formed in 2001, “amended” Articles of Association took effect, which changed the original ownership structure to the following: (i) Certificate 3 showed that a Mexican citizen and resident, and, coincidentally, the spouse of the architect who worked for Husband in his Mexican real estate business, owned 36,500 shares, or 73 percent; (ii) Certificate 4 showed that Husband owned 4,500 shares, or nine percent; (iii) Certificate 5 showed that Wife owned 4,500 shares, or nine percent; and (iv) Certificate 6 showed that the daughter of Husband and Wife owned 4,500 shares, or nine percent. Husband offered no proof of this new ownership structure other than the “amended” Articles of Association, which he ultimately admitted had been “backdated.”

In 2005, Wilshire Belize opened an account at UBS in Switzerland. A number of documents and communications related to such account undermined the position by Husband that he was just a minor owner of Wilshire Belize. For instance, Husband and Wife opened the Swiss account using the original Articles of Association (showing Husband and Wife as 50/50 owners) and not the “amended” Articles of Association described above, Husband and Wife were listed as the “beneficial owners” of the account, Husband signed account-related documents in his capacity as “First Director” of Wilshire Belize, Husband and Wife controlled the investment activity in the account, and Husband and Wife signed the wire-transfer orders in 2008 and 2009, as “Directors” of Wilshire Belize, to empty the Swiss account and remit all funds to a U.S. account.

Husband and Wife filed timely Forms 1040 for 2001 through 2009, but they did not attach any Forms 5471 to disclose Franchise Food or Wilshire Belize.

### 3. An Audit Ensues

The IRS started an audit in 2012, presumably as a result of data that the IRS received directly from UBS in connection with its criminal investigation of UBS. The Revenue Agent sought information from Husband and Wife during the audit using various tools, including IDRs and at least one Formal Document Request (“FDR”). Husband and Wife only partially responded to these demands by the Revenue Agent. Therefore, in August 2012, the Revenue Agent sent pre-assessment notices about potential Form 5471 penalties. Then, in October 2012, the Revenue Agent sent a letter warning Husband and Wife that additional penalties of \$10,000 per month would be imposed until they filed the

required Forms 5471. In January 2013, Husband sent to the Revenue Agent Forms 5471 for 2001 and 2002 with respect to Franchise Food, but he filed no Forms 5471 for Wilshire Belize. In February and March 2013, the Revenue Agent assessed a total of \$110,000 in Form 5471 penalties, as follows: (i) \$20,000 for 2001, for penalties related to Franchise Food and Wilshire Belize; (ii) \$20,000 for 2002, for penalties related to Franchise Food and Wilshire Belize; and (iii) \$10,000 for each of 2003, 2004, 2005, 2006, 2007, 2008, and 2009 for penalties related only to Wilshire Belize.

### 4. Seeking Justice via a Collection Due Process Hearing

Husband did not voluntarily pay the Form 5471 penalties, so the IRS eventually sent him the pre-levy notice in December 2013, indicating that the IRS intended to start seizing assets in order to satisfy the penalties and notifying Husband of his right to request a collection due process (“CDP”) hearing. Husband filed a timely request for a CDP hearing, claiming, among other things, that (i) the Forms 5471 for 2001 and 2002 for Franchise Foods, filed with the Revenue Agent approximately a decade late and only in response to a letter from the Revenue Agent warning of imminent penalties, sufficed to satisfy the filing duty, and (ii) Husband was not required to file Forms 5471 for Wilshire Belize for 2001 through 2009 because he had only a nine percent ownership interest, and thus was not a “U.S. shareholder,” or Category 5 filer.

The IRS Settlement Officer conducting the CDP hearing rejected the first argument on grounds that the Forms 5471 for Franchise Food were filed many years after the fact and, in all events, were “inaccurate and incomplete” because they were filed under the wrong Category and had “\$0” or “unknown” written in several boxes. The Settlement Officer rejected the second argument, too, pointing out that the Revenue Agent had obtained “compelling third-party documentation” from UBS showing that Husband and Wife were owners, officers, and directors of Wilshire Belize from 2001 through 2009. Husband did not provide the Settlement Officer with a narrative explaining why “reasonable cause” existed for the violations and did not present a collection alternative, such as an offer-in-compromise or installment agreement. Accordingly, the Settlement Officer issued his Notice of Determination concluding that the IRS was free to proceed with the proposed levy of assets.

### 5. Penalty Dispute Rises to the Tax Court

Husband was not willing to go down without a fight; he filed a timely Petition with the Tax Court challenging the conclusions reached by the Settlement Officer in the Notice



of Determination. This Petition was brief, completed using the fill-in form available on the Tax Court website. Husband summarized his entire case for the Tax Court in the following manner: “Taxpayer has complied with Form 5471 reporting requirements as required by law and has filed the appropriate tax forms” and “Taxpayer has documents and IRS filings indicating proper filing of tax forms in accordance with ownership of tax reporting entities.”

