Willful FBAR Penalty Case Shows Importance of Privileged Communications: What *Kelley-Hunter* Adds to the Foreign Account Defense Discussion

*By Hale E. Sheppard**

Introduction

There is an old saying that the fish dies by his mouth, which generally refers to the fact that people get into trouble because of what they say, just like the fish meets its doom by swallowing the hook. This saying applies in many contexts, of course, including situations where the U.S. government is asserting large penalties against taxpayers for willfully failing to file FinCEN Form 114 (*Report of Foreign Bank and Financial Account*) ("FBAR"). A recent case, *United States v. Kelley-Hunter*, provides an opportunity to underscore all the obligations associated with holding or controlling a foreign financial account, review the lessons learned from five previous willful FBAR penalty cases, and appreciate the types of evidence that a court might consider in rendering a verdict, including after-the-fact communications between a taxpayer and her accountant.[1]

Overview of Foreign Account Obligations

To appreciate the events and significance of *Kelley-Hunter*, one must first have a basic understanding of U.S. obligations related to holding or controlling a foreign financial account. These are summarized below.

FBAR Duties and Penalties

Many people mistakenly believe that the duty to file an FBAR is something new. It is not. Indeed, Congress enacted the Bank Secrecy Act nearly five decades ago, in 1970.[2] One purpose of this legislation was to require the filing of reports, like the FBAR, where doing so would help the U.S. government in carrying out criminal, tax, and regulatory investigations.[3] Applicable law requires the filing of

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

an FBAR in cases where (i) a U.S. person, (ii) has a direct financial interest in, has an indirect financial interest in, has signature authority over, and/or has some other type of authority over (iii) one or more financial accounts (iv) located in a foreign country (v) whose aggregate value exceeds $10,000 (vi) at any point during the relevant year.[4]

Concerned with widespread FBAR non-compliance in the past, the Treasury Department transferred authority to enforce FBAR duties to the IRS in 2003.[5] The IRS is now empowered to investigate FBAR violations, issue summonses, assess civil penalties, publish administrative rulings, and take "any other action reasonably necessary" to enforce the FBAR rules.[6]

The predictable result, of course, will be more FBAR penalty litigation in the future.

Congress did its part, too, enacting stiffer FBAR penalty provisions in 2004.[7] Under the old law, the government could only assert civil penalties where it could demonstrate that taxpayers "willfully" violated the FBAR rules.[8] If the government managed to satisfy this high evidentiary standard, it could impose relatively small FBAR penalties, ranging from $25,000 to $100,000.[9] Now, however, the IRS can impose a civil penalty on any person who fails to file an FBAR when required.[10]

In the case of non-willful violations, the maximum fine is $10,000,[11] and the law permits penalty waiver when taxpayers can demonstrate that there was "reasonable cause."[12] Higher maximum 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.[13] The willful FBAR penalty is a powerful enforcement tool. For instance, if a foreign account has a balance of $1 million, and a taxpayer intentionally refuses to disclose such account on an FBAR for two consecutive years, then the IRS can sanction the taxpayer $1 million (*i.e.*, $500,000 plus $500,000), thereby draining the entire account.

References to the FBAR on Form 1040; Declaration to the IRS

U.S. citizens and residents have other duties when they have reportable foreign accounts, in addition to electronically filing a timely, complete FBAR. In particular, they must (i) report all income generated by the account on the federal income tax return (*i.e.*, Form 1040), (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, and (iii) depending on the circumstances, report the foreign account on a Form 8938 (*Statement of Specified Foreign Financial Assets*).[14]

The IRS, DOJ, and the courts have placed great emphasis on the fact that Forms 1040 are involved for two main reasons. First, Schedule B to Form 1040 expressly mentions foreign accounts and then cross-references the FBAR and its instructions. The IRS has slightly modified and expanded this language over the years, with the materials for 2016 stating the following:

> At any time during 2016, 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.

Second, taxpayers are required to sign and date their Forms 1040, thereby swearing that (i) they have reviewed the entire Form 1040, including all Schedules and Statements attached to the Form 1040, (ii) as far as the taxpayers know, the Form 1040, Schedules, and Statements are correct, and (iii) the Form 1040 accurately reports all income and how it was obtained. Below is the text of the sworn statement that taxpayers must provide to the IRS each year:

> Under penalties of perjury, I declare that *I have examined this [Form 1040] and accompanying schedules [including Schedule B referencing the FBAR duty] 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.

