What is so civil about penalties, anyway?

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When it comes to tax law, governments have two main arrows in their quiver: governments require taxpayers to **pay** taxes that are assessed on the basis of income or other factors (such as specific transactions, use of certain resources, etc.) and also require that taxpayers **file** a number of forms and documents. The primary purpose of these documents is, at least theoretically, to ensure that a taxpayer is complying with all payment obligations, not to independently generate revenue.

But sometimes the reporting horse comes unhitched from the revenue cart. Consider the recent US court proceedings and jury verdict against Carl R. Zwerner, a resident of Coral Gables, Florida (you can read the US Department of Justice's press release on the decision here). Mr. Zwerner had maintained a secret bank account in Switzerland since the 1960s. He maintained the account in the name of two different foundations (i.e. not in his name and arguably in a manner designed to mask his access to the funds). The US government imposed penalties with respect to Zwerner's failure to comply with his US foreign bank account reporting (FBAR) obligations. The Florida jury found that Zwerner "willfully" failed to file FBAR reports for three tax years. This finding could allow the IRS to impose a penalty of one half (50%) of the balance in the Swiss account for **each year** that he willfully failed to file such reports. Even Swiss bank accounts only have two halves, so applying this penalty for each of the three years would more than deplete the entire value of the account. In this particular case, the result was an approximate $2.2 million in penalties for failure to report an account holding $1.4 million in funds. At first glance, it may be challenging to muster much sympathy for Mr. Zwerner, who apparently maintained a secret off-shore account for decades and used funds from this account to pay for personal expenses, including vacations.

However, this case presents a number of issues that bear serious consideration. Zwerner is now 87 years old. Moreover, the IRS did not learn of his account through a wiretap, cooperating Swiss banker, angry employee, embittered mistress, or other central casting favorite for tax dramas. Rather, the IRS learned of this account from Mr. Zwerner himself, who disclosed the account at issue in a timely filed 2007 return, which he filed after consultations with his tax attorney and the attorney's disclosure of the account to the IRS (albeit on an anonymous basis). The mustering of sympathy is thus perhaps less challenging than first appeared.

Moreover, the amount of penalty imposed – approximately 150% of the current account balance – is noteworthy, even if Mr. Zwerner were a spry 35-year-old drug lord whose abused wife and mistress jointly approached the IRS after learning of his human trafficking activities.[1] Recall that this "civil" (substance over form doctrine notwithstanding) penalty is meant to be an incentive for taxpayers to comply with their reporting obligations, not an independent revenue mechanism. Not all facts are available, but it seems safe to infer that the penalty imposed represents many years, if not decades, of the tax owing to the US government for income recognized on the funds in the account.

While the circumstances of this case are unusual in many ways (one assumes that there are only so many remorseful near-nonagenarian tax evaders with substantial balances in Swiss banks), a few useful

lessons do jump out of this case.

First, as has been repeatedly reiterated in this blog, the IRS is of the strong view that taxpayers interested in making a voluntary disclosure must participate in the appropriate program made available by the IRS (OVDI, OVDP, Streamlined, etc.). The history of this case indicates that actual participation in one of these quasi-official disclosure programs was not an option when Mr. Zwerner's attorney approached the IRS. Nevertheless, it would appear that the IRS viewed this case as an opportunity to remind taxpayers and their advisors that they have a strong distaste for "quiet" (i.e. not made through a prescribed administrative process) disclosures. In case this message was missed, the US Department of Justice included in its press release celebrating the jury verdict the observation that "the cost of not *coming forward and fully disclosing* a secret offshore bank account to the IRS can be quite high." [Emphasis added.] It is safe to assume that the reference to a disclosure which does not consist of "coming forward" or of "fully disclosing" is a mildly veiled warning to taxpayers still contemplating "quiet disclosures."

Second, the horse has left the barn (domestic) and the ship has sailed (cross-border) on whether reporting requirements will continue to be the procedural "younger sibling" of the more substantive payment obligations imposed on taxpayers. The FBAR requirement began as a banking law[2] designed to detect and penalize money laundering and associated crimes, and has now evolved into a tax reporting requirement and anti-avoidance mechanism with the potential to ensnare non-compliant taxpayers in general, rather than the previous target audience of more nefarious financial criminals. Nevertheless, taxpayers may be penalized more for failing to file the FBAR form than for failing to report the income earned in the account.

Third, the presence of the adjective "civil" does not reduce the potential bite of a penalty. There are many criminal penalties imposed under tax and other laws that pale in comparison to a 150% penalty on the entire balance of an account. US courts have a long history of analyzing whether a penalty is "civil" or "criminal" in nature. Courts use the test adopted by the Supreme Court in *Hudson v. U.S.*: whether the penalty is so "severe in purpose and effect" as to support a conclusion that a purportedly civil penalty is in fact criminal. However, mere amount will not be a sufficient indicator of whether a penalty is civil or criminal.[3] Professor Leslie Book addresses this point more thoroughly **here**. Nor is this issue limited to US tax law. In December 2014, the Supreme Court of Canada (SCC) will confront the issue of how excessive a penalty can be before its imposition must satisfy constitutional requirements applicable in criminal cases. In *Guindon v. R.*, the SCC will address the imposition, under section 163.2 of the *Canadian Income Tax Act*, of an approximate C$500,000 "adviser penalty" against a lawyer for issuing an opinion in support of a tax shelter investment. The opinion stated that the lawyer had reviewed documents giving effect to transfers of real property that were necessary to achieve the desired tax benefit. However, the lawyer had not reviewed the documents, and in fact the required transfers did not occur. One of the lawyer's arguments against the imposition of this penalty is that despite the severity of the penalty imposed, she was not afforded the procedural constitutional protections (including burden of proof) afforded to criminal defendants. While the SCC may be able, for now, to avoid addressing this question, this case is also a stark reminder that just as is frequently the case in criminal proceedings, the struggle between government revenue agents and non-compliant taxpayers is asymmetrical. A taxpayer's entire net worth or life savings may be on the line, while a single tax liability, even if substantial, will rarely have a significant impact on government finances. On the macro level, this asymmetry represents a tension to be addressed by courts and policy makers. On the micro level, it is yet another good reason why proper professional guidance is a necessity in today's complicated tax environment.

1. Tax professionals have limited opportunity to employ dramatic prose and thus I've taken some exaggerated liberties here.

2. The FBAR filing requirement is codified as part of the *Bank Secrecy Act*, which requires banks to report large cash transactions and other suspicious financial activity. Until recently, the Act's FBAR requirement was viewed as essentially an anti-money laundering provision, and authority for its enforcement rested with FinCen, a bureau within the U.S. Treasury charged with facilitating enforcement of laws against money laundering and other financial crimes.

3. This issue is strikingly similar to the difference between the deductibility of non-punitive damages and the non-deductibility of punitive damages, which has been a tenet of US tax law since *Tank Truck Rentals, Inc. v. Commissioner*, 336 U.S. 30 (1958).