Court Holds that Pervasive Ignorance Is No Defense to Willful FBAR Penalties: This and Other Lessons from *Garrity*

*By Hale E. Sheppard**

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I. Introduction

The IRS announced that it will end the longstanding Offshore Voluntary Disclosure Program ("OVDP") in September 2018, and no replacement compliance initiative is contemplated. Many have interpreted this as a sign that the IRS is finally getting serious about international tax enforcement, but that has been happening for years. The IRS is using foreign account data that it receives from multiple sources (including the Foreign Account Tax Compliance Act, deferred prosecution agreements with banks, whistleblowers, thousands of participants in disclosure programs, *etc.*) to identify U.S. tax non-compliance and aggressively pursue the perpetrators. One recent example is *Garrity*, a willful FBAR penalty situation in which the U.S. government has the estate of taxpayer, who has been dead for more than a decade, embroiled in four different cases, in four different courts, defending against penalties that far exceed the highest balance in the unreported account.[1] This article explains the duties of those holding foreign assets, the interesting aspects of *Garrity*, and the obscure yet valuable lessons to be learned from this case.

II. Summary of U.S. Tax and Information-Reporting Duties

A. Overview of Requirements

Generally, U.S. citizens and residents have four main duties when they hold a reportable interest in a foreign financial account: (i) report all income generated

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by the account on Form 1040 (*U.S. Individual Income Tax Return*), (ii) check the "yes" box in Part III (Foreign Accounts and Trusts) of Schedule B to Form 1040 to disclose the existence and location of the foreign account, (iii) electronically file an FBAR, and (iv) starting in 2011, report the foreign account on a Form 8938 (*Statement of Specified Foreign Financial Assets*).[2] As explained below, if the U.S. person holds an interest in a foreign financial account through a foreign entity, then he likely will need to file additional international information returns with the IRS with respect to such entity.

B. Form 1040—Duty to Report Account and Related Income

With respect to the second duty described above, Part III of Schedule B to Form 1040 contains an FBAR inquiry and a cross-reference. 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.

One should grasp what taxpayers are declaring when they execute and file their annual Forms 1040 with the IRS, including Schedule B. 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, which often comes back to haunt them during an IRS audit:

> Under penalties of perjury, I declare that *I have examined this return and accompanying schedules 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.

C. FBAR—Duty to Report Foreign Financial Accounts

Congress enacted the Bank Secrecy Act in 1970.[3] One purpose of this legislation was to require the filing of certain reports, like the FBAR, where doing so would be helpful to the U.S. government in carrying out criminal, tax, and regulatory investigations.[4] The relevant statute, in conjunction with the corresponding regulations and FBAR Instructions, generally require the filing of an annual FBAR in cases where (i) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (ii) had a direct 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 year at issue.[5]

Concerned with widespread FBAR non-compliance, the U.S. government has taken certain actions in recent years. Notably, the Treasury Department transferred authority to enforce FBAR duties to the IRS in 2003.[6] The IRS is now empowered to investigate potential FBAR violations, issue summonses, assess civil penalties, issue administrative rulings, and take "any other action reasonably necessary" to enforce the FBAR rules.[7]

Congress enacted new FBAR penalty provisions in 2004.[8] The IRS may penalize any U.S. person who fails to file an FBAR when required, period.[9] In the case of non-willful violations, the maximum penalty is $10,000 per violation, but the IRS cannot assert this penalty if the violation was due to "reasonable cause."[10] 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.[11] Given the astronomical balances in some unreported accounts, FBAR penalties can be enormous.

D. Form 3520 and Form 3520-A—Duty to Report Foreign Trusts

Code Sec. 6048 requires the filing of a Form 3520 (*Annual Return to Report Transactions with Foreign*

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Trusts and Receipt of Certain Foreign Gifts) and/or Form 3520-A (*Annual Information Return of Foreign Trust with a U.S. Owner*) in certain situations involving foreign trusts.

1. Form 3520

In the context of foreign trusts, Form 3520 generally must be filed in two circumstances. First, the responsible party generally must file a Form 3520 within 90 days of certain "reportable events," such as the creation of any foreign trust by a U.S. person, the transfer of any money or other property (directly or indirectly or constructively) to a foreign trust by a U.S. person, and the death of a U.S. person, if the decedent was treated as the "owner" of any portion under the grantor trust rules, or if any portion of the foreign trust was included in the gross estate of the decedent.[12] Second, a U.S. person ordinarily must file a Form 3520 if he receives during a year (directly or indirectly or constructively) any distribution from a foreign trust.[13]

The penalty for not filing a Form 3520 is equal to $10,000 or 35 percent of the so-called "gross reportable amount," whichever amount is larger.[14] However, the IRS will not assert penalties where there is "reasonable cause" for the violation.[15]

2. Form 3520-A

A Form 3520-A normally must be filed if, at any time during the relevant year, a U.S. person is treated as the "owner" of any portion of the foreign trust under the grantor trust rules.[16] A person, other than the grantor, is treated as the owner of any portion of a trust with respect to which such person has "a power exercisable solely by himself" to vest the assets or income from the trust in himself.[17] Moreover, a U.S. person who transfers property, directly or indirectly, to a foreign trust generally shall be treated as the owner during the year of the transfer for his portion of the trust attributable to such property, if there is a U.S. beneficiary of any portion of such trust.[18]

The normal penalty for Form 3520-A violations is the higher of $10,000 or five percent of the "gross reportable amount."[19] Penalties will not be asserted where there is "reasonable cause" for the violation.[20]

3. Foreign Trust Issues on Form 1040

Part III to Schedule B of Form 1040 presents the following question about foreign trusts:

> During 2017, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back.