As explained below, in their efforts to convince courts that a certain taxpayer knowingly violated his FBAR duties, the IRS and DOJ often point to multiple factors, including, but certainly not limited to, the non-filing of the FBAR, the express references to the FBAR on Schedule

B to Form 1040, and the declaration by the taxpayer, under threat of perjury charges, that he reviewed the entire Form 1040 and Schedule B.

Lessons Learned from Past Willful FBAR Cases

In addition to comprehending the U.S. obligations associated with holding or controlling a foreign financial account, a review of past willful FBAR cases helps us understand the contribution of *Kelley-Hunter* to the discussion.

The U.S. government has already litigated a number of willful FBAR penalty cases, the most noteworthy of which are *United States v. Williams*, *United States v McBride*, *United States v. Bussell*, *United States v. Bohanec*, *and Bedrosian v. United States.*[15] Regardless of the outcome, each case provides non-compliant taxpayers with valuable information, something that might help them when the taxman pulls their card. We have learned the following, before adding the recent contributions by *Kelley-Hunter*:

- 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 the highest 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 the taxpayer 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.
- 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*.
- The evidence presented in most FBAR penalty cases indicate that the taxpayer has other costly problems, too. These generally involve income generated by the unreported foreign account that did not make its way onto the Form 1040, thereby triggering back taxes, accuracy-related penalties or civil fraud penalties, and interest charges. Taxpayers frequently hold unreported foreign accounts through foreign entities, as another layer of defense against detection by the IRS. The problem for taxpayers is that, when caught, they face separate penalties for failure to file international information returns for foreign entities. Among the unfiled returns are Forms 5471 (related to foreign corporations), Forms 8865 (related to foreign partnerships), Forms 8858 (related to foreign disregarded entities), Forms 8621 (related to passive foreign investment companies), and Forms 3520 and Forms 3520-A (related to foreign trusts), *etc*.[16]

Analysis of *Kelley-Hunter*

The description of *Kelley-Hunter* below derives from the decision by the court, supplemented by a review of multiple filings by the parties.[17] To enhance readability, certain aspects have been paraphrased or abbreviated.

Background

Nancy Kelley-Hunter is a lifelong U.S. citizen. She earned several college degrees and worked various jobs before she married Burt Hunter in 1997. They moved to France the year after the nuptials, in 1998. Nancy and Burt opened certain foreign accounts after moving abroad, including one at Bank Sarasin in Switzerland and another at Banque National de Paris in France. These two accounts were not the subject of the FBAR penalty litigation.

The account on which the IRS and, later, the DOJ focused was held at UBS in Switzerland. The funds in the UBS account, opened in 2006, came from three main sources: proceeds from the sale of Burt's business and sailboat, an inheritance that Nancy received upon the death of her parents, and passive income generated by the investments in the account. Although unclear from the court record, it appears that Nancy and Burt, or one of their advisors, formed an entity to hold the UBS account in order to obscure their true ownership. This entity, established in Mauritius and controlled by just one bearer share, was called Towers International, Inc. The evidence demonstrated that Nancy and Burt controlled the UBS account, despite the existence of Towers International, Inc. For instance, they met periodically in person with UBS representatives, they communicated with them by phone and fax, they directed payment of medical and other bills from the account, and the UBS files included a "Power of Attorney for Management of Assets" identifying them as authorized individuals.

In terms of return preparation, it appears that Nancy and Burt hired accountants when they first moved abroad, continuing this practice until 2003. Things changed at that point, with Nancy assuming the return-preparation responsibilities. The earlier items prepared by Nancy tend to indicate that she understood her U.S. obligations related to foreign accounts. For example, she answered "yes" to the foreign-account question on Schedule B to Forms 1040 for 2004 and 2005 (before the large UBS account was opened), properly listing Switzerland and France as the locations of the accounts. Moreover, Nancy filed an FBAR for 2003.

In February 2009, Nancy and Burt received a notice from UBS that it had disclosed the account to the U.S. government. Four months later, Nancy filed a late 2007 FBAR and a timely 2008 FBAR, reporting the UBS account.

