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Challenging the IRS's Assertion of the Non-willful FBAR Penalty: A New Hope

The current economic and political climate is very hostile towards foreign account holders. Many people have a vision of wealthy expats who throw Great Gatsby-esque parties, during which the attendees burn their delinquent tax notices with fondue candles as they cackle over bad jokes and gossip about people who aren't in the room. Many politicians are only too happy to promote this image.

Only a handful of court cases have considered the procedures and substance relating to FBAR penalties – until now. As a result, the procedures associated with imposing civil penalties are not well-established. In the case of Moore v. United States, the district court for the western district of Washington examined the procedures and standards that apply to penalties for non-willfully failing to file an FBAR. Its holdings were both good and bad for taxpayers.

Let's start out with the good. The judge issued a preliminary ruling stating that the IRS cannot spin the "Wheel of Misfortune" and arbitrarily determine the amount of a civil penalty in a Report of Foreign Banks and Financial Accounts (FBAR) failure to file case. Now for the bad. Moore violated the law by not filing FBARs and did not have reasonable cause for not filing. Nevertheless, the record before the court was insufficient for it to determine whether the amount of the penalties was appropriate.

The Moore case is important for taxpayers who are seeking to challenge the IRS's assertion of the nonwillful FBAR penalty. First, It discusses the constitutional challenges raised by Moore in opposing the IRS's imposition of non-willful FBAR penalties. And second, it explains the merits of Moore's reasonable cause defense – a defense that has spawned a significant amount of case law in the context of civil tax penalties, but little more than a "mole hill" of law in the context of FBAR penalties.

Let's waste no time and get right to the facts. James Moore probably does not even own a dinner jacket or an ascot tie, but he does own a bank account in Switzerland that originated in the Bahamas, where Mr. Moore relocated in 1989. And that was more than enough to put him on the IRS's radar screen. Mr. Moore did not file a FBAR for 20 years, even though the account balance never dipped below $300,000 and no exemptions applied. Around 2009, he approached the IRS through counsel as part of the Offshore Voluntary Disclosure Program. Both sides agreed that he owed about $18,000 in back taxes.

With that unpleasantness out of the way, the IRS began calculating the penalty. In October 2011, an

agent interviewed Mr. Moore via telephone for about five minutes. The agent never specifically said anything about penalties. Yet based on that conversation, and prior research, Agent Shu Lin Tjoa prepared a detailed, eight-page Summary Memorandum that recommended a $40,000 penalty, or $10,000 per year for 2005-2008.

At some point, someone also produced an "Appeals Memo." The Service refused to produce this second memo during discovery, and the Court agreed that it was confidential. Two months later, the Service sent Mr. Moore a bill for $40,000, but provided no explanation of the charges. Mr. Moore never saw the Summary Memorandum until it was produced during discovery.

Although the December 2011 letter said he could appeal and the IRS would hold off for another six weeks, the IRS reneged on its own promise (is anyone really surprised at that?) and almost immediately assessed a $10,000 penalty for 2005.

Mr. Moore appealed the assessment, and the Service responded with a three-sentence letter that began with the dreaded words "Dear Taxpayer" and ended with "Your case is now closed in Appeals." In addition to a payment coupon, the letter included an invitation to participate in an "appeals customer satisfaction survey." I'm not really a betting man, but I'd wager that Mr. Moore was not very satisfied at that particular moment. The Service said nothing about the remaining $30,000 in penalties, which were apparently hanging over his head like the sword of Damocles.

Mr. Moore eventually filed suit in 2013, alleging a host of Constitutional and Administrative Procedures Act (APA) violations. We'll get to those in a minute. He asked for a refund of the penalty he paid, and for the court to set aside the unassessed $30,000.