The IRS's Instructions to Schedule B expand on the foreign trust concept, providing the following guidance:

> If you received a distribution from a foreign trust, you must provide additional information. For this purpose, a loan of cash or marketable securities generally is considered to be a distribution. See Form 3520 for details. If you were the grantor of, or transferor to, a foreign trust that existed during 2017, you may have to file Form 3520. Don't attach Form 3520 to Form 1040. Instead, file it at the address shown in its instructions. If you were treated as the owner of a foreign trust under the grantor trust rules, you are also responsible for ensuring that the foreign trust files Form 3520-A. Form 3520-A is due on March 15, 2018, for a calendar year trust. See the instructions for Form 3520-A for more details.

Finally, rooted in Colliot and other District Court cases in which taxpayers are raising similar arguments, courts might cap willful FBAR penalties at $100,000 per violation, unless and until the regulations are changed to match current law.

III. Relevant Facts

Synthesizing multiple court documents and making some basic assumptions, the key facts in *Garrity* appear to be the following.[21]

Paul G. Garrity, Sr. ("Paul") founded Garrity Industries, Inc. ("Domestic Company") in 1967. It primarily manufactures and sells lighting products.

About two decades later, in 1989, Paul established the Lion Rock Foundation, a so-called Stiftung in Liechtenstein ("Foreign Trust"). Paul was named the primary beneficiary of the Foreign Trust from inception,

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and, during his lifetime, he retained the right to amend or revoke the governing documents. Paul entered into an agreement with BIL Treuhand AG ("Foreign Trustee"), whereby it would appoint the Board of Directors for the Foreign Trust. Among other things, the agreement with the Foreign Trustee expressly mandated that all members of the Board of Directors act in accordance with instructions from Paul or anyone authorized to act on his behalf. For these reasons, the U.S. government takes the position that Paul "exercised complete control" over the Foreign Trust, and it should be treated as a foreign grantor trust for U.S. tax purposes, necessitating the filing of an annual Form 3520 and Form 3520-A.

In 1989, Paul also opened an account in Liechtenstein in the name of the Foreign Trust with a predecessor to LGT Bank ("LGT Account").

In 1990, the Foreign Trustee, with assistance, formed a company in the British Virgin Islands ("Foreign Corporation"), whose ownership was memorialized solely by bearer shares. Then, the Foreign Trustee arranged for another company ("Nominee") to act as principal for the Foreign Corporation, holding the bearer shares. Next, the Nominee opened an account at Standard Chartered Bank, presumably in the British Virgin Islands ("Standard Chartered Account"). The U.S. government alleges that all documents related to this international structure were either signed or initialed by Paul.

Later, in 1990, Paul instructed the Foreign Trustee to arrange for "suitable documentation" between the Domestic Company and the Foreign Corporation, showing that the former was supposedly paying the latter "inspection fees." It appears that the money flowed in the following manner: The Foreign Corporation would send invoices to the Domestic Company for "inspection services" rendered; the Domestic Company would send payment of the invoices to the Standard Chartered Account; and the Nominee would cause the funds to be transferred from the Standard Chartered Account to the LGT Account, which was held directly by the Foreign Trust. The U.S. government claims that (i) the Foreign Corporation never performed any "inspection services," and (ii) the purpose of the foreign entities, accounts, and transactions was to "disguise" transfers of pre-tax funds from the Domestic Company to Paul.

In 2004, Paul traveled to Liechtenstein with his three sons, withdrew $100,000 from the LGT Account, kept $25,000 for himself, and divided the remainder equally between his sons. During this trip in 2004, the Foreign Trustees allegedly notified Paul that the arrangement might trigger U.S. tax and information-reporting issues for Paul and suggested that he seek advice from a U.S. tax professional. Paul agreed to act as the U.S. agent for the Foreign Trust during this same trip, likely without appreciating the duties associated with such title.

The U.S. government makes the following allegations with respect to 2005: (i) Paul did not report the existence of the LGT Account on Schedule B to the 2005 Form 1040; (ii) Paul did not report any income generated by the Foreign Trust or the LGT Account on his 2005 Form 1040; (iii) Paul executed his 2005 Form 1040 under penalties of perjury; (iv) Paul did not notify his accountant about the LGT Account; (v) Paul failed to file an FBAR disclosing the LGT Account; and (vi) All the preceding actions and inactions by Paul are evidence of his "willfulness."

The U.S. government claims that the balance of the LGT Account on the date of the FBAR violation (*i.e.*, June 30, 2006) was at least $1,873,382.

Paul died in February 2008, at the age of 84, from brain cancer and related illnesses. In May 2008, just three months after his death, the IRS started a civil audit. Perhaps nothing helps a grieving family more than an unexpected visit from the tax man.

In October 2009, one of the personal representatives of Paul's estate filed FBARs for 2003 through 2008, apparently attempting to participate in the OVDP. The court pleadings are unclear, but the important point is that the IRS, predictably, rejected the OVDP application because the audit had already started.

As anyone who regularly defends taxpayers with international tax problems would guess, the audit did not go well. Among other things, the IRS assessed a willful civil FBAR penalty for 2005 related to the LGT Account seeking the maximum penalty of $936,691, and the DOJ later filed a collection lawsuit in District Court demanding $1,061,181 as a result of post-assessment penalties and interest charges.