In their pre-trial memo to the Tax Court, the IRS attorneys essentially took the same main positions as those adopted earlier by the Settlement Officer in connection with the CDP hearing. First, the IRS attorneys argued that penalties related to Franchise Food for 2001 and 2002 were appropriate because the Forms 5471 were filed approximately a decade after the deadline, they were filed under the wrong Category, such that the appropriate Schedules on Forms 5471 had not been filled in, and they were “incomplete and inconsistent with the information” that Husband previously supplied to the Revenue Agent during the audit. Second, the IRS attorneys maintained that, despite Husband’s claim that he only owned nine percent of Wilshire Belize from 2001 through 2009, the documents show that he personally owned 50 percent and constructively owned another 50 percent through his wife. This renders Wilshire Belize a CFC and requires the filing of a Form 5471. Third, the IRS attorneys reminded the Tax Court that the Revenue Agent issued an FDR in December 2012, with which Husband had failed to substantially comply. Thus, the IRS attorneys warned that they would ask the Tax Court to ban the attempted introduction by Husband of any foreign-based documentation covered by the FDR that was not provided to the Revenue Agent in a timely manner in response to the FDR.

Husband presented the same arguments that he had previously (and unsuccessfully) raised with Settlement Officer during the CDP hearing. They consisted of the fact that (i) the Forms 5471 for 2001 and 2002 for Franchise Food, filed with the Revenue Agent during the audit in 2013, sufficed to satisfy the filing duty, and (ii) Husband was not required to file Forms 5471 for Wilshire Belize for 2001 through 2009 because he had only a nine percent ownership interest. Along with these longstanding arguments, Husband introduced two new ones in his post-trial memo. First, he contended that the Forms 5471 for 2001 and 2002 were “substantially complete” because Franchise Food was “dormant” and thus had a less stringent filing requirement under Rev. Proc. 92-70. As Husband explained, “[t]he first page of Form 5471 was completed correctly and substantially complies with the requirements of Form 5471.” Second, Husband argued that he reasonably relied on his return preparer in Mexico.

The IRS attorneys quickly attacked the Husband’s new positions. They pointed out that Franchise Food was not dormant after the stock sale in 2002, as it continued to be involved in a joint real estate venture for many years thereafter. Moreover, from a technical perspective, the IRS attorneys underscored that the “dormant” rules only apply if a CFC is dormant during the entire year at issue, and Franchise Food was active until at least February 2002.

In terms of the reasonable-reliance defense, the IRS attorneys explained that this is inapplicable because Husband could not demonstrate that his return preparer in Mexico was qualified to complete Forms 1040 and give related advice, he admitted that he never had a call or meeting with the preparer, and he conceded that he never provided the preparer information about Franchise Food or Wilshire Belize. The IRS attorneys summarized their attack on the reasonable-reliance defense as follows: “Given [Husband’s] testimony that he does not know his return preparer’s professional qualifications and failed to provide necessary and accurate information, he cannot have relied on his preparer’s advice, if any such advice were, in fact, given.”

## 6. Decision by the Tax Court

The Tax Court reduced this case to its essence in making its ruling.

With respect to Franchise Food, the Tax Court concluded that Husband was a Category 5 filer in 2001 and a Category 3 filer in 2002, thus obligated to file a Form 5471 for each year. It further held that the argument that the Forms 5471 filed in 2013, years after the deadline and as a part of the audit, should be given “retroactive effect” lacks merit.

Regarding Wilshire Belize, the Tax Court noted that Husband was a Category 4 and Category 5 filer for 2001 through 2009, and Husband “merely provided self-serving testimony and a backdated document to support his claim that he maintained only a 9% ownership interest during the tax years in issue.”

Finally, the Tax Court rejected the notion that Husband should be relieved of Form 5471 penalties under a reasonable-reliance theory because Husband was unable to demonstrate that his return preparer in Mexico had sufficient qualifications and expertise, and Husband never gave the preparer information about Franchise Food and Wilshire Belize during the relevant years.

## B. Second Case—Unreported Foreign Accounts

While the IRS attorneys were seeking Form 5471 penalties in Tax Court, the DOJ attorney were busy initiating a collection action in District Court to recoup civil “willful” FBAR penalties for 2007 and 2008.<sup>34</sup>

## 1. Key Facts

The DOJ filed a Motion for Summary Judgment, asking the District Court to rule that Husband willfully violated his duty to file FBARs for 2007 and 2008, because he (i) knowingly disregarded the FBAR duty, or (ii) recklessly ignored a high probability that he was breaking the law, even if he lacked specific knowledge about his FBAR duty.

