When Penalties Are Excessive– The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty

By Steven Toscher and Barbara Lubin

Steven Toscher and Barbara Lubin examine how the Excessive Fines Clause of the Eighth Amendment may limit the IRS's ability to impose an excessive FBAR penalty.

Over the last five years, international tax enforcement has become a high priority for the IRS, both as an outgrowth of the globalization of the U.S. economy and the realization that taxpayer compliance with our international tax regime is in need of improvement. The compliance problem is attributable to a number of factors, including the breadth and complexity of the U.S. tax regime, which imposes income tax on transactions that occur beyond our borders; the difficulty of enforcing compliance where documents, people and information are outside the United States; and what might be referred as a historical and ingrained "Las Vegas" attitude of many taxpayers when it comes to disclosing their offshore transactions, that is, what happens overseas should stay overseas.

Congress attempted to increase compliance with international reporting in 2004 by drastically increasing the penalties imposed on U.S. taxpayers who "willfully" fail to report the existence of their foreign financial accounts. U.S. taxpayers are required to report the existence of certain foreign financial accounts on their federal income tax returns and are also required to file a Report of Foreign Bank and Financial Account, formally known as TD F 90-22.1, and disclose the details of the account (hereinafter, "FBAR").[1] The disclosure requirement is separate and apart from the duty to report and pay tax on the income earned on the account.

Failing to disclose an offshore account can subject a taxpayer to severe penalties. There are three separate monetary penalties authorized for FBAR reporting violations: (1) criminal fines for willful violations; (2) civil penalties for willful violations; and (3) civil penalties for nonwillful violations.[2] The statute authorizes the stacking of civil and criminal fines for the same violation.[3] Since the first enactment of FBAR reporting obligations in 1970, up until the recent legislation under the American Jobs Creation Act of 2004,[4] the civil penalty for willful violations could be up to $100,000 per violation. Notwithstanding the fact that few, if any, penalties were ever imposed for violations during the almost 40-year history of the reporting requirement, Congress increased the civil penalty for willful violations to an amount up to the greater of $100,000 or 50 percent of the balance in the account at the time of the violation.[5]

The legislative provision amending the FBAR penalties originated in the Senate and only included the addition of a penalty for nonwillful reporting violations. Only in the Conference Committee was the increased penalty for willful violations added to the legislation. The legislative history to the 2004 Jobs Act provides no rationale for increasing the willful FBAR penalty from a maximum of

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$100,000—to an amount up to 50 percent of the foreign bank account. The legislative history focuses entirely on adding a penalty of up to $10,000 for nonwillful FBAR reporting violations. As noted in the Senate Report:

> The Committee understands that the number of individuals involved in using offshore bank accounts to engage in abusive tax scams has grown significantly in recent years. For one scheme alone, the IRS estimates that there may be hundreds of thousands of taxpayers with offshore bank accounts attempting to conceal income from the IRS. The Committee is concerned about this activity and believes that improving compliance with this reporting requirement is vitally important to sound tax administration, to combating terrorism, and to preventing the use of abusive tax schemes and scams. Adding a new civil penalty that applies without regard to willfulness will improve compliance with this reporting requirement.[6]

It appears Congress was concerned with taxpayers not complying with their foreign reporting obligations and took the legislative leap to conclude that increasing the penalty, to what amounts to draconian levels, would fix the problem. It might help, but what Congress did not consider were the constitutional limits on imposing excessive penalties in an effort to change taxpayer behavior. These limits and protections go back to the origins of our republic and were born out of the excessive fines imposed by the unlimited power of the King. Fortunately, we have a Constitution that limits the government's ability to punish—including limitations on draconian financial penalties for even willful noncompliance with the laws.

As discussed in detail below, the Excessive Fines Clause of the Eighth Amendment to the Constitution require that any fine—including the FBAR penalty—be "proportionate" to the conduct it seeks to punish, provides real limitations on the government's ability to impose an excessive FBAR penalty. The case law developed under the Excessive Fines Clause also provides a meaningful structure—through a proportionality analysis—of how the IRS must exercise its discretion in imposing the FBAR penalty, in order to avoid running afoul of the Constitution by imposing the type of excessive penalties that the Eighth Amendment sought to banish to medieval English history.

The Excessive Fines Clause of the Eighth Amendment

The Eighth Amendment provides:

> Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.

