FBAR Penalty Assessment and Enforcement

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SPECIAL REPORT

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Procedures for collection of FBAR assessments differ markedly from tax assessments, as the FBAR penalty is not classified as a tax penalty, and fluency with the standards and collection methods is vital when advising clients of relative risks.

For several years, offshore disclosures have been a point of heightened emphasis by the Internal Revenue Service (IRS), with significant penalties assessable for failures to comply with relevant requirements. In the offshore realm, the source of greatest consternation from a penalty perspective is FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). Willful failures to file an FBAR can lead to a statutory assessment of an annual penalty of $100,000 or 50 percent of the total balance of the foreign account per violation, whichever is greater. Nonwillful failures to file carry a penalty of $10,000 per violation under statute. For both willful and nonwillful failures, there is a six-year statute of limitations for assessments based on failures to file required FBARs. Fear of these penalties (and others assessable for failures to meet requirements related to international holdings) has spurred tens of thousands of U.S. persons to make voluntary disclosures with the IRS, with the programs raising more than $10 billion of revenue to date.

Recent developments have increased the likelihood that the IRS's compliance focus will shift from voluntary disclosures to assessments. Offshore programs have existed for several years; while programs are still used regularly and actively, diminishing returns can be expected at some stage (i.e., people who would rather hide their holdings will continue to do so, whether programs exist for a year or a decade). More important, however, the IRS's ability to obtain information on an individual's foreign accounts (rather than waiting for them to come forward) is increasing continually. Specifically, the Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 primarily to create a withholding and reporting system related to account holders with American connections. FATCA's passage led to agreements between the United States and a significant majority of prominent foreign countries regarding U.S. account holders. Under these intergovernmental agreements, the home country of a financial institution passes laws requiring the institution to provide information on U.S. taxpayers to the home country, with the home country then passing the information to the United States. In many instances, reciprocal obligations are imposed on the United States. In addition, a multitude of financial institutions have entered into agreements with the IRS regarding American account holders.

Given the increasing likelihood of a paradigm shift, an introduction to procedures for assessment and enforcement of FBAR penalties is beneficial. While FBAR caselaw is relatively sparse, the IRS has developed assessment standards that are primarily in the Internal Revenue Manual. As to enforcement, procedures for collection of FBAR assessments differ markedly from tax assessments, as the FBAR penalty is not classified as a tax penalty. Fluency with the standards and collection methods is vital when advising clients of relative risks.

Penalty assessment

Generally, U.S. persons with financial interests in or signature authority over foreign financial accounts must disclose their foreign holdings on an FBAR if the aggregate value of these accounts exceeds $10,000 during the calendar year.[1] U.S. persons include citizens or residents of the United States and numerous types of entities, including corporations, trusts, partnerships and limited liability companies created under U.S. law.[2] Reportable accounts for FBAR purposes include savings accounts, deposit accounts, demand deposit accounts, checking accounts, securities accounts and any other account maintained with a person engaged in the business of banking or securities.[3] Mutual funds and insurance/annuity policies with cash values are also reportable.[4] Stocks, bonds or similar financial instruments held directly by a person (rather than in a financial account), real estate or an account holding solely real estate, and safety deposit boxes are not classified as reportable accounts.[5]

A financial interest exists in an account when a U.S. person is the owner of record/holder of legal title or has the beneficial interest in the account.[6] A "beneficial interest" can exist, for example, when the owner of record/holder of legal title is (1) a person acting as an agent for the U.S. person, (2) a corporation in which the U.S. person owns greater than a 50 percent interest, (3) a trust in which a U.S. person is the trust grantor and has an ownership interest in the trust for tax purposes or (4) a trust in which a U.S. person either has a present beneficial interest in more than 50 percent of the assets or from which that person receives more than 50 percent of the income.[7] A trust beneficiary is not required to report the trust's foreign financial accounts on an FBAR if the trust, trustee of the trust or agent of the trust is a U.S. person and that person files an FBAR disclosing the trust's foreign financial accounts.[8]

