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HEADLINE: 2012 TNT 142-2 FBAR PENALTY CASE REVERSAL RAISES QUESTIONS ABOUT CIVIL WILLFULNESS STANDARD. (Release Date: JULY 23, 2012) (Doc 2012-15556)

ABSTRACT: An appeals court's recent unpublished reversal of a previous dismissal of the government's attempts to enforce collection of civil penalties for failure to file foreign bank account reports has tax practitioners concerned that the government will be allowed to apply a new willfulness standard that is contrary to long-held judicial interpretation.

SUMMARY: Published by Tax Analysts(R)

An appeals court's recent unpublished reversal of a previous dismissal of the government's attempts to enforce collection of civil penalties for failure to file foreign bank account reports has tax practitioners concerned that the government will be allowed to apply a new willfulness standard that is contrary to long-held judicial interpretation.

In 2010 the U.S. District Court for the Eastern District of Virginia held in *United States v. Williams*, No. 1:09-cv-00437 (E.D. Va. 2010), that the federal government could not recover civil FBAR penalties from J. Bryan Williams because his actions were not willful. While it was clear that Williams held foreign financial accounts that were not timely reported, the court did not believe he had willfully violated the FBAR reporting requirements in part because his interaction with Swiss and U.S. authorities showed that he "lacked any motivation to willfully conceal the accounts from authorities."

Although Williams pleaded guilty to one count of tax evasion, the district court did not view that admission as relevant in establishing the applicability of the FBAR penalty. The failure to report income on the account is a separate matter from FBAR reporting, the court said, faulting the government for being unable to "differentiate tax evasion from failing to check the box admitting the existence of a foreign account." Williams's reliance on tax advisers in completing his Form 1040 "constituted an understandable omission" rather than an intentional or "deliberate disregard for the law," the court held.

But the Fourth Circuit Court of Appeals, in a split decision, held in *United States v. Williams*, No. 10-2230 (4th Cir. 2012), on July 20 that the district court erred in finding that Williams's conduct was not willful. Williams's signed tax return, on which he had checked "no" on a schedule asking about the existence of foreign financial accounts, "is prima facie evidence that he knew the contents of the return," the majority wrote.

The majority focused on showing Williams's willfulness from inferential conduct, concluding that actions meant to "conceal or mislead" or a "conscious effort to avoid learning about reporting requirements" were sufficient to carry the government's burden of proof. Although those indicia have been applied in the context of affirming tax liabilities under Title 26, the court was also confident in using them for a Title 31 civil penalty. The requirement of proving willfulness for a civil liability includes not only "knowing violations of a standard, but reckless ones as well," the court said.

The circuit court decided to overturn the district court, even though the lower court's opinion rested on credibility determinations of Williams, because it deemed the circumstance "so internally inconsistent or implausible on its face that a reasonable factfinder would not credit it." Williams's lack of consulting the FBAR form and instructions, as well as false answers on the federal tax return, constitute "willful blindness to the FBAR requirement," the court said.

Although the appeals court opinion is unpublished and thus not binding, James N. Mastracchio of Baker & Hostetler LLP said he expects the outcome of future cases involving civil FBAR penalties to "likely go beyond fact-finding that depends on evaluating the belief of each defendant."

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tioners concerned that the government will be allowed to apply a new willfulness standard that is contrary to long-held judicial interpretation.

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"The evidence as a whole leaves us with a definite and firm conviction that the district court clearly erred in finding that Williams did not willfully violate" the FBAR reporting requirements, the circuit court held. "At a minimum, Williams' undisputed actions establish reckless conduct, which satisfied the proof requirement" of the FBAR reporting statute, the court concluded.

A dissenting judge chastised the majority for substituting its own judgment for that of the lower court, given the evidence in the record supporting the district court's opinion. Williams's direct testimony that he was unaware of the FBAR requirement, as well as his lack of objective incentive to

hide the foreign accounts because tax authorities were already aware of them, were sufficient grounds to defer to the district court, the judge wrote.

Moreover, the dissenting judge took issue with the government's alternative arguments regarding collateral and judicial estoppel not addressed by the district court. "Pleading guilty to hiding the existence of the two accounts for income tax purposes does not necessarily establish that Williams willfully failed to file a FBAR," he said, noting that "the FBAR-related penalty is not a tax penalty, but a separate penalty for separate conduct." Consequently, Williams's guilty plea on criminal tax evasion charges "is inapplicable" to an FBAR proceeding because the two charges are not identical, he wrote.

Williams is "the first case that I can recall where a federal appeals court was willing to go beyond the criminal definition of willfulness in setting the civil standard for FBAR penalties," said James N. Mastracchio of Baker & Hostetler LLP. Because the court said the defendant couldn't avoid a willfulness penalty even though he failed to review the FBAR and instructions, taxpayers "might be held to be aware of an FBAR obligation simply by signing a tax return," Mastracchio said.

Although the appeals court opinion is unpublished and thus not binding, Mastracchio said he expects the outcome of future cases involving civil FBAR penalties to "likely go beyond fact-finding that depends on evaluating the belief of each defendant."

The court's reversal may also affect taxpayers who are participating in the IRS's offshore voluntary disclosure initiative (OVDI) but are considering opting out to avoid mandatory penalties, Mastracchio said. "For anyone who checked the box 'no' on a tax return or tax questionnaire, the court's decision certainly gives added support to the government's efforts to impose a willfulness penalty," he said. "But I think the government's position in this case raises legitimate questions given the existence and reliance on the standard previously announced" in 2006 chief counsel advice regarding a higher knowledge requirement applicable in the civil context, he said.