Below are certain facts supplementing those learned from the earlier Form 5471 penalty battle, which have come to light in the ongoing FBAR fight.

In 2005, Husband opened an account with UBS in the name of Wilshire Belize. He instructed UBS not to invest in U.S. securities, ostensibly because he was worried about the stability of U.S. banks at the time. In October 2008, Husband closed the UBS account and transferred all funds to a Fidelity investment account in the United States.

In the early 2000's, Husband hired Leonard Purcell, a U.S. return preparer with offices in the United States and Mexico, and his partner, Adriana Bautista Luna, to prepare his Forms 1040 ("Mexican Accountants"). They prepared the Forms 1040 for the relevant years, 2007 and 2008, disclosing only the existence of Husband's account in Mexico, but not the larger account in Switzerland. Moreover, Husband did not file timely FBARs for 2007 or 2008. He filed them late, in June 2010, and even then, he seriously understated the value of the UBS account, missing the mark by approximately \$600,000 one year. At trial, Husband attributed these inaccuracies to the fact that, in June 2010, he lacked access to his UBS records and was obligated to "cobble together" estimates from his notes and memory.

There was conflicting testimony about whether, or precisely when, Husband told the Mexican Accountants about the UBS account, but they all agreed that Husband never supplied any documents regarding such account. The Mexican Accountants said that they first notified Husband about his FBAR obligation around 2003 or 2004, and sent him an annual letter thereafter reminding him. Husband, on the other hand, claimed that the Mexican Accountants never informed him of FBAR duties until many years later, in 2010.

Husband acknowledged to the District Court that he was not particularly diligent about his tax considerations. Indeed, he did not read his Form 1040 "word for word" and he did not take the time to read the instructions from the IRS, expressly referenced in Schedule B, about FBAR filing requirements. He simply checked the income amount, which seemed appropriate, signed the Forms 1040, and trusted that the Mexican Accountants had prepared them accurately. Husband signed the Form 1040 each year, indicating that he had reviewed it, and it was true, correct, and accurate.

Husband had a personal account executive at UBS ("Swiss Bank Representative"), with whom he corresponded regularly about the account, and with whom he met at his house in Mexico to discuss the account. In early 2008, Husband instructed Swiss Bank Representative to send certain funds from UBS to the account in Mexico, before sending the remainder to the Fidelity account in the United States. The notes of Swiss Bank Representative indicate that Husband's main concern was the investigation by the IRS of UBS and the need to maintain the account confidential. Husband denied this at trial, of course.

## 2. Analysis by the District Court

The District Court indicated that the definition of "willfulness" in the civil FBAR context is an issue of first impression in the Fifth Circuit, and emphasized that only a limited number of cases have thoroughly analyzed the issue. The District Court then went on to examine the concept of "willfulness" under three different legal theories.

**a. Actual Knowledge—First Legal Theory.** The District Court identified several pieces of evidence tending to show that Husband tried to hide his UBS account: (i) He only disclosed the Mexican account, and not the Swiss account, on Schedule B to his Forms 1040; (ii) The Mexican Accountants testified that Husband never disclosed the UBS account to them and never supplied any account statements to them; (iii) The Swiss Bank Representative explained that Husband's main worries during their meeting in Mexico was maintaining the account confidential and the IRS's investigation of UBS; (iv) The Swiss Bank Representative told Husband of the importance of disclosing the Swiss account on Schedule B to his Form 1040; (v) Husband instructed UBS not to invest any funds in U.S. securities; (vi) Husband opened the account under the name of a foreign corporation, Wilshire Belize; and (vii) When Husband filed the late FBARs in 2010, he seriously understated the value of the UBS account.

All this evidence notwithstanding, the District Court found that a reasonable factfinder could still conclude the Husband did not have actual knowledge of his FBAR duty. The District Court first focused on the testimony of Husband during pre-trial depositions. He claimed that he informed the Mexican Accountants about his UBS account soon after it was opened in 2005, he did not learn of his FBAR duty until 2010, he never saw Schedule B of Forms 1040 because he only did a cursory review and depended on his Mexican Accountants, he never expressed concern about keeping the UBS account confidential during his meeting in Mexico with the Swiss Bank Representative, he opted not to invest funds

from the UBS account in U.S. securities because he was concerned about bank failure in the United States, and he opened the account in the name of Wilshire Belize solely to “legally postpone” payment of income taxes. The District Court explained that, even though the statements by Husband were “self-serving,” it was not permitted to make credibility determinations in ruling on Motions for Summary Judgment.