Signature authority exists when an individual (alone or in conjunction with another) can control the disposition of money, funds or other assets held in a financial account by direct communication (in writing or otherwise) to the person with whom the financial account is maintained.[9] For purposes of determining whether the $10,000 threshold is met, aggregated values are used for all accounts in which any interest is maintained (including solely owned accounts, jointly owned accounts, direct financial interest accounts, indirect financial interest accounts and signature authority accounts).[10]

In prior years, the FBAR was filed by June 30, with no filing extensions available. However, beginning with the 2016 tax year (i.e., forms to be filed in 2017), the due date was changed to April 15, with a six-month extension available for filing.

Primary focus is typically given to reporting requirements in the FBAR context; however, there are also recordkeeping requirements. Any person with a financial interest in or signature authority over a reportable account must keep the following records: (1) name in which the account is maintained, (2) number or other designation identifying the account, (3) name and address of the foreign financial institution or other person with which the account is maintained, (4) type of account and (5) maximum value of each account during the reporting period.[11] These records must be kept for five years and be available for inspection.[12]

Assessment types

Various provisions of the Internal Revenue Manual contain detailed information on the process of penalty assessment in the FBAR context. The IRS is delegated authority to enforce civil FBAR matters, even though the requirement to report foreign accounts is codified in Title 31 of the United States Code, rather than Title 26 (discussed below in greater detail in the context of collection procedures).[13] FinCEN retains rulemaking authority for the FBAR.[14]

Assessable penalties for FBAR violations are delineated in 31 U.S.C. section 5321, with standards and guidance for these penalties further developed in the Internal Revenue Manual. Four primary civil penalties are used for FBAR violations: (1) negligence, (2) a pattern of negligent activity, (3) nonwillful violations and (4) willful violations.[15] As to the first two, failures due to negligence can subject an institution failing to comply with FBAR rules and regulations to penalties. If such an institution engages in a pattern of negligent activity, a penalty of $50,000 may be imposed.[16] These penalties apply only to trades and businesses, not to individuals.[17] There are no mitigation guidelines for the pattern of negligence penalty; the IRS says that this penalty is to be imposed only in "egregious" cases.[18]

Nonwillful violation penalties

As to the penalties assessable against individuals, nonwillful failures to file FBARs can be penalized up to $10,000 per account per year.[19] An exception to nonwillful penalty imposition applies if the relevant violation was due to reasonable cause, and the amount of the transaction or the balance of the account at the time of the transaction was reported properly.[20] For this penalty, mitigation guidelines apply, and examiners are given discretion in determining the penalty amount.[21]

The IRS says that, after May 12, 2015, in most instances examiners will recommend one penalty per open year (regardless of the number of accounts), despite its ability to assess "per account"; the penalty will normally be limited to $10,000.[22] This position appears to originate in an Interim Guidance Memorandum that the IRS issued on May 13, 2015, which recommended limitations on FBAR penalties.[23] The IRS does maintain that, in some circumstances, assessing separate nonwillful penalties per account will still be appropriate.[24] In no instance, however, should nonwillful penalties exceed 50 percent of the highest aggregated balance of all accounts to which the violations relate during the years at issue, as this is the level of penalty appropriate for willful violators (as discussed below).[25] In certain instances, examiners may determine that multiple $10,000 nonwillful penalties are inappropriate despite nonwillful failures covering multiple years: When this is the situation, a one-year $10,000 penalty may be assessed.[26] The IRS has indicated informally that when markers of willfulness exist but do not rise to the required level to assert a willful penalty, assertion of a higher nonwillful penalty (compared with a situation where no indicia of willfulness existed) may occur.