In ILM 200603026, the IRS said it expected courts to apply the same willfulness standard for both civil and criminal penalties under the FBAR statutes, as well as require a clear and convincing burden of proof for the government. (For ILM 200603026, see *Doc 2006-1196* or *2006 TNT 14-14*.)

Caroline D. Ciraolo of Rosenberg Martin Greenberg LLP said the majority opinion "essentially creates strict liability for the FBAR penalty" by holding that the filing of a tax return in and of itself establishes willfulness under Title 31. Because the FBAR statute expressly provides for imposition of non-willful penalties, the majority got the law wrong in treating the failure to review the text at the bottom of Schedule B as conscious disregard of a nontax reporting requirement, she said. "Even the IRS has said in the OVDI regime that taxpayers may want to opt out because there are circumstances where the non-willful penalty is appropriate," she said.

Ciraolo said that because willfulness in criminal cases is often substantiated by inference under a facts and circumstances analysis -- which includes reference to a defendant's motivation -- the district court's reliance on a lack of motivation to establish a lack of willfulness was proper. "It really seems that the [appeals] court tried to find a way to reverse the lower court because it was offended by the result," she said. "If the circuit's standard is applied in the future -- and it's hard to believe it

won't be despite the fact that the opinion is unpublished -- then the interpretation of willfulness eviscerates the non-willful and reasonable cause provisions of *section 5321* of Title 31 and the related [Internal Revenue Manual] provisions."

Jeffrey A. Neiman, a criminal defense attorney in Fort Lauderdale, Fla., called the reversal "a big win for the government." Although a favorable development for the IRS, the case "still shows the practical difficulty the Service has had in enforcing FBAR penalties," he said. "It's one thing to prove unreported income, but it is much harder to show willful noncompliance with a Title 31 reporting requirement."

Neiman, who led the prosecution of Swiss bank UBS as an assistant U.S. attorney in the Southern District of Florida, said that in shifting its position on the applicable legal standard for showing willfulness in the civil context, "the IRS has been forced to take a more aggressive position because they are largely dealing with taxpayers who weren't willfully committing fraud with regard to FBAR reporting."

The FBAR "is a big money-maker for the government with the large penalty attached, so the Service has to make whatever arguments they can," Neiman said.

Procedurally, the IRS must realize that the FBAR penalty is not a Title 26 penalty, Neiman said. "With the right facts, taxpayers should challenge the IRS in these cases," resulting in the IRS having to decide which cases to refer to the Justice Department, he said. "I hope that the IRS will only refer cases with egregious fact patterns," he added.

Regarding the OVDI, Neiman said he believes that "there will be a tsunami of opt-outs, because practically, the IRS will have a difficult time in run-of-the-mill cases to prove the elements of willfulness."

Steven Toscher of Hochman, Salkin, Rettig, Toscher & Perez PC characterized the circuit court's opinion as a significant government victory but downplayed the result. "It is not surprising that a court could easily find that someone who pleaded guilty to a tax evasion scheme utilizing foreign bank accounts over a period of years was guilty of willfully failing to file the FBAR form," he said. "What is surprising is that the appellate court -- at least two of the three judges -- would reverse the district court's finding of non-willfulness, given the very limited scope of review."

Toscher said that when there is a criminal conviction, "a more fruitful defense" against the FBAR penalty will be that the penalty is excessive under the Eighth Amendment, which precludes excessive fines. (See Steven Toscher and Barbara Lubin, "When Penalties Are Excessive -- The Excessive Fines Clause as a Limitation on the Imposition of the FBAR Penalty," *Journal of Tax Practice & Procedure*, Jan. 2010.)

"The most disturbing aspect of the unpublished opinion is the court's statement that 'recklessness' is sufficient to establish liability for the FBAR willfulness penalty," Toscher said, noting that the court's language is based on a Supreme Court decision that had nothing to do with an FBAR penalty. "Extrapolating that language -- in what amounts to dictum in this case -- will no doubt create

uncertainty in what the government will have to prove in the context of a willful FBAR penalty," he said.

Jack Townsend of Townsend & Jones LLP told Tax Analysts that "the proper burden of proof on willfulness, however it is conceived, is still not resolved after *Williams*." The burden of proof "should be clear and convincing given the punitive nature of the penalty," he said, "but that too is a big issue."

With the circuit court making the decision non-precedential, "it is a bad case to present the proposition -- if the majority intended to present it -- that the mere Schedule B question is sufficient to prove conscious avoidance as a proxy for willfulness," Townsend said. (For related commentary, see *Doc 2010-19736* or *2010 TNT 188-14*.)

"The willful ignorance concept is a very problematic proxy for willfulness," Townsend said. "In the criminal arena, the courts have been very careful to limit the use of conscious avoidance to specific situations where the overall facts point to some affirmative conscious avoidance so that it then is fair to indulge the notion that it is a proxy for willfulness."

Thomas E. Zehnle of Miller & Chevalier said that application of the circuit court's legal analysis in future cases would upend longstanding precedent. "I hope that taxpayers will continue to challenge the theory of willful blindness in criminal tax cases, and that the Supreme Court will ultimately address the issue," he said. "It is hard to believe that a court would assume constructive knowledge of a legal duty in the case of any taxpayer who uses a return preparer and did not themselves scrutinize each line of the tax return to understand what obligations they might have under instructions or other forms," he said. "I find that extremely troubling, because there are two separate duties involved: one is to comply with tax obligations under Title 26, and the other is to file a Treasury report under Title 31."