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What the IRS Says Is 'Willful' Keeps Expanding

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In this article, Wood and Smeltzer explain the difference between willful and non-willful conduct for purposes of the penalties for failing to report offshore accounts.

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Under the tax law, willful and non-willful conduct are treated differently. Innocent tax mistakes can often be forgiven, sometimes with no penalty. And even when penalties are imposed, they are much lower than the penalties for conduct involving bad intent.

The willful versus non-willful demarcation is thus a particularly important one in tax law. In a criminal tax case, this fundamental dichotomy can mean the difference between innocence and guilt, or freedom and incarceration. Fortunately, very few taxpayers have to worry about becoming a target in a criminal tax case.

But what about more pedestrian tax matters? In the civil context, what happens if you are audited and the IRS tries to impose big penalties? This can happen in many different factual settings, but a particularly sensitive one involves offshore accounts. If you fail to report one, even if you are only a signatory on the account and it really isn't your money, the stakes can be significant.

Every U.S. person with a financial interest in, or signature or other authority over, a financial account in a foreign country must report it annually to the IRS. These interests must be disclosed on a "Report of Foreign Bank and Financial Accounts," now also called the Financial Crimes Enforcement Network Form 114, or the foreign bank account report. These forms are distinct from tax returns and they are not even filed with the IRS. They must be filed with FinCEN, a unit of the Treasury Department.

The Financial Crimes name alone may raise the hairs on the back of your neck. FinCEN works hand in hand with the IRS, and the IRS handles audits and penalty assessments. Curiously, some people may not want to file, thinking that filing such a form exposes you to scrutiny. Of course, the reverse is true.

In fact, the mantra today should be "disclose, disclose, disclose," even in situations involving strange or quirky accounts or assets. It may not be 100 percent clear that you are required to disclose something on an FBAR, but when in doubt, it seems safer to file. There is no penalty for erring on the side of over-reporting.

Are You Willful?

This brings us to a pivotal but worrisomely tenuous line between willful and non-willful. Both willful and non-willful failures to report an account can be penalized.[1] The difference between willful and non-willful conduct in the context of civil FBAR penalties is particularly severe. Civil penalties for non-willful violations can range up to $10,000 per account per year.

That non-willful penalty alone can be much more than a slap on the wrist, considering that the statute of limitations is usually six years. Thus, for non-willful violations — even innocent mistakes — the penalty could be $60,000 per account. If you have five accounts that you fail to list for six years, that could be $300,000. This kind of penalty structure for non-willful gaffes should foreshadow that when it comes to willful failures, the stakes are likely to be harsh.

Civil penalties for willful violations can range up to the greater of $100,000 or 50 percent of the amount in the account. Again, we are not talking about criminal violations or criminal intent. These are all penalties imposed in civil matters in the context of regular IRS audits. The penalties can even be imposed entirely through the mail.

If the IRS claims that you were willful and imposes substantial penalties, you have the option of paying, of course. But many taxpayers are likely to dispute the findings and appeal the audit administratively to the IRS Appeals Division. Some disputes can be resolved there. In fact, IRS Appeals is among the most common forums for the IRS and taxpayers to hammer out differences of opinion and often, reach a settlement.

However, resolving a case at IRS Appeals nearly always involves compromise. And sometimes either the IRS or the taxpayer won't budge, or at least not enough. Moreover, post-assessment appeals of FBAR penalties exceeding $100,000 require approval from the Justice Department Tax Division. These settlement limitations can, consequently, require going to court. Some taxpayers are doing just that in FBAR penalty cases, but the pattern that is emerging from these contests is a disturbing one.

There is emerging case law about willfulness determinations in civil FBAR penalty cases. Unfortunately, these court decisions are not entirely consistent. Further, the Justice Department and the IRS sometimes take different positions. Therefore, determining what constitutes willfulness in the FBAR context at any given time can be complex and confusing for taxpayers attempting to deal with past compliance issues.