Imposition of Penalties

In June 2013, the IRS sent Nancy and Burt a notice indicating that it was proposing willful FBAR penalties for 2007. They did not dispute or appeal the notice, so the IRS assessed such penalties in December 2013. The balance in the UBS account at the time of the FBAR violation was $3,430,500, and both Nancy and Burt had a reportable interest in the account. Therefore, the IRS originally assessed a penalty of $1,715,250 against each of them; that is, a 50-percent penalty for Nancy and another 50-percent penalty for Burt. The IRS, in effect, was taking the entire balance in the account as a penalty for filing late FBARs for one year, 2007.

Collection Lawsuit by the DOJ

The taxpayers did not pay the FBAR penalties, which resulted in the DOJ filing a collection action with the District Court in December 2015. Burt died soon after, in January 2016, at which point the litigation was focused solely on Nancy, both as the executor of Burt's estate and in her individual capacity as an FBAR violator.

In its Complaint, the DOJ emphasized the fact that, with respect to 2007, the taxpayers (i) held a multi-million dollar account at UBS through a foreign entity, Towers International, Inc., (ii) did not report the passive income generated by the account on Schedule B of the 2007 Form 1040, despite the fact that an email shows that a UBS representative sent Nancy this data, (iii) did not acknowledge the existence and location of the UBS account in Part III to Schedule B to the 2007 Form 1040, and (iv) did not file a timely FBAR reporting the UBS account. The DOJ also underscored that Nancy self-prepared the 2007 Form 1040, and both Nancy and Burt swore to its accuracy and completeness under penalties of perjury. According to the DOJ, the evidence "presents a quintessential example of willful failure to disclose a foreign bank account."[18]

Citing to the standards of willfulness described in *Williams*, *McBride*, and *Bohanec*, the DOJ presented a number of positions to the court. First, Nancy admitted that she had actual knowledge about the existence of the UBS account and her authority over it starting in 2006. Second, Nancy had actual knowledge of her duty to report foreign accounts, as evidenced by the fact that she filed an FBAR for 2003 and she disclosed the existence of foreign accounts and their locations (*i.e.*, Switzerland and France) on Forms 1040 for 2004 and 2005. Third, proof of her intent to hide the UBS account includes her awareness that the holding of the previous foreign account, at Bank Sarasin in Switzerland, was supposed to be secret, as well as a series of emails that she sent her accountant, Peter Kent, in later years revealing her mindset and desire to hide money from the IRS through trusts. Finally, the fact that Nancy took no steps to understand her foreign account reporting obligations constitutes, at a minimum, willful blindness and reckless disregard of U.S. law.

Nancy raised some justifications for her FBAR noncompliance in response to interrogatories from the DOJ. For example, she indicated that Burt handled the banking business and thus she was unaware of her financial interest in or authority over the UBS account in 2007, she could not file an FBAR for Burt for 2007 because he was already suffering from advanced dementia at that time, she was taking strong prescription medications in connection with a serious automobile accident, and she was doing her best, alone, without the assistance of an accountant or Burt. Nancy summarized her position in the following manner in response to an interrogatory: "I signed whatever our professional tax preparers prepared for us, and in later years when I tried to do it by myself I made a very ineffective attempt to mimic their work."

Decisions by the Court

The court records tend to indicate that Nancy and Burt retained at least two reputable U.S. law firms to defend them throughout the FBAR litigation, but they ceased to participate when the taxpayers stopped paying their fees, refused to follow their advice, and/or insisted on disobeying court mandates regarding discovery and other matters. Ultimately, the DOJ asked the court to find in its favor, by filing a Motion for Default Judgment (related to Burt's estate) and a Motion for Summary Judgment (related to Nancy). Nancy never filed any documents with the court opposing the DOJ's requests, so the court ruled in favor of the DOJ in both instances.