IV. Interesting and Obscure Issues

Garrity is an interesting case, completely aside from the key issue of whether Paul committed a "willful" FBAR violation. Analyzed below are a number of intriguing issues, of which the public and practitioners likely would

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be unaware, unless they took the time to find and review all court pleadings. To be clear, these are just some of the noteworthy issues in *Garrity*; addressing all of them would make this article unacceptably long, even for the most avid FBAR enthusiast.

A. Battle over Potential Expert Report by International Tax Accountant

The FBAR violation allegedly occurred on June 30, 2006, Paul died in February 2008, and the trial started in June 2018, which is 12 years after the violation, and more than 10 years after Paul's death. Under these circumstances, it is logical that Paul's attorneys had to get creative in terms of evidence of non-willfulness.

1. Proposed Expert Report

Paul's attorneys presented an expert report by, and offered testimony from, Howard B. Epstein, an accountant with more than 25 years of experience, whose practice focuses on international tax compliance and planning for individuals and businesses. Mr. Epstein explained that he had been retained to opine on (i) the state of public guidance and public awareness of the FBAR filing requirement as of 2006 "to provide an objective backdrop or perspective on the inquiry," (ii) how the guidance evolved before and after 2006, and (iii) how international tax compliance was viewed and understood by tax practitioners and taxpayers as of 2006. Based on this overview, Mr. Epstein stated that he would opine on "whether an individual taxpayer could have been unaware of his filing foreign income and asset reporting requirements."

Mr. Epstein stated in his report several times that the U.S. government alleges in the FBAR litigation that Paul "should have known" about his duty to file an FBAR to report the LGT Account held through the Foreign Trust.

Mr. Epstein explained that the Foreign Trustee was partially at fault for not informing Paul of his U.S. tax and information-reporting duties. For instance, he indicated that, if the Foreign Trustee had complied with its duties and filed annual Forms 3520-A for the Foreign Trust, this would have alerted Paul to his obligation to file Forms 3520 and an FBAR. Mr. Epstein concluded that "it is difficult to see how an individual [like Paul] would know he was supposed to file additional forms with the IRS," when LGT Bank and/or the Foreign Trustee failed to file required returns with the IRS or provide some other type of communication.

Spreading the blame around, Mr. Epstein indicated that knowledge about the need to report foreign trusts and accounts was "lacking," even among experienced tax practitioners, until the IRS introduced the first OVDP program in 2009 and Congress enacted the Foreign Account Tax Compliance Act in 2010.

Mr. Epstein ultimately came to the following conclusion: "[I]t is my opinion that, under the applicable published guidance and in practice, the IRS should not and does not determine—without specific supporting evidence—that a taxpayer *should have known* of his foreign bank account reporting requirements."

2. Efforts by the U.S. Government to Exclude the Report

The DOJ filed a Motion, along with a legal memorandum in support, asking the District Court to disallow the proposed expert report by, and testimony from, Mr. Epstein. The DOJ characterized the report as a description of whether a "reasonable person" or "generic individual taxpayer" would not have known about the FBAR filing duty in June 2006, and whether the IRS should have determined that Paul acted willfully.

The DOJ argued that Mr. Epstein should not be permitted to participate in the trial because he does not satisfy Rule 702 of the Federal Rules of Civil Procedure, which defines an expert witness as an individual with specialized knowledge that will, among other things, help the jury understand the evidence or determine a fact. Additionally, even if the report were considered acceptable under Rule 702, the DOJ contended that it would still be inadmissible under Rules 401 and 403 because it is not legally relevant in that it does not have a tendency to make a fact more or less probable.

In raising these positions, the DOJ underscored that (i) Mr. Epstein's conclusions are inherently speculative because there is no evidence that Paul was aware of what other taxpayers knew about FBAR filing requirements back in 2006, (ii) Mr. Epstein incorrectly assumes that low FBAR compliance rates were a consequence of lack of public knowledge, when there are many other potential causes, such as an insufficient enforcement of FBAR rules by the IRS and other U.S. government agencies, (iii) Mr. Epstein cites to anecdotal evidence, including personal experiences with clients, (iv) whether the IRS should have determined that Paul acted willfully is irrelevant because the District Court will hear the case *de novo*, meaning the judge and the jury will act solely

on the evidence presented at trial, and (v) Mr. Epstein discusses the law, which is solely the domain of the judge.

The biggest problem, according to the DOJ, is that Mr. Epstein misunderstands and mischaracterizes the FBAR penalty theories that the DOJ is advancing. In particular, the DOJ explained that it is not arguing that Paul "should have known" about his FBAR filing duty, but rather that the actions and inactions of Paul demonstrate that he had at least "reckless disregard," which suffices to prove willfulness in this context. The DOJ clarifies its position in the following manner:

> [T]he government has not merely asserted that [Paul] "should have known" of the FBAR requirement. Rather, the government will show that [Paul] acted willfully in failing to file an FBAR because either he knew that he had to file an FBAR (actual knowledge), or he acted with reckless disregard of his FBAR requirement (willful blindness). Presumably, the Defendants equate the "reckless disregard" standard with "should have known." But the standards are not the same. The government is alleging that [Paul] acted with reckless disregard in that he failed to inquire or learn that he had a requirement to file an FBAR after he was specifically alerted to the fact that he needed to do so, and thus [Paul] was "willfully blind" to the FBAR requirement. The government is not arguing that he "should have known" to file an FBAR simply because it is the law.[22]