"Gee, I didn't know," can work in some cases. However, the failure to learn of filing requirements, coupled with efforts to conceal the income or the true facts, may suggest a violation was willful. Your conduct is relevant, too. Some courts say willfulness is a resolution to disobey the law, but one that can be inferred by conduct. Watch out for conduct meant to conceal. Even if you can explain one failure, repeated failures to comply can morph conduct from inadvertent neglect into reckless or deliberate disregard.

Willfulness regarding civil FBAR penalties includes voluntary, intentional violations of a known legal duty. That formula might sound simple, but questions of proof are rarely easy to resolve. Taxpayers may testify about their intent, and there are often questions of credibility if they do. But a taxpayer's conduct is often a telltale sign. Taxpayer intent or awareness of the reporting requirements might be evidenced by something you told your banker, using a different passport, moving banks, or giving a Foreign Account Tax Compliance Act certification to a bank that turns out not to be true.

Willful Blindness and Recklessness

However, the threshold for what is considered willful is much lower than that. The IRS also asserts willful conduct penalties for willful blindness and recklessness. In the FBAR reporting context, willful blindness is usually shown by evidence that a taxpayer made a conscious effort to avoid learning about reporting requirements, or efforts to conceal the existence of accounts or the amounts in the accounts. Recklessness can be even more broad.

[1] 31 U.S.C. section 5321(a)(5).

When the government talks about recklessness, it usually frames the issue in the context of the standard for penalties under section 6672.[2] This provision involves payroll taxes. Every U.S. employer paying wages must withhold taxes and send the money to the IRS. If the employer fails to comply, section 6672 permits the government to collect from officers, directors, check signers, or basically any responsible person who willfully fails to pay employment taxes up to the amount unpaid.

What does willful mean in the payroll tax context? This standard is well-developed in the case law, and not surprisingly, very favorable to the government. Taxpayers are readily found to be willful under section 6672 if they merely ought to have known that there was a risk that withholding taxes were not being paid, and if they were in a position to have found out for sure very easily. The IRS almost always wins these payroll tax cases, so what is willful in the payroll tax context generally means little.

Apples and Oranges?

Of course, payroll taxes are fundamentally trust fund taxes belonging to the government. But aren't foreign bank accounts quite different? The IRS appears not to think so. A recent FBAR penalty case, *Bedrosian*,[3] is being closely watched by the tax law community. The taxpayer in that case opened two Swiss bank accounts in the 1970s but did not inform his accountant about the accounts until the 1990s.

The accountant said the taxpayer was required to report the accounts but advised him to do nothing. In fact, the accountant insisted the whole thing would be cleared up at Bedrosian's death, when the assets in the accounts were repatriated as part of his estate. Bedrosian did nothing until 2007, when his accountant died and a newly hired accountant included the smaller of the two accounts on Bedrosian's return, still omitting the larger account. An FBAR was only filed for the smaller account.

Eventually, Bedrosian received a letter from the Swiss bank warning that it would be reporting the accounts to the IRS. At that point, he amended his returns to correctly report the accounts. So far, so good, but the IRS decided to audit. The IRS said some penalties would be due, and evidently started to determine how much. The IRS was reportedly ready to treat Bedrosian as non-willful, but then the case was transferred to another IRS agent. The new agent wrote up the violations as willful, proposing a penalty of $975,789 — 50 percent of the maximum value of the account.

There was no easy compromise, and the case went to trial. At the district court, Bedrosian did well. The Justice Department argued that the court should interpret willfulness for FBAR penalties in the same terms and context as trust fund recovery penalties under section 6672. Despite urging this standard, the court found Bedrosian's actions "were at most negligent," and that the omission of the large account was "unintentional oversight or a negligent act."

The district court found the specific FBAR penalty cases more persuasive and cited those cases in reaching its decision. However, the court noted that the analysis of willfulness under section 6672 was still relevant. The government did not like what it saw as the district court's leniency or its rejection of the stricter recklessness standard applied under section 6672. So the government appealed to the Third Circuit.