The District Court went on to explain that, even if the District Court were to ignore the testimony of Husband, as the DOJ urged it to do, a genuine dispute of fact about Husband’s actual knowledge about the FBAR duty would still exist for several reasons. First, a factfinder could infer that Husband was ignorant of the FBAR duty because he did not file an FBAR for the Mexican account either, and it was reported on Schedule B to Form 1040. Second, a factfinder could discredit the testimony of the Mexican Accountants as self-serving in that admitting that they failed to properly notify Husband of FBAR duties could expose them to malpractice claims. Third, the fact that Husband transferred the funds in the UBS account to a Fidelity account in the United States is evidence that he was not attempting to hide the account from the IRS. Finally, a factfinder could conclude that Husband learned about the FBAR obligation in 2010 from the fact that he filed the late FBARs for 2007 and 2008 in June 2010.

The District Court made several interesting observations in this regard: (i) Husband’s “freely disclosing” of the UBS account in 2010, some two years before the IRS audit began in 2012, suggests that he did not try to hide it from the IRS in June 2008 (when the 2007 FBAR was due) or June 2009 (when the 2008 FBAR was due); (ii) Finding willfulness in situations where taxpayers act promptly to rectify errors would create “a perverse incentive” in that it would “encourage taxpayer who have not filed FBARs on time to never file them at all in hope that the IRS does not discover their foreign accounts;” and (iii) While it is possible that Husband knowingly hid the UBS account earlier and then had a change of heart in 2010, the DOJ failed to identify any event in 2010 that would have triggered this decision.

Based on the preceding, the District Court ruled that, “with or without [Husband’s] testimony, there is a genuine dispute as to [his] actual knowledge of this FBAR reporting obligations.”

***b. Constructive Knowledge—Second Legal Theory.*** Relying largely on *McBride*, the DOJ argued that Husband at least had constructive knowledge of his FBAR duty, because he signed his Forms 1040, which contained instructions to consult the FBAR filing requirements.

***i. Flashback to the Origins.*** To comprehend the significance of the recent holding in *Flume*, it is imperative to understand the root of the DOJ’s argument and the judicial support that it received years ago in *McBride*.

The District Court examined Mr. McBride’s level of knowledge of the FBAR filing requirement. It began by citing the general rule that all taxpayers are charged with knowledge, awareness, and responsibility for all tax returns executed under penalties of perjury and filed with the IRS. However, the District Court recognized that several cases stand for the proposition that a taxpayer’s signature on a tax return does not, by itself, prove that the taxpayer had knowledge of the contents of the return. The District Court distinguished such cases, though, by emphasizing that the language there about “knowledge of the contents of the return” referred to the taxpayer’s awareness about specific figures/numbers on the return. When dealing with the FBAR situation, the District Court pointed out that “knowledge of what instructions are contained within the form is directly inferable from the contents of the form itself, even if it were blank.”<sup>35</sup> Fortifying its position, the District Court went on to cite and quote various criminal cases, including a criminal FBAR case, where the courts attributed knowledge of the contents of a tax return to the taxpayer based solely on the taxpayer’s signature on the return.<sup>36</sup> The District Court, eliminating any ambiguity about its stance on constructive knowledge in the FBAR arena, rendered the following holding:

Knowledge of the law, including knowledge of the FBAR requirements, is imputed to McBride. The knowledge of the law regarding the requirement to file an FBAR is sufficient to inform McBride that he had a duty to file [an FBAR] for any foreign account in which he had a financial interest. McBride signed his federal income tax returns for both the tax year 2000 and 2001. Accordingly, McBride is charged with having reviewed his tax return and having understood that the federal income tax return asked if at any time during the tax year he held any financial interest in a foreign bank or financial account. The federal income tax return contained a plain instruction informing individuals that they have the duty to report their interest in any foreign financial or bank accounts held during the taxable year. McBride is therefore charged with having had knowledge of the FBAR requirement to disclose his interest in any foreign financial or bank accounts, as evidenced by his statement at the time he signed the returns, under penalty of perjury, that he read, reviewed, and signed his own federal income tax returns for the tax years 2000 and 2001, as indicated

by his signature on the federal income tax returns for both 2000 and 2001. As a result, McBride's willfulness is supported by evidence of his false statements on his tax returns for both the 2000 and the 2001 tax years, and his signature, under penalty of perjury, that those statements were complete and accurate.<sup>37</sup>

The District Court expanded on this perspective later in the opinion. Mr. McBride seemed to argue that he was aware of the FBAR filing requirement, but decided not to comply because of his belief, based on the analysis by his accountant, that he did not possess a sufficient interest in the foreign accounts under the peculiar FBAR attribution rules. As the culmination to its analysis of the "willfulness" issue, the District Court repeated its extreme position that, if a taxpayer executes and files a Form 1040, then all FBAR violations, regardless of the validity of a taxpayer's rationale for not filing, are willful and vulnerable to maximum sanctions.