After clarifying its tax and legal positions, the DOJ identified for the District Court what it calls "just a sample" of the actions and inactions that it would prove at trial demonstrating that Paul was willful with respect to his FBAR violation. First, Paul signed and filed his 2005 Form 1040, checking the "no" box in response to the foreign-account question on Schedule B. Second, Paul exhibited "willful blindness" by not reviewing the instructions, explicitly cross-referenced in Schedule B, about the need to report foreign financial accounts.[23] Third, Paul completed the "organizer" provided by his longstanding accountant in connection with the 2005 Form 1040, erroneously indicating that he did not have an interest in a foreign account.[24] Fourth, Paul filed at least one FBAR in earlier years for the Domestic Company, meaning that he knew of its existence and purpose.[25] Fifth, Paul was a sophisticated businessman, who formed the Foreign Trust, instructed the Foreign Trustee to open the LGT Account, and personally visited Liechtenstein in 2004 and withdrew funds.[26] Finally, Paul was told in 2004 to consult U.S. tax advisors about potential U.S. tax and information-reporting duties related to the Foreign Trust and LGT Account, but he did not do so.[27]

3. Decision by the District Court

The District Court agreed with the DOJ on essentially every point, holding that the proposed report and testimony by Mr. Epstein would not be welcome for a number of reasons.

For starters, the District Court pointed out that Mr. Epstein was focused on the wrong legal issue and standard. Citing a list of former willful FBAR cases, including *Bedrosian*, *Williams*, *Bohanec*, and *McBride*, the District Court explained that whether Paul "should have known" about his FBAR filing duty in June 2006 is not germane.[28] The pertinent standard is willfulness, which, based on precedent in the FBAR penalty realm, encompasses both knowing and reckless violations. The report by Mr. Epstein addresses only an objective standard (*i.e.*, what Paul should have known in light of the IRS's public education on the issue) instead of the subjective standard (*i.e.*, whether Paul personally knew about or recklessly disregarded his FBAR duty).

Moreover, the District Court indicated that the proposed report and testimony should be excluded because there is no link between generalized public and practitioner unawareness of FBAR duties in June 2006 and Paul's particular state of mind. It stressed that lack of connection in many ways:

> What [Paul] actually knew (or consciously chose to avoid learning) is the key issue, and there is no evidence linking that issue with [Mr. Epstein's] proposed testimony. Defendants point to no evidence in this case that [Paul] knew or believed that, for example, there was uncertainty about IRS guidance regarding the reporting of foreign financial accounts or about whether an account held in the name of a Liechtenstein *Stiftung*, such as the [Foreign Trust] had to be disclosed to the IRS. Indeed, defense counsel conceded during the pre-trial conference that there is no evidence that [Paul] was aware (or that he was unaware) of any IRS guidance and no evidence that he was certain or uncertain about any FBAR reporting obligation. For example, defense counsel acknowledged that there is no evidence that [Paul] had conversations about IRS guidance or any lack thereof, or even about the reporting requirement in

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general, with his accountant. In short, there is no evidence that [Paul's] state of mind was influenced by any lack of IRS guidance.

The District Court further held that, even if the data from Mr. Epstein were to qualify as expert testimony under Rule 702, it would still be excluded under Rules 401 and 403 because its probative value would be substantially outweighed by the danger of confusing the issues and misleading the jury. On this score, the District Court gives the following warning: "The jurors will be instructed that the Government must prove willfulness, but [Mr. Epstein's] testimony may lead them to conclude—incorrectly—that [Paul's] willfulness depends on the degree to which the IRS enforced, publicized, or explained the reporting obligation—or the degree to which others were aware of it."

Finally, the District Court pointed out that Mr. Epstein, as an expert witness, cannot comment on the law, which means that he could not discuss any of the rules, regulations, IRS publications, or other documents addressing legal matters that he attached to his report as exhibits. The District Court succinctly explained that "[t]he law is for the Court, rather than the jury, to decide."

B. Fighting the U.S. Government on Multiple Fronts Concurrently

Taxpayers with undeclared foreign accounts and unreported foreign income often find themselves engaged in a multi-faceted war of attrition against a rival, the U.S. government, which seems to possess limitless resources.

1. Example of Foreign Account Problems and Procedures

A simple example shows how this works. Assume that Offshore Otto held foreign accounts during 2017, with an aggregate balance of approximately $2 million, which yielded a total of $50,000 in interest income annually. Further assume that Offshore Otto did not report the foreign-source income on his 2017 Form 1040, did not disclose the existence of the foreign accounts by checking the "yes" box on Part III of Schedule B of the 2017 Form 1040, did not enclose a Form 8938 with his 2017 Form 1040, and did not electronically file an FBAR.

After conducting an audit, the IRS might issue the following items to Offshore Otto: (i) a Notice of Deficiency proposing increased taxes on the $50,000 of unreported income, an accuracy-related penalty or civil fraud penalty, and interest charges, (ii) an FBAR 30-day letter (*i.e.*, Letter 3709) and an FBAR Agreement to Assessment and Collection (*i.e.*, Letter 13449) asserting a penalty of $1 million, which constitutes the maximum sanction of 50 percent of the highest aggregate balance of the unreported foreign accounts,[29] and (iii) a Notice Letter (*i.e.*, Letter 4618) and/or Form 8278 (*Assessment and Abatement of Miscellaneous Civil Penalties*) asserting a penalty of $10,000 for failure to file Form 8938.[30]

If Offshore Otto disputes all proposed taxes and civil penalties, then he will become familiar with three different venues, as well as the costs of fighting in each. First, Offshore Otto may file a Petition with the Tax Court to dispute the income taxes and tax-related penalties proposed in the Notice of Deficiency.[31] As explained further below, this is precisely what happened in *Garrity*.