The Supreme Court has explained that the Excessive Fines Clause "limits the government's power to extract payments, whether in cash or in kind, 'as punishment for some offense.'"[7] "The notion of punishment, as we commonly understand it, cuts across the division between the civil and the criminal law."[8] "The touchstone of the constitutional inquiry under the Excessive Fines Clause is the principle of proportionality: the amount of the forfeiture must bear some relationship to the gravity of the offense that it is designed to punish."[9]

The Forfeiture Cases

The applicability of the Excessive Fines Clause to the FBAR penalty can be found in the case law applying the clause to the government's efforts to forfeit property connected with criminal activity. While the Supreme Court has interpreted the Excessive Fines Clause on only a few occasions over its more-than-200-year history, these cases indicate that a civil penalty or forfeiture is unconstitutional if the penalty or forfeiture is at least in part "punishment" and that punishment is grossly disproportionate to the conduct which the penalty is designed to punish.

The Supreme Court considered the Excessive Fines Clause in *R.L. Austin*, where it held that the Clause applied to certain forfeitures by the federal government. In *Austin*, the Supreme Court held that the Excessive Fines Clause applied to forfeitures of property under 21 USC §881(a)(4) and (7), and remanded for a determination of whether the forfeiture was excessive.[10]

The Supreme Court made clear that to come within the ambit of the Excessive Fines Clause, the forfeiture could in part serve a remedial purpose; it was only necessary for the forfeiture to be in part punishment. In evaluating whether the Excessive Fines Clause applied, the Supreme Court explained: "We need not exclude the possibility that a forfeiture serves remedial purposes to conclude that it is subject to the limitations of the Excessive Fines Clause. We, however, must determine that it can only be explained

as serving in part to punish."[11] The Court evaluated the history of forfeiture as well as the particular forfeiture statutes at issue, and found punishment to be an aspect of these forfeitures. For instance, there was an innocent owner defense, and the relevance of the culpability of the owner made the statutes look more akin to punishment.[12]

While *Austin* dealt with forfeitures and not a fine or penalty such as the FBAR penalty, the label is not what is determinative. What counts is whether the imposition of the penalty has a punitive element to it, and one can have no doubt that an FBAR penalty equal to 50 percent of the taxpayer's foreign bank account will be punitive in most factual situations under any reasonable understanding of the word "punishment."

Having determined that the Excessive Fines Clause could apply to a forfeiture in *Austin*, the Court took the next step in *H.K. Bajakajian* and found that if a forfeiture was grossly disproportionate to the conduct it sought to punish that it was indeed unconstitutional. In *Bajakajian*, the Supreme Court held that forfeiture of $357,144, under 18 USC §982(a)(1), in connection with a criminal conviction for willfully failing to report that he was transporting more than $10,000 out of the United States in violation of 31 USC §5316(a)(1)(A), violated the Eighth Amendment's Excessive Fines Clause.[13] "The amount of the forfeiture must bear some relationship to the gravity of the offense that it is designed to punish."[14] "Although the Government has asserted a loss of information regarding the amount of currency leaving the country, that loss would not be remedied by the Government's confiscation of [Bajakajian]'s $357,144.15 "[F]ull forfeiture of [Bajakajian]'s currency would be grossly disproportional to the gravity of his offense."[16]

In many cases, the application of the 50-percent FBAR penalty will be grossly disproportionate to the conduct sought to be punished and should suffer the same fate as the forfeiture in *Bajakajian.* For example, assume an individual willfully failed to report the existence of a foreign bank account with a balance of $2 million and for which there was unreported tax of $150,000.[17] The IRS could assert a penalty of up to 50 percent of the account balance for each year in which there was a willful failure to report. Assuming the IRS asserted a penalty of 50 percent for one year or a penalty of $1 million, the penalty seems grossly disproportionate to the conduct sought to be punished. This is especially true if the taxpayer was also required to pay a civil fraud penalty on the unpaid tax which was evaded.

In determining that the forfeiture was excessive in *Bjakajian,* the Supreme Court reviewed the penalty structure under the Federal Sentencing Guidelines to determine the seriousness of the offense. The Supreme Court determined that under the Guidelines, the period of incarceration was five months and the fine was up to $5,000 comparatively and that a forfeiture of $347,000 was disproportionate under the Eighth Amendment. The Supreme Court affirmed the lower courts determination that a forfeiture of $15,000 and a $5,000 fine was proportionate and constitutional.