Willful violation penalties

Willful violations of FBAR requirements create assessable penalties in the amount of the greater of $100,000 or 50 percent of the amount of the balance of unreported accounts at the time of the violation.[27] The penalty applies to both the reporting and record-keeping requirements; the IRS says that there may be both a reporting and record-keeping violation regarding each account.[28] The IRS indicates that, for penalty computation purposes, the amount in the account as of June 30 (the historical FBAR due date) is the amount to use in calculating the violation.[29] Presumably, given the recent FBAR deadline modifications and extension availability, penalties for prospective failures will be assessed based on the value as of April 15 (or, if the FBAR requirement is extended but not filed, as of October 15).

The burden of establishing willfulness rests with the IRS, which says that, in this context, "willfulness" is defined as a voluntary, intentional violation of a known legal duty.[30] "Willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements. In an FBAR situation, the person only need know that a reporting requirement exists. If a person has that knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR."[31]

Many (if not the majority of) individuals who become aware of retroactive failures indicate that previously they had no familiarity or direct knowledge of the FBAR form itself; when this is the situation, the concept of willful blindness becomes relevant. Under the IRS's standards, willfulness is attributed to individuals who exhibit willful blindness, defined as circumstances where a person makes a "conscious effort" to avoid learning of FBAR requirements.[32] In its discussion of willful blindness, the IRS references questions concerning financial accounts at foreign banks on Schedule B of Form 1040. Noting that this section of the income tax return refers individuals to instructions that provide FBAR information, the IRS says, "It is reasonable to assume that a person who has foreign bank accounts should read the information specified by the government in tax forms. The failure to act on this information and learn of the further reporting requirement, as suggested on Schedule B, may provide evidence of willful blindness on the part of the person."[33] However, the IRS also says that the "mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, in itself, to establish that the FBAR violation was attributable to willful blindness."[34]

The above position is largely consistent with the Fourth Circuit Court's position on willfulness in *Williams*, 110 AFTR2d 2012-5298, 489 Fed. Appx. 655 (CA-4, 2012), one of the primary sources of guidance in the FBAR context. Williams' 2000 tax return contained the aforementioned Schedule B inquiry to which he answered "no." Though Williams' accountant prepared his return for 2000, the court said that by filing his 2000 tax return, Williams had declared "under penalty of perjury that he had examined [the] return and accompanying schedules and statements and that, to the best of his knowledge, the return was true, accurate, and complete."

The court said that signing the return creates constructive knowledge of the return's contents, and provides prima facie evidence that the signing party knew the contents of the return. The court also said that the question regarding foreign accounts put Williams on inquiry notice of the FBAR requirement. Though Williams testified that he never read that part of the return, the court said that his failure to do so constituted "a conscious effort to avoid learning about reporting requirements," and his answer on the return that he had no foreign accounts evidenced "conduct that was meant to conceal or mislead sources of income or other financial information." This conduct constituted willful blindness of the FBAR requirement. Ultimately (after consideration of other factors also evidencing willfulness by Williams), the court found that Williams had acted willfully in failing to file the required FBAR.

The IRS concedes that willfulness typically cannot be proven by direct evidence; thus, reasonable inferences are to be drawn from available facts.[35] In its list of factors evidencing willfulness, the IRS emphasizes the weight given to an individual's efforts to conceal his or her foreign account (e.g., if the individual uses funds for daily living expenses in a manner that conceals the source of the funds).[36] Curiously, another factor stated as evidence of willfulness is costs associated with foreign investment management firms that are significantly higher than they would be for the same services domestically.[37] Additional items that support a willful FBAR penalty include nondisclosure of a foreign account to a return preparer, lack of business reasons for the account and lack of family/business connection to the country where the account is located. Conversely, factors not supporting a willful FBAR penalty include that the account was inherited, disclosure of the foreign account to the return preparer and a legitimate connection to the country where the account is held. Representations have also been made that white-collar workers can be held to a higher standard/expected degree of knowledge than others (rightly or wrongly). Fraud technical advisors can be used to develop the rationale for the willful FBAR penalty.