Second, because the FBAR penalty derives from Title 31 of the U.S. Code (*i.e.*, Money and Finance) as opposed to Title 26 of the U.S. Code (*i.e.*, Internal Revenue Code), it cannot be challenged in Tax Court.[32] Thus, after Offshore Otto exhausts his administrative appeal rights with the IRS, the DOJ will bring a civil collection against him in District Court.[33] Again, this is exactly what occurred with *Garrity*.

Third, given that penalties for not filing Form 8938 are not related to a tax deficiency, the IRS takes the position that they are not challengeable in Tax Court.[34] Since the Form 8938 sanction is an "assessable" penalty, taxpayers generally find themselves challenging it in one or more of the following manners: (i) Filing a protest letter, essentially requesting penalty abatement, in response to the first notice from the IRS; (ii) Administratively appealing any negative decision by the IRS Service Center of the penalty-abatement request; (iii) Filing a request for, and participating in, a Collection Due Process ("CDP") hearing with the IRS, after the IRS issues its notice threatening imminent levies of the taxpayer's property to satisfy the penalty; and/or (iv) Paying the penalty under protest and then initiating a refund action with the IRS. A variation of this happened with *Garrity*.

2. Exceeding Normal Expectations

Based on the documents filed in connection with the FBAR case in *Garrity*, as well as independent research, it appears that Paul has surpassed Offshore Otto, simultaneously clashing with the U.S. government on four fronts, instead of three. Below are the four battlegrounds where representatives of Paul's estate are devoting significant time, money, and effort.

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a. Tax Court

The IRS issued a Notice of Deficiency in December 2011 for unpaid taxes of $65,147, penalties of $13,029, and interest charges related to the 2005 Form 1040. Representatives of Paul's estate filed a timely Petition, and now the case sits with the Tax Court.[35] This litigation has stalled for approximately five years, since March 2013, awaiting resolution of issues in other courts. The most recent Order from the Tax Court aptly describes the situation:

> This case was on the Court's May 20, 2013 trial calendar for Buffalo, New York, but is only a small piece of much larger legal troubles. The Court put it on a long-term status-report track, and the parties continue to report that litigation in a downstate probate court continues, with the most important recent development is the executors' rejection of the government's claim for penalties. These penalties are now also being actively contested in U.S. District Court. They reasonably ask to report again in the summer, and it is ordered that the parties file another status report on or before June 29, 2018, describing their progress toward settlement or a narrowing of the issues to be tried, and any relevant developments in the probate-court and district-court matters.[36]

b. District Court—Foreign Trust Penalties

The year at issue in *Garrity* is 2005, and the duty to file Forms 8938 did not take effect until 2011. Therefore, these penalties do not apply, but other "assessable" international penalties do. Namely, the IRS assessed penalties in December 2012 for unfiled Forms 3520 for 1996, 1997, 1998, and 2004, and for unfiled Forms 3520-A for 1997 through 2008 related to the Foreign Trust. The DOJ later filed a collection lawsuit in District Court in January 2018, seeking a total of $1,504,388.[37] The representatives of Paul's estate tried to consolidate the FBAR litigation and the Form 3520 and Form 3520-A litigation in January 2018, and the DOJ opposed.

c. District Court—Foreign Account Penalties

The IRS assessed a willful FBAR penalty for 2005 related to the LGT Account seeking the maximum penalty of $936,691, and the DOJ later filed a collection lawsuit in District Court. This triggered *Garrity*, the case on which this article focuses.

d. Probate Court

Finally, the DOJ filed a claim in the Probate Court against Paul's estate, presumably requesting an amount equal to all the liabilities described in the preceding three lawsuits.[38]

3. Various Places, Various Penalties, Various Excesses

The pleadings in *Garrity* indicate that the balance in the LGT Account as of the date of the FBAR violation (*i.e.*, June 30, 2006) was $1,873,382, but the DOJ is seeking far more than that. Adding the penalties for the unfiled FBAR, Forms 3520, and Forms 3520-A, the DOJ is demanding $2,441,079, and this amount does *not* even contemplate the (i) taxes, penalties, and interest charges related to the 2005 Form 1040, or (ii) the post-assessment penalties and interest charges related to the FBAR, Forms 3520, and Forms 3520-A. Representatives of Paul's estate take the position that such "stacking" of penalties under Title 31 (*i.e.*, FBAR) and Title 26 (*i.e.*, Forms 3520 and Forms 3520-A) violates the prohibition against excessive fines in the Eighth Amendment to the U.S. Constitution.[39]

C. Asserting FBAR Penalties for Only One Year

As indicated above, in an apparent attempt to get preferential treatment under the OVDP, a representative of Paul's estate filed FBARs for 2003 through 2008 in October 2009. The IRS started the audit in May 2008, a representative of Paul's estate voluntarily granted an extension of the assessment-period for the 2005 FBAR until June 30, 2013, and the IRS assessed the FBAR penalty for 2005 in February 2013. At the time of the assessment, taking into account the voluntary extension, the IRS could have asserted penalties for late FBARs for 2005, 2006, 2007, and 2008, yet it did not.

This type of selective or limited FBAR penalty is consistent with the IRS's new policy, announced in May 2015, in Memorandum SBSE-04-0515-0025, which was called Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties ("Interim Guidance"). The official purposes of the Interim Guidance were to improve the administration of the FBAR compliance program, ensure fairness and consistency in penalty amounts, and obligate IRS personnel to take into account all available facts and circumstances of each case.

The Interim Guidance provides the following instructions about situations involving willful FBAR violations. The portions applicable to *Garrity* have been marked. The

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IRS seems to have employed a variation on this mandate in *Garrity*, asserting the reduced maximum penalty to just one year, 2005.