[E]ven if the decision not to disclose McBride's interest in the foreign accounts was based on McBride's belief that he did not hold sufficient interest in those accounts to warrant disclosure, that failure to disclose those interests would constitute willfulness. Because McBride signed his tax returns, he is charged with knowledge of the duty to comply with the FBAR requirements. Whether McBride believed [that accountant] had determined that a disclosure was not required is irrelevant in light of [the applicable case], which states that the only question is whether the decision not to disclose was voluntary, as opposed to accidental. The government does not dispute that McBride's failure to comply with FBAR [sic.] was the result of his belief that he did not have a reportable financial interest in the foreign accounts. However ... the FBAR requirements did require that McBride disclose his interest in the foreign accounts during both the 2000 and 2001 tax years. As a result, McBride's failure to do so was willful.<sup>38</sup>

**ii. Rejecting Earlier Judicial Reasoning.** The District Court refused to follow *McBride* for three reasons.

First, the District Court indicated that the constructive-knowledge theory ignores the distinction that Congress drew between willful and non-willful FBAR violations: "If every taxpayer, merely by signing a tax return, is presumed to know the need to file an FBAR, it is difficult to conceive of how a violation could be non-willful."

Second, the District Court warned that it would exceed its authority if it were to conclude the case on summary judgment because, while Husband admittedly signed his Form 1040 for 2007 in 2008, and thus would be charged

with FBAR knowledge as of that time under the constructive-knowledge theory, Husband later testified during a deposition that he was unaware of the FBAR duty until years later, in 2010. The District Court pointed out that a factfinder, such as the jury, must decide which of these two conflicting items carries more weight.

Third, and most importantly, the District Court announced that the constructive-knowledge theory is "rooted in faulty policy arguments." The DOJ argued that ruling in favor of Husband would encourage taxpayers to sign tax returns without reading them in hopes of later avoiding any negative consequences from inaccuracies and would permit taxpayers to escape liability by simply claiming that they did not read what they were signing. The District Court flatly rejected the DOJ's position, calling it "incorrect," because the IRS can still impose a \$10,000 penalty for each non-willful FBAR violation and the IRS can still pursue taxpayers under a reckless-disregard theory. The District Court ended its comments on this issue as follows:

[T]here is no policy need to treat constructive knowledge as a substitute for actual knowledge ... Accordingly, the Court will not hold that [Husband] had constructive knowledge—and that he owes the Government more than half a million dollars—merely because he signed his tax returns under penalties of perjury. The Government has thus failed to conclusively establish that [Husband] was willful on the ground that he knowingly disregarded his FBAR obligations.

**c. Reckless Disregard of Duty—Third Legal Theory.** The DOJ argued that, even if Husband did not have actual knowledge of his FBAR duty, and even if he did not have constructive knowledge of the same, he still deserved a willful penalty because he recklessly disregarded the risk that he was violating the law.

The District Court first explained that, when dealing with civil FBAR penalty cases, recklessness means conduct that creates an unjustifiably high risk of violating the law, which is either known by the taxpayer or so obvious that it should have been known, and it is substantially greater than "merely careless" behavior by the taxpayer.

The District Court then pointed out that the most recent, and most factually similar, case to *Flume* is *Bedrosian*, and it set a "high bar" in terms of what actions or inactions by a taxpayer constitute recklessness. After reciting a long list of questionable behaviors by the taxpayer in *Bedrosian*, the District Court emphasized that its judicial colleagues determined, after hearing all the evidence at trial, that the taxpayer in *Bedrosian* did not meet the recklessness standard and was, at most, negligent,

despite the fact that he had annual meetings with UBS representatives, he could have easily learned that he had two accounts instead of one, he was aware of his FBAR duty, he filed FBARs disclosing only one account, which coincidentally had a much smaller balance, and he sent separate letters to UBS instructing it to close two separate accounts mere weeks after filing the incomplete FBARs.

The DOJ argued that Husband actively tried to hide the UBS account, which equates to awareness of a significant risk that he was breaking the law. The DOJ further suggested that Husband's "conscious decision" not to consult the FBAR instructions, even though Schedule B on Form 1040 directs taxpayers to do so, constitutes recklessness. The Husband's sophistication as a businessperson might also constitute evidence that the FBAR violations were reckless, but, as the District Court pointed out in a footnote, the DOJ did not raise the argument, and it would not have been a strong one because Husband testified that he relied on the sophistication of the Mexican Accountants, not his own, to ensure that he maintained full U.S. compliance.<sup>39</sup>

The arguments by the DOJ fell flat. First, the District Court explained that there was a genuine factual dispute about whether Husband attempted to hide the UBS account from the IRS. Second, because Husband hired a return-preparer (*i.e.*, the Mexican Accountants), the District Court explained that it might not have been reckless for Husband not to read the FBAR instructions. Indeed, Husband testified that he relied on the competence of the Mexican Accountants, and if this were the case, then it is not clear that Husband was taking an "unjustifiably high risk" in not reading everything closely. Moreover, explained the District Court, the warning on Schedule B to consult the separate FBAR instructions explicitly states that exceptions exist, and Husband might "understandably have reasoned" that he had no FBAR filing duty because the Mexican Accountants had already determined that an exception applied to him. Finally, in a footnote, the District Court emphasized that Line 7b of