Unlike the previous civil willful FBAR penalty cases, particularly *Williams*, *McBride*, and *Bohanec*, *Kelley-Hunter* was not a hard-fought legal battle, characterized by extensive discovery, testimony, and briefing. Accordingly, the court had no need to issue a long opinion explaining the law, clarifying conflicting facts, *etc*. It stated, quite simply, that the key element, willfulness, "can prove challenging to establish, but not here." In deciding that willfulness existed and that the DOJ was entitled to collect the FBAR penalties against both Burt's estate and Nancy, the court noted the following: (i) Nancy personally prepared and filed Forms 1040 disclosing foreign accounts, such that she was aware of the obligation; (ii) Nancy sent emails to her accountant, Peter Kent, "that display a consciousness of guilt;" and (iii) Willful blindness satisfies the required mental state for a willful FBAR violation, and Nancy "certainly acted with at least that degree of intent."

Why *Kelley-Hunter* Is Interesting

Every FBAR case, regardless of whether it involves willful or non-will penalties, contains interesting information that might be valuable to future taxpayers facing the wrath of the IRS and/or DOJ. *Kelley-Hunter* is no exception to this rule. It features a few noteworthy issues, three of which are discussed below.

Using the Taxpayer's Own Words Against Her

Maintaining communications with clients confidential is always critical, but it acquires additional importance when dealing with international tax and FBAR issues, which can trigger large penalties. Tax professionals use many theories to safeguard their communications from the U.S. government, with the big three consisting of the attorney-client privilege, federal tax practitioner privilege under Code Sec. 7525, and work-product doctrine. A detailed explanation or analysis of these tools far exceeds the scope of this article; identifying them suffices to frame an important issue in *Kelley-Hunter*.

In determining that Nancy and Burt acted willfully in not filing a 2007 FBAR to reveal their UBS account, the court gave considerable weight to three items. One was the series of emails that Nancy sent to her accountant in 2012, many years after the 2007 FBAR violation, which occurred way back on June 30, 2008. From the perspective of the court, such emails by Nancy to Peter Kent, who was not even working for Nancy and Burt during the time of the violation, "display a consciousness of guilt."

Below are relevant portions of certain emails from Nancy to Peter Kent in 2012 and 2013, obtained by the DOJ through the pre-trial discovery process:

- "We discussed it and both agree that the Assurance Vie [account] could be considered like an IRA and the unreceived income/interest need not be declared. Make it look similar to last year and I don't think anybody will notice. And I'll write to you from the federal pen. Just saw Escape From Alcatraz and am sure I could work my way out and join you at the vegetable stand in Tahiti."
- "We don't pay income tax in France, only two residence taxes and the worldwide wealth tax (which we've never paid, but owe). It is possible that the assurance vie might be considered a retirement account and I think that's a good idea to call it that. We're in enough trouble with the IRS already, so what's one more arrow in the quiver. And I also think that they are so far behind with the UBS junk, that they won't catch up with [Burt] in his lifetime and I'll be on my way to Tahiti. So leave out the assurance vie dividend and let's go for it."
- "Our case has reached the top of the IRS file in Scranton and they are looking into it now, saying that they might offer us the original deal for self-disclosures. I don't want to hire [the former tax attorney] again as she would cost us a fortune but I am afraid that they can attach our funds in the US to pay all the huge fines, back taxes, and penalties. Does the Hunter Family Trust actually exist and could our retirement monies be safely put into it? … I would be willing, shamelessly of course, to throw myself on the mercy of the IRS as I wanted to do back in 2003. I'm a pretty good actress."
- "When you saw [the relevant individual], did he talk at all about the [Hunter Family] Trust? I need to know if it still exists and, if it does, if that might be a place to put some money … I am getting terribly spooked about this whole [IRS] thing, crazier than before, if

> that's possible. It is a constant worry and is making me sick and old. Is talking on the phone secure as I am starting to get paranoid on top of everything else."

As indicated above, the court records indicate that Nancy and Burt retained two different, reputable, U.S. law firms to defend them in connection with the FBAR matter and that such firms later terminated representation for what appears to be failure to pay legal fees, follow advice of counsel, and/or respect court orders. Because tax counsel was not involved at the end, objections to the use of the emails based on privilege, relevancy, authenticity, *etc*. were neither raised by Nancy nor addressed by the court. Nevertheless, *Kelley-Hunter* still underscores some important lessons, including (i) in FBAR penalty litigation, the DOJ generally uses its broad discovery powers to gather as much information as possible about the alleged willfulness by the taxpayer, which covers email communications, (ii) taxpayers embroiled in any type of audit, investigation, or litigation with the IRS or DOJ should be cautioned about making anything that might be construed as an "incriminating" statement, either orally or in writing, to anyone other than their attorneys, (iii) specific procedures must be established and followed in order to enjoy protection from the attorney-client privilege, tax practitioner privilege, and/or work-product doctrine, and (iv) in the absence of adequate defenses raised by taxpayers or their legal counsel, courts might be willing to consider, and even give significant weight to, after-the-fact emails sent by taxpayers commenting on tax and FBAR issues.