> For cases involving willful violations over multiple years, examiners will recommend a penalty for each year for which the FBAR violation was willful. *In most cases, the total penalty amount for all years under examination will be limited to 50 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination.* In such cases, the penalty for each year will be determined by allocating the total penalty amount to all years for which the FBAR violations were willful based upon the ratio of the highest aggregate balance for each year to the total of the highest aggregate balances for all years combined, subject to the maximum penalty limitation in 31 U.S.C. §5321(a)(5)(C) for each year.

The IRS and DOJ have applied the Interim Guidance to limit potential FBAR penalties in other recent cases, too.[40]

D. Effect of Age and Mental Condition on Willfulness

Taxpayers have long argued, and the IRS and the courts have sometimes accepted, that illness might support the concept of "reasonable cause." On this score, the U.S. Supreme Court has held that "[t]he Internal Revenue Service has articulated eight reasons for a late filing that it considers to constitute 'reasonable cause.' These reasons include … the death or serious illness of the taxpayer or a member of his immediate family…"[41] Other courts have come to the same conclusion.[42] The Internal Revenue Manual also contains several sections clarifying that illness represents reasonable cause for not imposing civil penalties. One pertinent part states the following: "Examples of sound causes for delay which, if established, will be accepted as reasonable cause are shown below: Death or serious illness of the taxpayer or a death or serious illness in his/her immediate family."[43] Furthering this idea, the courts have recognized that a mental illness, emotional affliction, depression, and even prolonged stress may constitute reasonable cause in certain situations, thereby mitigating any tax-related penalties.[44] The current state of the law in this regard may be summarized as follows:

> Incapacity on the part of a taxpayer due to mental or physical illness can establish reasonable cause for failure to file timely returns. However, mental or emotional disorder does not excuse a failure to file timely returns unless it is shown that the disorder rendered the taxpayer incapable of exercising ordinary business care and prudence during the period in which the failure to file continued. Moreover, a taxpayer's selective inability to meet his or her tax obligations when he or she can carry on normal activities does not excuse a late filing.[45]

The representatives of Paul's estate, building on this notion, plan to present expert medical testimony explaining that Paul's mental deterioration before and on the date of the alleged FBAR violation (*i.e.*, June 30, 2006) prevented him from acting willfully. Paul was over 80 years old at the time of the violation. The representatives will call the Chair of the Department of Neurology at the Roswell Park Cancer Institute, who is expected to explain that (i) Paul started showing signs of mild cognitive impairment ("MCI"), a common precursor to Alzheimer's disease, as early as 1998, (ii) he was diagnosed with MCI in early 2005 by a qualified neurologist, and (iii) while it is impossible to say with certainty whether Paul's mental condition directly caused him to neglect to file the FBAR or to provide the relevant documents to his accountant, such duties are the type that could have been affected by his MCI because they were not learned or highly repetitive activities of daily living.[46] It will be interesting to see whether the District Court believes that age-related mental deterioration can mitigate a finding of willfulness in the FBAR context.

E. Novel Argument About Assessment-Period Extensions

As explained above, the IRS started the audit in May 2008, a representative of Paul's estate voluntarily granted an extension of the assessment-period for the 2005 FBAR until June 30, 2013, and the IRS assessed the penalty for 2005 in February 2013. Were it not for this extension, the normal assessment period would have expired on June 30, 2012.

Likely based in both regret (for giving the IRS extra time with false hope that doing so might convince the IRS not to assert a penalty) and ingenuity (for identifying a possible path to redemption), representatives of Paul's estate raise a novel argument at trial. In particular, they maintain that, while the IRS was given authority

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to assert FBAR penalties, it was not empowered to seek FBAR penalty extensions. The representatives frame it in the following manner to the District Court:

> [A]lthough Congress has, by explicit statutory provision, granted the Secretary of the Treasury the authority to extend the statute of limitations for the assessment of taxes and penalties under Title 26, Congress has not by any statute granted the Secretary of the Treasury the authority to extend the statute of limitations for the assessment of civil penalties under Title 31, such that the assessment which this action seeks to reduce to a judgment is untimely pursuant to 31 U.S.C. 5321(b)(1).[47]

A determination by the District Court that the IRS can request extensions related to income taxes and certain international information return penalties, but cannot seek the same for FBAR penalties, would have a significant impact on FBAR cases, past, pending, and future.

F. Capping Willful FBAR Penalties at $100,000

Taxpayers recently celebrated a significant FBAR-related victory in *Colliot*.[48] This case essentially held that the IRS could not assert an FBAR penalty exceeding $100,000 per violation, even if such violation were willful.

The winning legal/tax argument in *Colliot* can be summarized as follows. A previous version of 31 USC §5321(a)(5) allowed the Treasury Department to impose willful FBAR penalties equal to, the greater of, (i) $25,000 or (ii) the balance of the unreported account up to $100,000. The related regulation promulgated *via* notice-and-comment rulemaking, 31 CFR §103.57, reiterated that "[f]or any willful violation committed after October 26, 1986 … the Secretary may assess upon any person a civil penalty … not to exceed the greater of the amount (not to exceed $100,000) equal to the balance in the account at the time of the violation, or $25,000."[49]

In 2002, the Treasury Department delegated authority to assess FBAR penalties to the Financial Crimes Enforcement Network ("FinCEN"), which delegation specifically stated that the related regulations would be unaffected by such transfer of power and would continue in effect "until superseded or revised."[50] Roughly six months later, FinCEN re-delegated the authority to assess FBAR penalties to the IRS.[51]

As explained earlier in this article, in 2004, Congress amended 31 USC §5321 to raise the maximum willful FBAR penalties.[52] Under the revised statute, the willful FBAR penalties increased to a (i) minimum of $100,000 and (ii) a maximum of 50 percent of the balance in the unreported account at the time of the violation.[53] Despite this change by Congress, the regulations remained unchanged; that is, 31 CFR §103.57 continued to indicate that the willful FBAR penalty was capped at $100,000.