Schedule B to Form 1040, which was drafted by the IRS, creates ambiguity because it instructs taxpayers to write the name of the "foreign country" not "foreign countries" in which taxpayers have an account. As a result, Husband "might reasonably have thought that he was not required to list both Mexico and Switzerland."<sup>40</sup> The District Court thus concluded that a reasonable factfinder could determine that Husband did not recklessly disregard his FBAR duties, such that a genuine factual dispute remains, and dispensing with the case *via* summary judgment is improper.

## VI. Conclusion

Taxpayers with pending FBAR problems are silently cheering for a positive result in *Flume*, hoping that the District Court determines after trial that the FBAR violations were not willful. This, combined with the favorable ruling in *Bedrosian*, might increase the chances for other taxpayers with undeclared foreign accounts of reaching an acceptable settlement on FBAR penalties or, if pushed, prevailing at trial.

Regardless of the ultimate outcome in *Flume*, it has already created important precedent, determining, in direct contrast to earlier FBAR cases, that the U.S. government cannot prove willfulness using the constructive-knowledge theory. Indeed, showing remarkable candor, the District Court in *Flume* criticized the constructive-knowledge theory as being based on "faulty policy" and warned that, taken to an extreme, this theory would trigger a finding of willfulness in every case. The District Court in *Flume* made noteworthy decisions regarding recklessness, too, explaining that it far exceeds "mere carelessness" and that there is a "high bar" for what conduct meets the level of recklessness.

As the U.S. government continues to aggressively pursue FBAR violations, and as it introduces more expansive legal theories for liability, taxpayers will be raising and relying on *Bedrosian* and *Flume* with frequency.

## ENDNOTES

\* Hale specializes in tax audits, tax appeals, tax litigation, and international tax compliance. You can reach Hale by phone at (404) 658-5441 or by email at [hale.sheppard@chamberlainlaw.com](mailto:hale.sheppard@chamberlainlaw.com).

<sup>1</sup> *Bedrosian*, 120 AFTR 2d 2017-5671 (D.C. PA 2017).

<sup>2</sup> *Flume*, Civil Action No. 516-CV-73 (S.D. TX 8/22/2018), Memorandum and Order.

<sup>3</sup> 31 USC §5314; 31 CFR §1010.350(a).

<sup>4</sup> For a detailed analysis of the Form 8938 filing requirement, see Hale E. Sheppard, *The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe*

*Consequences of Noncompliance*, 38(3) INT'L TAX J. 11 (2012); Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules After IRS Issues Final Regulations*, 41(2) INT'L TAX J. 25 (2015); Hale E. Sheppard, *Specified Domestic Entities Must Now File Form 8938: Section 6038D, New Regulations in 2016, and Expanded Foreign Financial Asset Reporting*, 42(3) INT'L TAX J. 5 (2016); and Hale E. Sheppard, *Unlimited Assessment-Period for Form 8938 Violations: Ruling Shows IRS's Intent to Attack Multiple Tax Returns*, 95(5) TAXES 31 (2017).

<sup>5</sup> American Jobs Creation Act (P.L. 108-357) (Oct. 22, 2004).

<sup>6</sup> 31 USC §5321(a)(5)(A).

<sup>7</sup> 31 USC §5321(a)(5)(B)(ii).

<sup>8</sup> 31 USC §5321(a)(5)(C)(i). As of July 2018, there is uncertainty regarding the maximum FBAR penalty, because two District Courts issued opinions stating that the willful FBAR penalty is capped at \$100,000 per violation because the IRS failed to update the operable regulations after Congress amended the law to increase penalties. See *Colliot*, Cause No. AU-16-CA-01281-SS (W.D.