While statutory authority for penalty imposition is enormous, relevant Internal Revenue Manual provisions provide significant limitations. The IRS says that, in accordance with SBSE-04-0515-0025, in most instances 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 all years under examination.[38] A higher penalty can be recommended based on the facts and circumstances presented; however, the IRS says explicitly that 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."[39] At least a portion of the IRS's desire to limit penalty assessment likely comes from concerns (which practitioners have raised already) that FBAR penalties could be found to violate the Eighth Amendment's Excessive Fines Clause whereby civil penalties cannot be grossly disproportionate to the violation at issue.

There are ample grounds for arguing a client's specific facts with the intention of minimizing penalty assessment.

Mitigation/examiner discretion

Mitigation guidelines are provided for FBAR penalties. When mitigation threshold conditions are met, an assessed individual can be subject to a penalty less than the maximum amount permissible. Examiners have additional discretion to determine that a penalty provided in the Internal Revenue Manual is not appropriate or that a lesser penalty amount should be imposed.[40] In some instances, warning letters (rather than a financial penalty) may be issued.[41] The IRS says that amounts at issue will be a factor as to whether examiner discretion for penalties is appropriate.[42] When no financial penalty is assessed, a warning letter is required.[43] The IRS says explicitly that while FBAR penalties have upper limits, there is no floor for minimum penalty requirements.[44] This (accurate) statement gives the IRS further discretion in determining penalty amounts. Thus, there are ample grounds for arguing a client's specific facts with the intention of minimizing penalty assessment.

Penalty enforcement

As part of the assessment process, the examiner is to discuss penalties with his or her group manager. When penalties are deemed appropriate but a criminal referral is not required, penalties are asserted in accordance with the aforementioned guidelines.[45] After determination of penalties, the examiner submits his or her case to a counsel FBAR area coordinator. Counsel normally renders legal advice on the appropriateness of the penalty recommended within 45 days (in some instances, more time for advice can be required).[46] Counsel's ultimate role is to determine whether the evidence that the examiner gathered is sufficient to support the penalty that the examiner and his or her group manager asserted. To this end, the examiner normally prepares a memorandum for counsel outlining the relevant facts. Counsel can recommend either a higher or lower penalty and can also advise not to assert a penalty. In some instances, counsel will consult with an associate chief counsel in making a determination.[47]

If an agreement is reached that penalties are proper, the examiner issues the FBAR 30-day letter (Letter 3709) and the FBAR Agreement to Assessment and Collection (Form 13449).[48] No interest accrues on FBAR penalties prior to assessment; thus, if full payment is made within 30 days after the date that a notice of the penalty amount due is first mailed to the filer, only the penalty amount will be owed.[49] A six percent delinquency penalty applies to amounts remaining unpaid 90 days from the date that a notice of the penalty amount due is first mailed to the filer in addition to interest on the amount owed.[50]

When an FBAR penalty is proposed but not agreed to by the individual against whom it is asserted, the examiner must wait to see if the penalized individual will appeal the assessment; the individual has 45 days to appeal.[51] To appeal, the individual must mail a written protest that is postmarked before the designated response date listed in Letter 3709 (containing all information indicated as required under Letter 3709) in duplicate to the examiner.[52] If an appeal is received, the group manager reviews the case file and then forwards the case to Appeals.[53]

Post-assessment FBAR cases are a priority and require expedited handling by Appeals.[54] Post-assessment FBAR cases in excess of $100,000 cannot be compromised by Appeals without approval by the Department of Justice.[55] Functionally, this provides limitations on the ability of Appeals to settle FBAR matters.