FinCEN later renumbered 31 CFR §103.57 as part of a large-scale reorganization of regulations; it is now called 31 CFR §1010.820. FinCEN also amended part of the relevant regulation to account for inflation.[54] However, FinCEN did *not* revise the regulation to account for the increased maximum penalty, enacted by Congress in 2004, ranging from $100,000 to 50 percent of the balance in the unreported account.

31 USC §5321(a)(5), in its current form, gives the Treasury Department discretion to determine the amount of willful FBAR penalties, so long as they do not exceed the ceiling set by 31 USC §5321(a)(5)(C) (*i.e.* 50 percent of the account balance at the time of the violation). However, 31 CFR §1010.820, a regulation validly issued many years ago, never changed, and still in effect, limits the penalty to $100,000. The U.S. Supreme Court has held that rules issued *via* the notice-and-comment procedures must be repealed in the same manner.[55] 31 CFR §1010.820 has not been repealed; therefore, it was in effect when Paul allegedly committed the willful FBAR violation and also when the IRS assessed the related FBAR penalty for 2005.

In *Garrity*, the parties stipulated that, unless the District Court holds in favor of Paul or determines that the FBAR penalty should be less than $100,000, then the District will give Paul's attorneys the opportunity to file a post-verdict Motion, such that the parties can file briefs on whether the willful FBAR penalty for 2005 must be capped at $100,000 in conformity with *Colliot*.[56]

V. Conclusion

The U.S. government has already litigated several willful FBAR penalty cases. As the OVDP ends in 2018 and the IRS continues getting more foreign account data from diverse outlets, the volume of FBAR cases will surely increase. Consequently, taxpayers with foreign assets or activities, as well as their tax advisors, must stay abreast

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of the latest in the FBAR world. Prior cases have taught us the following lessons:

- The Tax Court lacks jurisdiction over FBAR penalty matters, in both pre-assessment and post-assessment (*i.e.*, collection) cases. Therefore, FBAR litigation will take place in the appropriate 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 the highest FBAR civil penalty.
- 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 Interim Guidance, thereby limiting 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, which means that taxpayers generally cannot offer evidence at trial related to the IRS's administrative process in conducting the audit, determining whether willfulness existed, *etc.*

Garrity has added to the discourse, introducing the following teachings. First, courts might reject as irrelevant, in an evidentiary sense, reports and testimony that attempt to make a link between general public unawareness of FBAR duties and particular ignorance of the taxpayer under attack. Second, depending on the circumstances, the U.S. government might be able to ensnare a taxpayer in four different, stressful, costly, and time-consuming cases at one time, including those for (i) income taxes, accuracy-related or civil fraud penalties, (ii) assessable international information return penalties, (iii) FBAR penalties, and (iv) estate taxes. Third, courts might give credence to the argument that age-related mental conditions preclude a finding of willfulness. Fourth, while the IRS undeniably has authority to impose FBAR penalties, it is unclear whether it is empowered to extend the relevant assessment periods. Finally, rooted in *Colliot* and other District Court cases in which taxpayers are raising similar arguments, courts might cap willful FBAR penalties at $100,000 per violation, unless and until the regulations are changed to match current law.

ENDNOTES

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1 *Garrity*, Case No. 3:15-cv-243 (D.C. Conn.).

2 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).

3 Bank Secrecy Act of 1970 (P.L. 91-508), Title I and Title II (Oct. 26, 1970).

4 *Id*. at §202.

5 31 USC §5314; 31 CFR §1010.350(a).

6 68 FR 26489 (May 16, 2003).

7 31 CFR §103.56(g), 68 FR 26489 (May 16, 2003).

8 American Jobs Creation Act of 2004 (P.L. 108-357) (Oct. 22, 2004).

9 31 USC §5321(a)(5)(A).

10 31 USC §5321(a)(5)(B)(ii).

11 31 USC §5321(a)(5)(C)(i). As of May 2018, there is uncertainty regarding the maximum FBAR penalty, as a District Court issued an opinion stating that the willful FBAR penalty was 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).

12 Code Sec. 6048(a)(1); Code Sec. 6048(a)(4). The term "responsible party" means (i) the

grantor, in situations where an *inter vivos* trust is created, (ii) the transferor, in cases involving a "reportable event," other than a transfer by reason of death, and (iii) the executor of a decedent's estate.

13 Code Sec. 6048(c)(1).

14 Code Sec. 6677(a).

15 Code Sec. 6677(d).

16 Code Sec. 6048(b)(1). The grantor trust rules are located in Sections 671 to 679.

17 Code Sec. 678(a)(1).

18 Code Sec. 679(a)(1).

19 Code Sec. 6677(b).

20 Code Sec. 6677(d).

21 Complaint and Jury Demand filed February 20, 2015; Defendant's Answer and Affirmative Defenses filed April 24, 2015; Expert Report by Howard B. Epstein, CPA dated April 28, 2017; Memorandum and Order regarding Standard of Proof filed April 3, 2018; Plaintiff's Motion in Limine to Exclude the Testimony of Howard B. Epstein filed April 3, 2018; Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018; Defendant's Opposition to Plaintiff's Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 24, 2018; Joint Trial Memorandum filed May 4, 2018; Stipulation regarding Determination of Factual and Legal Issues filed May 30, 2018; and Memorandum and Order regarding Proposed Expert Testimony of Howard B. Epstein filed June 1, 2018.