Reduction of FBAR Penalties

Kelley-Hunter is also interesting because it shows the IRS's relatively new philosophy with respect to FBAR penalties.

As indicated above, the balance in the UBS account at the time of the 2007 FBAR violation was $3,430,500, and both Nancy and Burt had a reportable interest in the account. Consequently, the IRS initially asserted a total penalty of $3,430,500, which was comprised of two separate penalties, against each of Nancy and Burt, equal to 50 percent of the value of the account, or $1,715,250. Few would argue that this is not a stringent penalty; the IRS can seize the entire account for one failure to timely report it on an FBAR.

After the time that the IRS assessed the FBAR penalties in December 2013, but *before* the DOJ filed the collection lawsuit in December 2015, the IRS changed its tune regarding the appropriate size for a penalty. This modification was announced by the IRS in May 2015, when it issued Memorandum SBSE-04-0515-0025, called "Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties." The official purposes of such "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 *Kelley-Hunter* have been marked:

> 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.
>
> *Example*: Assume highest aggregate balances of $50,000, $100,000, and $200,000 for 2010, 2011, and 2012, respectively. The total penalty amount is $100,000 (50 percent of the $200,000 highest aggregate balance during the years under examination). The total of the highest aggregate balances for all years combined is $350,000. The penalty for 2010 is $14,286 ($50,000/$350,000 × $100,000). The penalty for 2011 is $28,571 ($100,000/$350,000 × $100,000). The penalty for 2012 is $57,143 ($200,000/$350,000 × $100,000). The penalty amounts for each year are subject to the maximum penalty limitation in 31 U.S.C. § 5321(a)(5)(C).
>
> Examiners may recommend a penalty that is higher or lower than 50 percent of the highest aggregate account balance of all unreported foreign financial accounts based on the facts and circumstances. *In no event will the total penalty amount exceed 100 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination*.

In addition, the "Interim Guidance" provides instructions for cases involving unreported foreign accounts with more than one U.S. owner. Again, the portions applicable to *Kelley-Hunter* have been marked.

> Where there are multiple owners of an unreported foreign financial account, examiners must make a separate determination with respect to each co-owner of the foreign financial account as to whether there was a violation and, if so, whether the violation was willful or non-willful. *For each co-owner against whom a penalty is determined, the penalty will be based on the co-owner's percentage ownership of the highest balance of the foreign financial account. If examiners are unable to determine a co-owner's percentage ownership, the penalty will be based on the amount determined by dividing the highest account balance equally among the co-owners*.

In summary, *Kelley-Hunter* allows us to experience the application of the IRS's "Interim Guidance" on FBAR penalties, which was not available to help taxpayers involved in earlier willful FBAR penalty cases, *i.e.*, those resolved before May 2015. The "Interim Guidance" made a significant financial difference in *Kelley-Hunter*, decreasing the total penalty from $3,430,500 to $1,715,250.

Additional Issues—Income Taxes and Form 5471 Penalties

As a collection lawsuit in District Court initiated by the DOJ, *Kelley-Hunter* focused solely on FBAR penalty issues. However, it is important to understand that, based on the limited information available from the court record, Nancy and Burt likely had other problems with the IRS, too. The two biggest that come to mind are penalties for failure to file Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*) and federal income taxes.