When an FBAR penalty is proposed but not agreed to by the penalized party, and the penalized party does not respond to the Letter 3709, the penalty is assessed and the collection process begins.[56] If penalties have not been paid in full, Notice and Demand for Payment (Letter 3708) is issued. The collection information is then forwarded to the Financial Management Service.[57]

Collection

FBAR penalties are classified as debts owed to the U.S. government; standards for collection of nontax penalties are expounded by statutes and regulations.[58] Government entities will send at least one, but normally no more than two, notices of a debt owed to an individual before commencing collection action.[59] Such notices are required to explain in full the debts owed and enforcement measures authorized for use in collection.[60] When debtors cannot pay amounts owed in full, regular installment payments can be made instead.[61] In certain instances, debts can be compromised.[62] When a debt is determined to be uncollectible, collection activity can be suspended or terminated.[63]

FBAR penalties are collected primarily through two methods: The government can **(1)** offset payments due to a penalized individual, or **(2)** file civil actions to collect the penalty. The ability to offset payments has no limitation period, but any civil action filed to recover an FBAR penalty must be brought within two years. The two-year period begins on the later of the date of penalty assessment or the date that a judgment becomes final in a criminal action.

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It is vital to juxtapose the collection methods available for FBAR penalties with those for traditional tax penalties under Title 26. Under Title 26, levies and liens can be obtained without court approval. In the FBAR context, this is not permitted because FBAR penalties are not classified as tax penalties.[67] Penalty collection methods are more restrictive, as the "special" provisions in Title 26 related to collection do not apply. Since methods under Title 26 cannot be used, collection is accomplished through the procedures generally used to collect debts owed to the United States.

Methods for collection by the government include (1) administrative offsets, (2) tax refund offsets, (3) federal salary offsets, (4) referrals to private collection contractors, (5) referrals to agencies operating a debt collection center, (6) reporting delinquencies to credit reporting bureaus, (7) garnishing wages of delinquent debtors and (8) litigation or foreclosure.[68]

Administrative offsets may be used only after the debtor receives written notice of the claim and an opportunity (1) to inspect and copy records related to the claim, (2) for review within the agency for the claim and (3) to make a written agreement with the head of the agency to repay.[69] For tax refund offsets, no agency may take action until it (1) notifies the person incurring the debt of the proposed action, (2) gives the person at least 60 days to present evidence that the debt is not past due or not legally enforceable, (3) considers evidence related to the same and (4) certifies that reasonable efforts have been made to obtain debt payment.[70] Additional restrictions apply in the context of federal salary offsets and wage garnishments, with a general 15 percent imposition limitation applicable.[71]

Treasury entities do not extend loans, loan guarantees or loan insurance to any person delinquent on a debt owed to a federal agency.[72] Licenses, permits and other privileges may also be revoked or suspended for inexcusable or willful failures of a debtor to pay debts owed.[73] When debts are collected but then waived or otherwise found not to be owed, refunds are to be issued promptly; however, refunds do not bear interest unless otherwise required by law.[74]

Given limitations regarding offsets of payments, the government's best option to collect penalties in full is often to file a civil action; however, as stated above, a two-year statute of limitations applies.[75] Delinquent debts are referred to the Department of Justice for litigation after aggressive collection activities have been taken if the debts should not be compromised and collection activity should not be suspended or terminated.[76] The venue for FBAR penalties is the U.S. District Court and the Federal Court of Claims (rather than the Tax Court).[77] Where a suit is filed and the government succeeds, an enforceable judgment exists, expanding collection options.

Conclusion

While FBAR reporting standards are often gauged appropriately as complex, the complexities can feel miniscule when compared with those associated with assessment and enforcement of FBAR penalties. As can be gleaned from the above, although the IRS maintains standards for penalties (e.g., willful versus nonwillful violations), these standards are far from clear-cut, and significant variances can exist in assessment amounts within penalty categories. Enforcement measures after assessment are similarly complicated, with the government maintaining numerous options for collection that differ significantly from those used for tax debts. Given the increasingly global landscape and potential shifts in FBAR compliance focuses, the number of clients for whom the above issues can be relevant is ever increasing. General familiarity with assessment and enforcement standards in the FBAR context is thus recommended, particularly if and when assessments become more widespread.