22 Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018, at 8.

23 Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018, at 4–5.

24 Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018, at 5.

25 Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018, at 5.

26 Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018, at 5–6.

27 Plaintiff's Memorandum in Support of Its Motion in Limine to Exclude Opinion Testimony of Howard B. Epstein filed April 3, 2018, at 5–6.

28 For an analysis of five prior willful civil FBAR cases, *see* 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, *Government Wins Fourth Straight FBAR Penalty Case: Analyzing Bohanec and the Evolution of "Willfulness,"* 126(3) J. Taxation 110 (2017); *selected for republication in 28(8)* J. Int'l Taxation 34 (2017); *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, *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); republished in 29(3) J. Int'l Taxation 54 (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); republished in 29(3) J. Int'l Taxation (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).

29 IRM §4.26.17.3 (Jan. 1, 2007).

30 IRM §20.1.9.2 (April 22, 2011); IRM §20.1.9.2.1 (April 22, 2011); IRM §20.1.9. 22 (April 22, 2011). Aside from these three civil lines of attack, the IRS might, depending on the facts and circumstances, bring some type of criminal charge, such as filing a false Form 1040, engaging in U.S. tax evasion, *etc.* The IRS often begins the process with criminal charges and then proceeds to the related civil matters.

31 Code Sec. 6213(a).

32 *See* Hale E. Sheppard, *Two More Blows to Foreign Account Holders: Tax Court Lacks FBAR Jurisdiction and Bankruptcy Offers No Relief from FBAR Penalties*, 11(1) J. Tax Practice & Procedure 27 (2009).

33 31 USC §5321(b)(2). The government must initiate this lawsuit within two years of assessing the FBAR penalty.

34 IRM §20.1.9.2 (April 22, 2011) (emphasis added); I.R.M. Exhibit 20.1.9-4; *See also* Chief Counsel Advice 201226028.

35 *Estate of Paul G. Garrity*, Tax Court Docket No. 006561-12.

36 *Estate of Paul G. Garrity, Sr.*, Tax Court Docket No. 006561-12, Order dated January 4, 2018.

37 *Diane M. Garrity, Paul G. Garrity, Jr. and Paul M. Sterczala, as Fiduciaries of the Estate of Paul G. Garrity, Sr.*, Case No. 2:18-cv-00111 (D.C. D. Conn.; Complaint filed January 18, 2018; and Defendant's Answer and Affirmative Defenses filed February 26, 2018.

38 *Estate of Paul G. Garrity, Sr.*, Case No. 08-0211 (Saybrook, Connecticut Probate Court) (filed Mar. 3, 2008).

39 *Diane M. Garrity, Paul G. Garrity, Jr. and Paul M. Sterczala, as Fiduciaries of the Estate of Paul G. Garrity, Sr.*, Case No. 2:18-cv-00111 (D.C. D. Conn.); Defendant's Answer and Affirmative Defenses filed February 26, 2018, paragraphs 27–33.

40 *Kelley-Hunter*, DC-DC, 120 AFTR 2d 2017-5566, December 12, 2017.

41 *R.W. Boyle*, SCt, 85-1 ustc ¶13,602, 469 US 241, 105 SCt 687, n. 1 (1985) (emphasis added).

42 *See, e.g.*, *Van Camp & Bennion*, CA-9, 2001-1 ustc ¶50,446, 251 F3d 862 ("It is clear that a taxpayer's serious illness can constitute reasonable cause").

43 IRM §1.2.1.3.3 (Dec. 29, 1970).

44 *See, e.g.*, *J.M. Thomas*, 90 TCM 477, Dec. 56,187(M), TC Memo. 2005-258; *Tobkin*, TC Summ. Op. 2004-42, *T.R. Jones v*, 92 TCM 168, Dec. 56,597(M), TC Memo. 2006-176; *A.L. Paradiso*, 90 TCM 110, Dec. 56,110(M), TC Memo. 2005-187; *H.R. Radde*, 74 TCM 1072, Dec. 52,330(M), TC Memo 1997-490; *E.K. Ozaki*, 86 TCM 96, Dec. 55,233(M), TC Memo. 2003-213; *S. Marrin*, 73 TCM 1748, Dec. 51,826(M), TC Memo. 1997-24; *J.A. Farley*, 65 TCM 1807, Dec. 48,835(M), TC Memo. 1993-31; *Lilley*, TC Memo. 1989-602.

45 *Wilkinson*, 74 TCM 566, Dec. 52,243(M), TC Memo. 1997-410 (internal citations omitted).

46 Joint Trial Memorandum, at 28.

47 Defendant's Answer and Affirmative Defenses, at 7 and paragraphs 29, 35 through 40.

48 *Colliot*, NO. AU-16-CA-01281-SS (W.D. Tex. May 16, 2018).

49 Amendments to Implementing Regulations under the Bank Secrecy Act, 52 FR 11436, 11445–11446 (1987).

50 Treasury Order 180-01, 67 FR 64697 (2002).

51 Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (2002).

52 Act Sec. 821 of American Jobs Creation Act of 2004 (P.L. 108-357), 118 Stat. 1418 (2004).

53 31 USC §5321(a)(5)(C).

54 Civil Monetary Penalty Adjustment and Table, 81 FR 42503, 42504 (2016).

55 *Perez v. Mortgage Bankers Ass'n*, 135 SCt 1199, 1206 (2015).

56 Stipulation Regarding Determination of Factual and Legal Issues, paragraph 5.

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