Four categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations ordinarily must file a Form 5471 with the IRS:[19]

- A Category 2 filer is a U.S. individual (*i.e.*, U.S citizen or U.S. resident) who is either an officer or director of a foreign corporation in which a U.S. person has acquired during the relevant year (i) stock in the foreign corporation that meets the "10 percent ownership test," or (ii) an additional 10 percent or more of the stock of the foreign corporation.
- A Category 3 filer includes several types of persons, including any U.S. person who acquires stock in a foreign corporation, and when such stock is added to any stock that the U.S. person already owns, he meets the "10 percent ownership test" described above.
- A Category 4 filer is a U.S. person who had "control" of a controlled foreign corporation ("CFC") for an uninterrupted period of 30 days during the relevant year, which means that such U.S. person held more than 50 percent of the stock of a CFC, by vote or value. For these purposes, a "CFC" is a foreign corporation that has "U.S. shareholders" who/that own (directly, indirectly, or constructively) more than 50 percent of the total voting power or stock value of the foreign corporation on any day of the relevant year.
- A Category 5 filer is a "U.S. shareholder" who/that owns stock in a foreign corporation that is a CFC for at least 30 uninterrupted days during the relevant year and who/that held the stock on the last day of the relevant year. In this context, the term "U.S. shareholder" means any U.S. person who/that owns (directly, indirectly, or constructively) 10 percent or more of the foreign corporation, by vote or value.

Form 5471 is filed as an attachment to the U.S. person's federal income tax return, which, in the case of individuals, is Form 1040.[20] If a person fails to file a Form 5471, files a late Form 5471, or files a timely but "substantially incomplete" Form 5471, then the IRS may assert a penalty of $10,000 per violation, per year.[21]

The standard penalty of $10,000 per year, per violation can hurt a taxpayer, but the real issue with Form 5471 violations is time. A relatively obscure provision, Code Sec. 6501(c)(8)(A), states that where a taxpayer fails to file a timely Form 5471 (and/or a long list of other international information returns), the assessment-period remains open "with respect to any tax return, event, or period" to which the Form 5471 relates until three years after the taxpayer ultimately files Form 5471.[22] The effect is that, if the taxpayer never files a Form 5471, then the general three-year assessment period never begins to run against the IRS. This prevents taxpayers with Form 5471 violations from "waiting out" the IRS.

In *Kelley-Hunter*, Nancy and Burt owned or controlled Tower International, Inc., a Mauritius corporation, through which they held the unreported account at UBS. Based on the court records, it appears that Nancy and Burt would have been required to complete and attach a Form 5471 to their annual Form 1040 for Tower International, Inc. To the extent that they failed to do so (which is likely considering that they did not report the UBS account on their 2007 Form 1040 or by filing FBARs), the IRS could assess, essentially at any time, a penalty of $10,000 per year, per Form 5471 violation. Moreover, to the extent that there was any unreported income on the Forms 1040 to which the Forms 5471 should have been attached, the IRS can assess taxes, too, thanks to Code Sec. 6501(c)(8).

Conclusion

The IRS has already received, and will continue to obtain, large amounts of data about foreign accounts held by U.S. persons thanks to cross-referencing of foreign account information on FBARs and Forms 8938, expanded reporting obligations by foreign financial institutions under the Foreign Account Tax Compliance Act, insight gleaned from hundreds of thousands of taxpayers participating in a variety of voluntary disclosure programs since 2009, public dissemination of the Panama Papers and similar events, deferred criminal prosecution agreements with foreign banks identified as "facilitators" of U.S. tax evasion, civil audits with an international focus, requests to foreign countries pursuant to bilateral treaties, whistleblowers, and more. The predictable result, of course, will be more FBAR penalty litigation in the future. As indicated earlier in this article, the five previous willful FBAR penalty cases generate a long list of lessons learned. *Kelley-Hunter* augments that list by showing that (i) taxpayers should ensure that the IRS is assessing proper, perhaps reduced, penalties in accordance with the "Interim Guidance" issued in 2015, and (ii) in determining whether an FBAR violation was willful, courts might be receptive to taking into account after-the-fact unprivileged communications between taxpayers and their tax advisors.

ENDNOTES

* Hale E. Sheppard specializes in tax audits, tax appeals, and tax litigation. You can reach Hale by phone at (404) 658-5441 or by email at *hale.sheppard@chamberlainlaw.com.*

1 *United States v. Kelley-Hunter*, DC-DC, 120 AFTR 2d 2017-5566.

