

Failure to Report Foreign Financial Accounts Continues to be a Costly Proposition

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The Internal Revenue Service ("IRS" or "Service") has repeatedly stated that, while its crackdown on the failure of taxpayers to report foreign financial accounts has been strong, it is reasonable in the application of the law. At least one taxpayer, Mr. Carl R. Zwerner, would likely debate that pronouncement.

On June 9, 2014, Bloomberg BNA Daily Tax Report (No. 110) revealed that a long and hotly-contested battle between Mr. Zwerner and the United States government has come to an end. This highly-publicized case is frightening. It illustrates that the IRS may not always be reasonable in the application of the foreign financial account reporting ("FBAR") laws.

Mr. Zwerner, an 87-year old retired specialty-glass importer, is a United States citizen who resides in Coral Gables, Florida. He had a financial account in Switzerland. The account balance never exceeded \$1.7 million. It appears the account was opened by Mr. Zwerner during 2004 in the name of a foundation. In 2007, he closed the original account and transferred the account balance to another Swiss account. The new account was opened in the name of yet another foundation. Mr. Zwerner controlled these accounts; he was undisputedly the beneficial owner of the accounts.

On June 11, 2013, the battle commenced when Assistant Attorney General Kathryn Keneally instituted a lawsuit against Mr. Zwerner in the United States District Court for the Southern District of Florida, seeking to collect almost \$3.5 million in penalties from him for violating the FBAR rules. The assessment which the government was pursuing against Mr. Zwerner amounted to more than double the highest account balance of his Swiss financial account.

In the past five to six years, the United States Justice Department has filed over 75 criminal cases against taxpayers for failure to report foreign financial accounts. In these cases, the penalties sought by the government have usually been 50 percent of an account's maximum balance, or less. While the government has authority to pursue multiple penalties, pursuit of penalties aggregating more than 50 percent of the maximum account balance has been rare. Mr. Zwerner's case raises the issue of whether collection of more than an account's highest balance constitutes a violation of the Eighth Amendment to the United States Constitution.

Pursuant to the Eighth Amendment, the amount of a penalty must bear a relationship to the gravity of the offense; it cannot be excessive. Is a penalty of the magnitude imposed on Mr. Zwerner excessive?

The facts of this case appear to be as follows:

Mr. Zwerner was required to report the foreign financial account from 2004 through 2007 by filing an FBAR on or before June 30 of each following year. He only filed an FBAR, however, in October 2008 (delinquent for 2007). Further, he did not report any income from the account before 2008.

The IRS alleged in its complaint that Mr. Zwerner, on October 13, 2008, filed a delinquent FBAR, reporting the account for 2007. At that time, he also filed an amended 2007 income tax return, reporting the account's income. On March 27, 2009, Mr. Zwerner filed delinquent FBARs, reporting the account for 2004, 2005, and 2006. At that time, he also filed amended income tax returns for those years, reporting the account's income.

The government asserted Mr. Zwerner's failure to report for 2004, 2005, 2006 and 2007 was willful. It pointed out the following facts in support of this position:

- The account was placed in the name of two separate foundations to disguise the identity of the true owner.
- On Mr. Zwerner's original income tax returns for 2004, 2005, 2006 and 2007, he specifically reported on Schedule B that he held no interest in a foreign financial account.
- For the years at issue, Mr. Zwerner reported to his CPA on a tax organizer that he had no interest or signatory authority over a foreign financial account.
- Mr. Zwerner admitted he was aware of the FBAR rules.

Based upon the above facts, the IRS assessed penalties against Mr. Zwerner relating to each tax year for "willful" failure to comply with the FBAR rules. Pursuant to 31 USC 5321(a)(5), the penalties are equal to the greater of \$100,000 or 50 percent of the account balance as of the date of violation. Consequently, for 2004, 2005, 2006 and 2007, these penalties, with interest, exceeded \$3.45 million or over twice the account's highest balance. Despite demand, Mr. Zwerner failed to pay the assessment. As a result, the lawsuit resulted.

The facts do not sound good. There are, however, some mitigating facts.

About four months after filing a late FBAR for 2007, and amending his 2007 income tax return, reporting the foreign financial account income, and paying the tax, in February 2009 Mr. Zwerner's legal counsel approached the IRS Criminal Investigative Division. Without disclosing Mr. Zwerner's identity, the lawyer inquired about his particular situation for tax years 2004, 2005 and 2006. The IRS issued a letter stating that no criminal action in the hypothetical case presented by the lawyer would be pursued. So, Mr. Zwerner, at counsel's advice, filed the delinquent FBARs and amended his income tax returns, reporting the income. At that time, he also paid all income tax due and owing. It is important to note, Mr. Zwerner was not under

exam when he took corrective action. In 2010, the Service began an examination of Mr. Zwerner's income tax returns. Mr. Zwerner's attempt at voluntary compliance pre-dated by a few months the formal FBAR voluntary disclosure programs.

Unfortunately for Mr. Zwerner, his case proceeded to trial in May 2014. The jury returned a verdict, finding Mr. Zwerner's violations of the FBAR rules were "willful" for tax years 2004, 2005 and 2006. It found, however, any violation of the FBAR rules for 2007 was not willful. This verdict left Mr. Zwerner faced with penalties of about \$2.2 million.

Mr. Zwerner's counsel filed a motion with the court to dismiss or reduce the verdict on the ground that the penalty was excessive and violated the Eighth Amendment of the United States Constitution. The court was set to hear arguments on the motion this month. The parties, however, settled the matter. So, this important issue remains open.

Several takeaways exist:

- Until the courts look at this issue, it remains unclear whether FBAR penalties in excess of an account's highest balance are excessive and constitute a violation of the Eighth Amendment.
- When a taxpayer goes to the Service, even on an anonymous basis, and obtains guidance, the Service may still bombard the taxpayer with noncompliance penalties.
- Despite rhetoric about its reasonable approach to FBAR enforcement, it appears the government will continue to use its strong arsenal of penalties to obtain compliance.

This area of law continues to be complex and full of traps for unwary taxpayers and their advisors. The Service continues to tell us that it intends to apply the FBAR rules in a reasonable manner. Time will tell. Tax advisors must be careful so that they do not walk their clients, without full disclosure of the risks, into the penalty assessment gauntlet.

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Authored by

[Larry J. Brant](#)

[Principal|Portland](#)

[503.553.3114](tel:503.553.3114) larry.brant@foster.com