1 31 C.F.R. section 1010.350(a).
2 31 C.F.R. section 1010.350(b).
3 31 C.F.R. section 1010.350(c).
4 *Id.*
5 IRM 4.26.16.3.2.3.
6 31 C.F.R. section 1010.350(e).
7 *Id.*
8 IRM 4.26.16.4.3.2.
9 31 C.F.R. section 1010.350(f).
10 IRM 4.26.16.3.6.3.
11 31 C.F.R. section 1010.420.
12 *Id.*
13 IRM 4.26.16.2.3.
14 *Id.*
15 31 U.S.C. section 5321(a).
16 31 U.S.C. section 5321(a)(6).
17 IRM 4.26.16.6.3.2.
18 IRM 4.26.16.6.3.5.
19 31 U.S.C. section 5321(a)(5)(B)(i).
20 31 U.S.C. section 5321(a)(5)(B)(ii).
21 IRM 4.26.16.6.4.3.
22 IRM 4.26.16.6.4.1.1.
23 SBSE-04-0515-0025.
24 IRM 4.26.16.6.4.1.3.
25 IRM 4.26.16.6.4.1.
26 IRM 4.26.16.6.4.1.2.
27 31 U.S.C. section 5321(a)(5)(D).
28 IRM 4.26.16.6.5.4.
29 IRM 4.26.16.6.5.5.
30 IRM 4.26.16.6.5.1.
31 IRM 4.26.16.6.5.1.3.
32 IRM 4.26.16.6.5.1.5.
33 *Id.*
34 *Id.*
35 IRM 4.26.16.6.5.2.
36 IRM 4.26.16.6.5.2.2.
37 *Id.*
38 IRM 4.26.16.6.5.3.
39 IRM 4.26.16.6.5.3.3 (emphasis added).
40 IRM 4.26.16.6.7.
41 *Id.*
42 *Id.*
43 IRM Ex. 4.26.16-1.
44 IRM 4.26.16.6.4.4.
45 IRM 4.26.17.4.3.1.
46 IRM 4.26.17.4.3.5.
47 *Id.*
48 IRM 4.26.17.4.3.6.
49 IRM 4.26.17.4.3.6.5.
50 *Id.*
51 IRM 4.26.17.4.6.1.
52 IRM 4.26.17.4.6.2.
53 IRM 4.26.17.4.7.3.
54 IRM 8.11.6.8.3.1.
55 IRM 8.11.6.1.6.
56 IRM 4.26.17.4.6.3.
57 IRM 4.26.17.4.6.6.
58 31 C.F.R. section 5.1.
59 31 C.F.R. section 5.4.
60 *Id.*
61 31 C.F.R. section 5.6.
62 31 C.F.R. section 5.7.
63 31 C.F.R. section 5.8.
64 IRM 8.11.6.3.1.1.2.
65 *Id.*; see also 31 U.S.C. section 3716(e)(1).
66 31 U.S.C. section 5321(b)(2).
67 *See Simonelli*, 614 F. Supp. 2d 241 (DC CT, 2008).
68 31 U.S.C. section 3711(g)(9).
69 31 U.S.C. section 3716(a). The FBAR is a debt to a U.S. executive agency; IRS is authorized to use collection methods enumerated as it is a Treasury entity. The head of any executive, judicial or legislative agency is authorized to collect under section 3716.
70 31 U.S.C. section 3720A(b).
71 31 U.S.C. section 3720D(b)(1).
72 31 C.F.R. section 5.17(a).
73 31 C.F.R. section 5.17(b).
74 31 C.F.R. section 5.19.
75 IRM 8.11.6.3.1.1.2.
76 31 C.F.R. section 5.16(b).
77 IRM 8.11.6.1.18.

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