- Texas May 16, 2018), and *Wadhan*, Civ. Action No. 17-CV-1287-MSK (Colo. July 18, 2018).
- <sup>9</sup> For more detailed information about the recent court battles regarding “willful” FBAR penalties, please see the following articles by the same author: Hale E. Sheppard, *Court Holds that Pervasive Ignorance Is No Defense to Willful FBAR Penalties: This and Other Lessons from United States v. Garrity*, 44(4) INT’L TAX J. 51 (2018); Hale E. Sheppard, *Willful FBAR Penalty Case Shows Importance of Protecting Privileged Communications: What Kelley-Hunter Adds to the Foreign Account Defense Discussion*, 44(1) INT’L TAX J. 15 (2018); Hale E. Sheppard, *Analysis of the Reasonable Cause Defense in Non-Willful FBAR Penalty Case: Teachings from Jarnagin*, 128(4) J. TAXATION 6 (2018); Hale E. Sheppard, *First Taxpayer Victory in a Willful FBAR Penalty Case: Analyzing the Significance of Bedrosian for Future Foreign Account Disputes (Part 1)*, 128(2) J. TAXATION 12 (2018); Hale E. Sheppard, *First Taxpayer Victory in a Willful FBAR Penalty Case: Analyzing the Significance of Bedrosian for Future Foreign Account Disputes (Part 2)*, 128(3) J. TAXATION 14 (2018); Hale E. Sheppard, *Can Recent “Willful” FBAR Penalty Cases against Taxpayers Help Tax Firms Fend Off Malpractice Actions?* 43(4) INT’L TAX J. 33 (2017); Hale E. Sheppard, *Government Wins Fourth Straight FBAR Penalty Case: Analyzing Bohanec and the Evolution of “Willfulness,”* 126(3) J. TAXATION 110 (2017); Hale E. Sheppard, *Government Wins Second Willful FBAR Penalty Case: Analyzing What McBride Really Means to Taxpayers*, 118(4) J. TAXATION 187 (2013); Hale E. Sheppard, *Third Time’s the Charm: Government Finally Collects “Willful” FBAR Penalty in Williams Case*, 117(6) J. TAXATION 319 (2012); Hale E. Sheppard, *District Court Rules That Where There’s (No) Will, There’s a Way to Avoid FBAR Penalties*, 113(5) J. TAXATION 293 (2010).
- <sup>10</sup> *Williams*, 131 TC 54 (2008); *Williams*, No. 1:09-cv-437, 2010 WL 347221 (E.D. Va. 9/1/ 2010); *Williams*, 489 Fed. Appx. 655 (4<sup>th</sup> Cir. 2012).
- <sup>11</sup> *Jon McBride*, U.S. District Court for the District of Utah Central Division, Case No. 2:09-cv-378, Findings of Fact, Conclusions of Law, and Order (Nov. 8, 2012). See also *McBride*, 908 FSupp2d 1186 (D. Utah 2012).
- <sup>12</sup> *Bussell*, 117 AFTR 2d 2016-439 (District Court, C.D. California 12/8/2015).
- <sup>13</sup> *Bohanec*, 118 AFTR 2d 2016-5537 (District Court, C.D. Cal. 12/8/2016).
- <sup>14</sup> *Bedrosian*, 120 AFTR 2d 2017-5671 (D.C. PA 2017).
- <sup>15</sup> *Kelley-Hunter*, 120 AFTR 2d 2017-5566 (D.C. Dist. Col.), Dec. 12, 2017.
- <sup>16</sup> *Garrity*, Case No. 3:15-cv-243 (D.C. Conn.).
- <sup>17</sup> *Markus*, D.C. New Jersey, Civil No. 16-2133, Opinion, July 17, 2018.
- <sup>18</sup> *Flume*, Civil Action No. 516-CV-73 (S.D. Tex. Aug. 22, 2018), Memorandum and Order.
- <sup>19</sup> *Bedrosian*, 120 AFTR 2d 2017-5671 (D.C. PA 2017). In an effort to fully and fairly describe the facts, the author obtained from the District Court and reviewed the following documents: Complaint filed October 27, 2015, Answer and Counterclaim filed February 26, 2016, Reply to Counterclaim filed March 21, 2016, United States’ Motion for Summary Judgment filed November 30, 2016, Memorandum of Law in Support of the United States’ Motion for Summary Judgment filed November 30, 2016, United States’ Statement of Undisputed Material Facts filed November 30, 2016, Plaintiff’s Statement of Undisputed Material Facts filed December 5, 2016, Plaintiff’s Motion for Summary Judgment filed December 5, 2016, Plaintiff’s Response to Defendant’s Statement of Undisputed Material Facts filed December 19, 2016, United States’ Response to the Plaintiff’s Motion for Summary Judgment filed December 19, 2016, Plaintiff’s Response to Defendant’s Motion for Summary Judgment filed December 19, 2016, United States’ Reply to the Plaintiff’s Response to Its Motion for Summary Judgment filed December 23, 2016, Order Denying Motions for Summary Judgment dated April 13, 2017, Memorandum Regarding Cross Motions for Summary Judgment dated April 13, 2017; Plaintiff’s Trial Memorandum filed August 28, 2017; United States’ Trial Brief filed August 28, 2017; Plaintiff’s Post-Trial Memorandum and Proposed Findings of Fact and Conclusions of Law filed September 14, 2017; United States’ Post-Trial Brief filed September 14, 2017; Order dated September 20, 2017; Findings of Fact and Conclusions of Law, dated September 20, 2017.
