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U.S. v. ZWERNER: WILLFUL NON-FILINGS RESULT IN MONSTROUS CIVIL PENALTIES

United States v. Zwerner[23] illustrates the potential for monstrous civil penalties resulting from willful failure to file F.B.A.R.'s. It further confirms the point that, if evidence of willfulness exists even in a sympathetic case, the I.R.S. may assert willful penalties in the case of "silent" or "quiet" disclosures, which the I.R.S. and its officials have consistently warned in official and non-official statements.[24]

The facts of the case in brief are as follows:

From 2004 through 2007, Carl Zwerner, currently an 87-year-old Florida resident, was the beneficial owner of an unreported financial interest in a Swiss bank account that he owned indirectly through two successive entities. He did not report the income on the accounts for the period of 2004 through 2007, according to the complaint filed by the United States, but in his answer to the complaint, Zwerner, while admitting that he filed a delinquent F.B.A.R. for 2007, denied filing an amended return for that year, stating that his financial interest in the foreign account was reported on his timely-filed 1040 for that year. The complaint also alleged that, for 2006 and 2007, he represented to his accountant that he had no interest or signature authority over a financial account in a foreign country. Zwerner denied those allegations.

According to the answer to the complaint, Zwerner made, what he thought to be, a voluntary disclosure. However, he was poorly represented. His attorneys advised him that a voluntary disclosure occurred, and that he should file amended returns and delinquent F.B.A.R.'s based on the advice of his then "counsel," and he was subsequently audited in 2010. His defense appeared to be reasonable reliance on what he thought to be competent attorneys and for the fact that, under past and then-existing programs, the penalties would be substantially reduced if not eliminated, to the extent that an actual voluntary disclosure would have been made.

Pursuant to an audit, Zwerner apparently admitted that he was aware of his reporting obligations in a statement addressed to the I.R.S. in hopes – or promise –

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23 *United States v. Zwerner*, S.D. Fla., No. 1:13-cv-22082, 5/28/14.

24 *See*, *e.g.*, O.V.D.P. FAQ #15, encouraging participation in the O.V.D.P. and stating that "[t]hose taxpayers making 'quiet' disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years."

of reduced penalties.[25] Citing this admission, the I.R.S. assessed a penalty for willful failure to file an F.B.A.R. in an amount of 50% of the highest balance of the unreported account for every year of this four-year period. The penalties were as follows:

- 2004 - $723,762, assessed on June 21, 2011;
- 2005 - $745,209, assessed on August 10, 2011;
- 2006 - $772,838, assessed on August 10, 2011; and
- 2007 - $845,527, assessed on August 10, 2011.

Zwerner refused to pay the fines. The U.S. filed a complaint to collect on June 11, 2013. The total sum of the amount of the fines, plus interest and additional amounts, owed to the United States as of the date of filing was $3,488,609.33. Zwerner responded in an answer to the complaint with multiple defenses, including a defense based on the Eighth Amendment to the Constitution, which prohibits excessive fines.

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On May 28, 2014, a U.S. District Court jury ruled against the taxpayer *finding three willful violations* of failing to file an F.B.A.R.

The consequences to the 87-year old taxpayer were chilling: he faced civil penalties amounting to 150% of the highest balance on the unreported account plus interest and additional amounts. This by far exceeded the value of the defendant's unreported account. Attorneys representing Zwerner stated they would present an Eighth Amendment challenge to the fines. In *U.S. v. Bajakajian*,[26] the Supreme Court ruled that forfeiture of $357,114 transported out of the country in violation of statute requiring reporting of transport of more than $10,000 would constitute an excessive fine. The Supreme Court stated:

> The forfeiture of respondent's entire $357,144 would be grossly disproportional to the gravity of his offense. His crime was solely a reporting offense. It was permissible to transport the currency out of the country so long as he reported it. And because §982(a)(1) orders currency forfeited for a "willful" reporting violation, the essence of the crime is a willful failure to report. Furthermore, the District Court found his violation to be unrelated to any other illegal activities. Whatever his other vices, respondent does not fit into the class of persons for whom the statute was principally designed: money launderers, drug traffickers, and tax evaders. And the maximum penalties that could have been imposed under the Sentencing Guidelines, a 6-month sentence and a $5,000 fine, confirm a minimal level of culpability and are dwarfed by the $357,144 forfeiture sought by the Government. The harm that respondent caused was also minimal. The failure to report affected

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[25] The answer alleges that the I.R.S. agent coerced an admission through an empty promise of reduced penalties.

[26] 524 U.S. 321 (1998).

> only the Government, and in a relatively minor way. There was no fraud on the Government and no loss to the public fisc. Had his crime gone undetected, the Government would have been deprived only of the information that $357,144 had left the country. Thus, there is no articulable correlation between the $357,144 and any Government injury.

Ultimately, the I.R.S. and the defendant settled, leaving the Eighth Amendment challenge for another day.