The Court's holdings, relating to the FBAR, are two-fold. First, it held that Mr. Moore committed non-willful violations of the Bank Secrecy Act by failing to file FBARs. However, that was not much of a shock considering that he admitted that he owed taxes and penalties right from the beginning. Remember, he was the one who came forward in the first place. Second, the Court made rulings regarding Mr. Moore's due process and APA claims, which are more relevant to our inquiry.

Some background information pertaining to Mr. Moore's APA claims is in order. The APA says that an agency – including the IRS – cannot act in a way that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." These claims are difficult to win, because the government gets the benefit of the doubt.

Now, we get to the heart of the matter. The Court explicitly ruled that it "Cannot, On the Record Before It, Determine if the IRS Acted Arbitrarily, Capriciously or Abused Its Discretion in Assessing the Penalties." That finding was the equivalent of a "one-two punch" to the IRS.

Even though a court presumes that an agency acted fairly in these situations, there must be some evidence in the record to support that presumption. Lawyers call this level of proof a scintilla. In other words, if there is a breadcrumb anywhere on the kitchen floor, the Court can presume that someone ate a pepperoni pizza with extra mushrooms from Dominos for lunch at 12:02 that day.

Judge Jones used a magnifying glass to look for a "crumb," and the only thing he found was the aforementioned three sentence "pay-or-else" letter. Although the Summary Memorandum was in the record, Mr. Moore didn't see it until he filed a lawsuit, so it doesn't count. Judge Jones looked at the case upside down, backwards, and sideways and bluntly concluded that he would not "rubberstamp a decision that lacks any explanation in the administrative record."

What does this mean for the IRS? The IRS must demonstrate that it had a rational basis for the $ 40,000 penalty and that Mr. Moore was at least somewhat in the loop. To do this, the IRS may simply supplement the record, and to the extent that the evidence it submits provides a rational basis for the $ 40,000 penalty, then Judge Jones' next order will be "roll on two."

However, there is a very good chance that this evidence does not exist. And in this alternative ending, an emotional Paul Edgcomb will quietly escort Mr. Moore out of the death house. From a practical point of view, the IRS may be in trouble. Unless there is something that we do not know, it does not appear as though the IRS can show that it had a rational basis for asserting the $ 40,000 penalty. On the contrary, it looks like the Service just gave Moore an account statement and informed him of his "right" to an appeal.

Will the phantom "Appeals Memorandum" help? Probably not, because it is unlikely that Mr. Moore saw it, or even knew of its existence, before he got the bill. On the other hand, the government's burden is very low. They only have to produce a scintilla. There may be a transcript of that October 2011 interview that gives some indication of the Service's thought process in the matter. Or, there may be a stray letter or email between the IRS and Mr. Moore's counsel.

In other words, there may be something the parties missed. Remember that any crumb will do. News flash! While most observers – myself included – expected the IRS to come forth with the scintilla of evidence required, and that would be the end of that, Judge Jones had different thoughts. In a decision that proves how dangerous it is to engage in idle speculation, Judge Jones ruled that he was not satisfied with the IRS' explanation and that these penalties were invalid.

Judge Jones reviewed supplemental briefs from both sides and had another look at the evidence in the record. The IRS only needed to produce a scintilla of evidence, which is basically a tiny scrap. So, if an agent had uttered the frightful words "penalty," "maximum," and "your" in the same sentence during a conversation with Mr. Moore, the Service probably would have met its burden of proof.

The IRS did produce the Penalty Summary Memo during discovery, but the court noted that it was only produced after litigation commenced. That will not do, because taxpayers should not be required to file suit to get an explanation of the charges. Judge Jones also chastised the Service for its conduct during the case; fighting the disclosure of the Penalty Summary Memo tooth and nail (Mr. Moore had to file a motion to compel) and "disregarding its own promise" with regard to the Appeals conference.

Reading between the lines, the judge seemed a bit miffed about the whole thing, so much of the ruling is very much fact-based. But the key takeaway is that, if the IRS sends an FBAR penalty notice, you can legitimately ask "says who?"