- <sup>20</sup> IRM §4.26.16.6.6.1 (11-06-2015).
- <sup>21</sup> Findings of Fact and Conclusions of Law, dated September 20, 2017, pp. 7–8.
- <sup>22</sup> Findings of Fact and Conclusions of Law, dated September 20, 2017, pp. 13–14.
- <sup>23</sup> Findings of Fact and Conclusions of Law, dated September 20, 2017, p. 10.
- <sup>24</sup> Findings of Fact and Conclusions of Law, dated September 20, 2017, p. 10.
- <sup>25</sup> Findings of Fact and Conclusions of Law, dated September 20, 2017, pp. 11–13.
- <sup>26</sup> Findings of Fact and Conclusions of Law, dated September 20, 2017, pp. 13–14.
- <sup>27</sup> *E.S. Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21.
- <sup>28</sup> Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471.
- <sup>29</sup> Code Sec. 6038(a)(2); Reg. §1.6038-2(i).
- <sup>30</sup> Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §1.6046-1(k).
- <sup>31</sup> Code Sec. 6038(b)(2); Reg. §1.6038-2(k)(1)(ii); Code Sec. 6046(f); Reg. §1.6046-1(k).
- <sup>32</sup> Reg. §1.6038-2(k)(3)(i) and (ii).
- <sup>33</sup> The author derived the key facts by reviewing the following documents related to *E.S. Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21: Petition filed July 7, 2014 (enclosing Notice of Determination); Answer by IRS filed August 27, 2014; First Stipulation of Facts filed September 30, 2015; First Supplemental Stipulation of Facts filed September 30, 2015; Pre-Trial Memorandum by Taxpayer filed September 11, 2015; Pre-Trial Memorandum by IRS filed September 30, 2015; Opening Brief by IRS filed January 15, 2016; Answering Brief by Taxpayer filed March 9, 2016; and Reply Brief by IRS filed April 8, 2016. The author also reviewed the Memorandum and Order issued by the U.S. District Court (S.D. Texas) dated August 22, 2018 (Civil Action No. 516-CV-73) related to the Motions for Summary Judgment focused on FBAR penalties. Finally, the author reviewed the decision from the related FBAR penalty case, *E.S. Flume*, Civil Action No. 516-CV-73 (S.D. Texas Aug. 22, 2018), Memorandum and Order.
- <sup>34</sup> *E.S. Flume*, Civil Action No. 516-CV-73 (S.D. Texas Aug. 22, 2018), Memorandum and Order.
- <sup>35</sup> *McBride*, 110 AFTR 2d 2012-6600 (Nov. 8, 2012); *McBride*, U.S. District Court for the District of Utah Central Division, Case No. 2:09-cv-378, Findings of Fact, Conclusions of Law, and Order (Nov. 8, 2012) pp. 36–37; *McBride*, 908 FSupp 2d 1186 (D. Utah 2012).
- <sup>36</sup> *McBride*, 110 AFTR 2d 2012-6600 (Nov. 8, 2012); *McBride*, U.S. District Court for the District of Utah Central Division, Case No. 2:09-cv-378, Findings of Fact, Conclusions of Law, and Order (Nov. 8, 2012) pp. 37–38; *McBride*, 908 FSupp 2d 1186 (D. Utah 2012).
- <sup>37</sup> *McBride*, 110 AFTR 2d 2012-6600 (Nov. 8, 2012); *McBride*, U.S. District Court for the District of Utah Central Division, Case No. 2:09-cv-378, Findings of Fact, Conclusions of Law, and Order (Nov. 8, 2012) pp. 38–39 (internal citations omitted); *McBride*, 908 FSupp 2d 1186 (D. Utah 2012).
- <sup>38</sup> *McBride*, 110 AFTR 2d 2012-6600 (Nov. 8, 2012); *McBride*, U.S. District Court for the District of Utah Central Division, Case No. 2:09-cv-378, Findings of Fact, Conclusions of Law, and Order (Nov. 8, 2012) pp. 48–49 (internal citations omitted); *McBride*, 908 FSupp 2d 1186 (D. Utah 2012).
- <sup>39</sup> *E.S. Flume*, Civil Action No. 516-CV-73 (S.D. Texas Aug. 22, 2018), Memorandum and Order, Footnote 16.
- <sup>40</sup> *E.S. Flume*, Civil Action No. 516-CV-73 (S.D. Texas Aug. 22, 2018), Memorandum and Order, Footnote 17.

This article is reprinted with the publisher’s permission from the Taxes The Tax Magazine®, a monthly journal published by Wolters Kluwer. Copying or distribution without the publisher’s permission is prohibited. To subscribe to the Taxes The Tax Magazine® or other Wolters Kluwer journals please call 800 449 8114 or visit CCHPELink.com. All views expressed in the articles and columns are those of the author and not necessarily those of Wolters Kluwer.