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

3 Act Sec. 202 of the Bank Secrecy Act (P.L. 91-508), Title I and Title II (Oct. 26, 1970).

4 31 USC §5314; 31 CFR §1010.350(a).

5 68 FR 26489 (May 16, 2003).

6 31 CFR §103.56(g), 68 FR 26489 (May 16, 2003).

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

8 31 USC §5321(a)(5)(A) (as in effect before Oct. 22, 2004).

9 31 USC §5321(a)(5)(B)(ii) (as in effect before Oct. 22, 2004).

10 31 USC §5321(a)(5)(A).

11 31 USC §5321(a)(5)(B)(i).

12 31 USC §5321(a)(5)(B)(ii).

13 31 USC §5321(a)(5)(C)(i).

14 The Form 8938 filing duty first occurred in 2011, and Kelley-Hunter solely deals with 2007. Accordingly, Form 8938 was not addressed by the court. 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); and 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).

15 *J.B. Williams v. Commissioner*, 131 TC 54, Dec. 57,547 (2008); *United States v. Williams*, No. 1:09-cv-437, 2010 WL 347221 (E.D. Va. 9/1/ 2010); *United States v. Williams*, CA-4, 489 Fed Appx 655; *United States v. McBride*, 908 FSupp 2d 1186 (D. Utah 2012); *Bussell*, DC-CA, 117 AFTR 2d 2016-439; *United States v. Bohanec*, DC-CA, 118 AFTR 2d 2016-5537; and *Bedrosian v. United States*, DC-PA, 120 AFTR 2d 2017-5671.

16 For an analysis of all prior FBAR penalty cases, *see* Hale E. Sheppard, *Court Applies Reasonable Cause Defense to FBAR Setting: Early Teachings from Jarnagin*, ___ J. TAXATION ___ (2018), republished in ____ J. INT'L TAXATION __ (2018); Hale E. Sheppard, *First Taxpayer Victory in a Willful FBAR Penalty Case: Analyzing the Significance of Bedrosian for Future Foreign Account Disputes*, ___ J. TAXATION ___ (2018), republished in ____ J. INT'L TAXATION __ (2018); Hale E. Sheppard, *Can Recent "Willful" FBAR Penalty Cases against Taxpayers Help Tax Firms Fend Off Malpractice Actions?* 43(4) INT'L TAX J. 33 (2017); Hale E. Sheppard, *Government Wins Fourth Straight FBAR Penalty Case: Analyzing Bohanec and the Evolution of "Willfulness,"* 126(3) J. TAXATION 110 (2017), republished in 28(8) J. INT'L TAXATION 34 (2017); Hale E. Sheppard, *Government Wins Second Willful FBAR Penalty Case: Analyzing What McBride Really Means to Taxpayers*, 118(4) J. TAXATION 187–199 (2013); Hale E. Sheppard, *Third Time's the Charm: Government Finally Collects "Willful" FBAR Penalty in Williams Case*, 117(6) J. TAXATION 319 (2012); Hale E. Sheppard, *The Internal Revenue Service Giveth and the Department of Justice Taketh Away: Recent Opinion Jeopardizes Retroactive Administrative FBAR Relief*, 114(1) J. TAXATION 18–23 (2011); Hale E. Sheppard, *District Court Rules That Where There's (No) Will, There's a Way to Avoid FBAR Penalties*, 113(5) J. TAXATION 293–300 (2010); 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).

17 Complaint filed December 10, 2015; Answer filed October 28, 2016; Motion for Default Judgment as to Estate of Burt Hunter filed July 11, 2017; Order Granting Motion for Default Judgment as to Estate of Burt Hunter filed July 27, 2017; Motion for Summary Judgment against Nancy Kelley-Hunter filed October 16, 2017; Order Granting Motion for Summary Judgment against Nancy Kelley-Hunter filed December 12, 2017; and Memorandum Opinion filed December 12, 2017.

18 Complaint, at 1.

19 Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471.

20 Code Sec. 6038(a)(2); Reg. §1.6038-2(i).

21 Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §§1.6046-1(k).

22 Code Sec. 6501(c)(8)(B) contains a limitation, stating that the assessment period will open remain only with respect to "the item or items" related to the late Form 5472 if the taxpayer can demonstrate that the delinquency was due to reasonable cause and not due to willful neglect.