Under the terms of the settlement, Zwerner agreed to pay to the U.S. two of the 50% FBAR penalties assessed against him relating to 2004 and 2005 in the amounts of $723,762 and $745,209 respectfully, plus interest thereon of $21,336.11 and $20,947.52 respectively, plus statutory penalties on the FBAR penalty assessments for 2004 and 2005 of $128,016.64 and $125,685.11 respectively.

The end result in Zwerner is bitter sweet for taxpayers. Facing four willful F.B.A.R. penalties, through litigating, Zwerner reduced it to two. However, two F.B.A.R. penalties, plus interest and penalties for late payment, is devastating to the taxpayer as the penalties exceed the balance of the unreported account. Further, although the U.S. settled, indicating doubt as to the strength of their position on the Eighth Amendment challenge, they can use this, and other cases, to incentivize taxpayers into compliance through voluntary disclosures as the Eighth Amendment issue remains unsettled.

U.S. v. HOM: NON-WILLFUL PENALTIES ON VARIOUS POKER RELATED ACCOUNTS

U.S. v. Hom[27] held that a taxpayer's accounts at an online financial company and at two online poker companies were F.B.A.R. reportable assets. As the assets were not reported on a timely filed F.B.A.R., the court upheld non-willful penalties that were assessed by the I.R.S.

The facts of the case can be summarized as follows:

During 2006, pro se defendant John Hom ("D") gambled online through internet accounts with PokerStars.com and PartyPoker.com. In 2007, D continued to gamble online through his PokerStars account. Both poker websites allowed defendant to deposit money or make withdrawals.

D used his account at FirePay.com, an online financial organization that receives, holds, and pays funds on behalf of its customers, to fund his online PokerStars and PartyPoker accounts. He deposited money into his FirePay account via his domestic Wells Fargo bank account or other online financial institutions, such as Western Union. In 2006, FirePay ceased allowing United States customers to transfer funds from their FirePay accounts to offshore internet gambling sites, so D

[27] 113 AFTR 2d 2014-XXXX, (DC CA), 06/04/2014.

used Western Union and other online financial institutions to transfer money from his Wells Fargo bank account to his online poker accounts. D admitted that at some points in both 2006 and 2007, the aggregate amount of funds in his FirePay, PokerStars, and PartyPoker accounts exceeded $10,000 in United States currency.

After the I.R.S. detected discrepancies in D's federal income tax returns for 2006 and 2007, the I.R.S. opened an F.B.A.R. examination. D did not file his 2006 or 2007 F.B.A.R.'s until June 26, 2010. Moreover, the 2006 submitted F.B.A.R. did not include his FirePay account.

On September 20, 2011, the I.R.S. assessed D with civil penalties for his non-willful failure to submit F.B.A.R.'s regarding his interest in his FirePay, PokerStars, and PartyPoker accounts. The I.R.S. assessed a $30,000 penalty for 2006, which included a $10,000 penalty for each of the three accounts, and a $10,000 penalty for 2007 based solely on defendant's PokerStars account.

The critical issue was whether D had an interest in a "bank, securities, or other financial account" for F.B.A.R. purposes. The Court stated as follows:

> While our court of appeals has not yet answered what constitutes "other financial account[s]" under 31 C.F.R. 103.24, the Court of Appeals for the Fourth Circuit found that an account with a financial agency is a financial account under Section 5314 … Under Section 5312(a)(1), a "person acting for a person" as a "financial institution" or a person who is "acting in a similar way related to money" is considered a "financial agency." Section 5312(a)(2) lists 26 different types of entities that may qualify as a "financial institution." Based on the breadth of the definition, our court of appeals has held that "the term "financial institution" is to be given a broad definition." . . . The government claims that FirePay, PokerStars, and PartyPoker are all financial institutions because they function as "commercial bank[s]." … The Fourth Circuit in Clines found that "[b]y holding funds for third parties and disbursing them at their direction, [the organization at issue]functioned as a bank [under Section 5314]." …

"Thus the court further held that '[a]s FirePay, PokerStars, and PartyPoker functioned as banks, defendant's online accounts with them are reportable.'"

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D also argued that even if he is liable, the amount of penalty assessed was too high because it might contravene the Internal Revenue Manual ("I.R.M."). However, the court stated:

> Our court of appeals, however, has foreclosed that argument by holding that "[t]he Internal Revenue Manual does not have the force of law and does not confer rights on taxpayers." Fargo v. Comm'r of Internal Revenue, 447 F.3d 706, 713 [97 AFTR 2d 2006-2381] (9th Cir. 2006). Thus, defendant's argument fails.

The case is interesting for a number of reasons, which include the following:

- D did not argue that the penalty should be on a per form basis and the court allowed assessment of the penalty on a per account basis.

- D was liable for $40,000 for non-willful violations for playing poker by simply failing to report his poker related accounts. It is unclear from the case what aggravating circumstances existed for the agent not to give an F.B.A.R. warning letter.

- The court states that the I.R.M. does not confer rights to the taxpayer. The I.R.M. provides mitigation guidelines in order to provide uniform consistency among examinations and also gives substantial discretion to the examiner to lower the penalty amount. It is not clear whether the examiner followed the I.R.M. or not; the court simply states that the I.R.M. does not provide rights to the taxpayer.