The Third Circuit reversed, indicating that it was unclear whether the district court applied the proper objective standard. The appeals court was concerned with an apparent reliance on the "subjective motivations" of the taxpayer's conduct. In fact, the Third Circuit said the objective standard for recklessness was consistent with prior cases addressing civil penalties by the IRS under the tax laws. As support for this proposition, the Third Circuit cited two section 6672 cases and quoted the standard for reckless disregard from one of them. *Bedrosian* was remanded to the district court to apply the objective standard. The case is awaiting decision following supplemental briefing by the government and the taxpayer.

Willfulness for purposes of payroll taxes under section 6672 is defined extremely broadly, both in the tax code and in a large volume of case law. As a result, the IRS can almost always easily show willfulness when payroll taxes are not paid.

[2] *See, e.g.*, PMTA 2018-013 (May 23, 2018).

[3] *Bedrosian v. United States*, No. 17-3525 (3d Cir. 2018).

This is one of the most commonly litigated tax issues in the federal courts. Viewing recklessness for FBAR penalties in the same way as the tepid "ought to have known" standard for payroll tax noncompliance will give the government countless examples.

Importing the well-worn and low-level section 6672 standard could dramatically expand the scope of willfulness to FBAR penalty cases. The flimsy "in a position to find out" standard in the context of section 6672 noncompliance is also very broad. In short, is the government seeking a sort of carte blanche when it comes to proving willful FBAR penalties?

That is where the government appears to be heading. The Justice Department's reply in *Bedrosian* claims that the taxpayer, by signing and filing his return without reviewing it, "ought to have known" that there was a "grave risk" that the form might not be accurate. This argument suggests an attempt to use the signing of a return as inherent reckless disregard of the duty to report foreign accounts.

The Justice Department has argued, successfully, in other FBAR willfulness cases that the mere signing of a return without the proper box checked is per se willfulness.[4] In both the *Horowitz* and *Kimble* cases, the government argued that checking the wrong box on Schedule B and then signing the return constituted willfulness. The taxpayer assertions in *Horowitz* and *Kimble* that they were unaware of the duty to file fell on deaf ears. The courts in both cases held that taxpayers have constructive knowledge of the content of their tax returns and cannot claim ignorance.

However, at least one court in Texas refused to grant summary judgment based on the mere signing of the return.[5] In *Flume*, the court refused to find constructive knowledge, noting that if every taxpayer is presumed to know they need to file an FBAR by merely signing the return, there is no real distinction between willful and non-willful violations. The court in *Flume* also refused to grant summary judgment on reckless disregard.

On remand in *Bedrosian*, the United States is already substituting the section 6672 language as the new standard for civil FBAR penalties. In its supplemental briefing, the Justice Department uses the quoted standard from the section 6672 case cited by the Third Circuit as the standard it claims the court "must" consider when determining whether the failure to file an FBAR was willful.

Uneasy Conclusions

It may be too soon to tell how all of this will shake out. Perhaps many taxpayers facing FBAR penalties will end up with understanding auditors who opt for non-willful penalties if the taxpayer's explanation and behavior seem reasonable. For the time being, though, people facing civil FBAR penalties are likely to see more comparisons to section 6672 payroll tax cases to earmark willfulness.

Taxpayers should be prepared to distinguish recklessness in these different contexts if they hope to avoid the ever-expanding net of willfulness. One key ruling that may prove ominous for taxpayers facing penalties is the district court's decision in *Bedrosian* on remand. Whether the cases that apply the willfulness standard based on merely signing the returns are upheld on appeal may also be particularly telling.

Inevitably, we can expect other court interpretations of the Third Circuit's view of what constitutes recklessness. In the meantime, taxpayers should redouble their efforts to disclose, disclose, disclose. And when it comes to penalty notices and disputing penalty findings at any level, extra care is likely to be required. ■

[4] *See United States v. Horowitz*, No. 8:16-cv-01997 (D. Md. 2019); *Kimble v. United States*, No. 1:17-cv-00421 (Ct. Fed. Cl. 2019).

[5] *See United States v. Flume*, No. 5:16-00073 (S.D. Tex. 2019).