Halper

The Supreme Court's decision in *Halper* lends support to the conclusion that the willful FBAR penalty constitutes punishment and is subject to proportionality limitations.[18] Like the constitutional inquiry pursuant to the Excessive Fines Clause, analysis under the Double Jeopardy Clause also distinguishes between sanctions that constitute punishment and those that do not. In *Halper,* the Supreme Court held that where the amount of the fine bears no rational relation to the government's loss, the fine constituted punishment that unconstitutionally violated the Double Jeopardy Clause when imposed subsequent to a criminal conviction for the same act.[19] The Court found that imposition of a fine in excess of $130,000 to be sufficiently disproportionate when compared to the government's costs of approximately $16,000.[20] Although *Halper* was largely disavowed for purposes of Double Jeopardy analysis in *J. Hudson*,[21] it is still viable precedent with respect to how the Court evaluates whether a civil penalty constitutes punishment for constitutional purposes. *Halper* was largely overruled by *Hudson* because the Supreme Court determined that the Double Jeopardy Clause limited successive prosecutions—not successive punishments.[22] Indeed, in Justice Breyer's concurrence in *Hudson*, he noted that, "the Court in Halper might have reached the same result through application of the constitutional prohibition of "excessive fines."[23]

The Tax Penalty Cases

The constitutionality of a tax penalty and whether it constitutes punishment has been before the Supreme Court before but not in the context of the Excessive Fines Clause. The seminal case with regard to the civil fraud penalty and whether it constitutes punishment was *Helvering v. Mitchell*.[24] Although *Mitchell* was a

Double Jeopardy case, the Supreme Court analyzed whether the civil fraud penalty was punishment (thus implicating the Double Jeopardy Clause) or purely remedial in character and not punishment. In finding that the civil fraud penalty was remedial in character, the Court stated:

> The remedial character of sanctions imposing additions to a tax has been made clear by this Court. ... They are provided primarily as a safeguard for the protection of the revenue and reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud.[25]

The government will be hard pressed to demonstrate that the 50-percent FBAR penalty for "willful" failures is anything but punishment—especially where it is imposed in addition to the civil fraud penalty. Moreover, the Supreme Court's subsequent punishment analysis in *Austin* and *Bajakajian* suggests that *C.E. Mitchell*'s punishment analysis is limited to tax penalties imposed under the Internal Revenue Code and is not applicable to a penalty imposed under Title 31—like the FBAR penalty.

Even with respect to tax penalties, a number of courts have revisited the application of "punishment analysis" in the wake of *Austin*, and have "recognized that ... it is now possible for forfeitures and fines in civil cases to be regarded as punitive exactions, thus implicating the [Excessive Fines Clause]."[26] The taxpayers in *T.H. McNichols*, *P.L. Thomas* and *W.D. Little* each challenged the civil penalty imposed under the Internal Revenue Code as punishment under the *Excessive Fines Clause*. The courts of appeals all suggested that the Excessive Fines Clause must be considered, but found that the imposition of these civil tax penalties did not violate the Excessive Fines Clause in those cases because "the additions to tax at issue in [these] case[s] are purely revenue raising because they serve only to deter noncompliance with the tax laws by imposing a financial risk on those who fail to do so."[27] The Fourth Circuit in *Thomas* explained that the penalty, being based on the taxpayer's individual tax deficiency, essentially protects the penalty from being excessive.[28] "If the addition to tax is always calculated as fifty percent of the tax deficiency ... the sanction could not be excessive as to one person, but not excessive as to another."[29] By contrast, the FBAR penalty is based on the value of the account rather than on the tax deficiency.

The FBAR Penalty Is Punishment and Not Purely Remedial

In order to be subject to the Excessive Fines Clause, the FBAR penalty for willful reporting violations must, at least in part, be punishment.[30] If it is solely remedial it is not subject to the Excessive Fines Clause.[31] Like in *Austin*, the lack of culpability of the owner was a defense to forfeiture under those statutes, and the civil FBAR penalty that provides for 50 percent of the account to be taken demands willfulness on the part of the taxpayer. This *mens rea* component in both the forfeiture statutes and the FBAR civil penalty is consistent with punishment.[32]

The FBAR civil penalty for willfulness has much more in common with the penalty for the reporting offense in *Bajakajian* than with the civil penalties in the tax cases. In *Bajakajian*, like application of the FBAR penalty, the penalty is simply based on how much currency the individual happened to have in his suitcase or bank account—which may have little to do with the culpability of the taxpayer.

In the context of a willful FBAR violation, an individual who failed to report $10 million would be subject to a penalty of $5 million, whereas an individual who committed the same violation, but only had $1 million in the bank would be penalized $500,000. Unlike the tax penalty held to be constitutional in *Mitchell* because of its correlation to the tax loss involved, the willful FBAR penalty has no correlation to the amount of the Government's tax loss and suffers the same constitutional problem as the forfeiture in *Bajakajian.*

Proportionality Test as Applied to FBAR Penalty

Since the willful FBAR penalty is at least in part punishment, the Supreme Court's proportionality analysis under the Excessive Fines Clause (and the Double Jeopardy Clause) should be applied in determining whether the penalty is excessive and therefore unconstitutional.

"The touchstone of the constitutional inquiry under the Excessive Fines Clause is the principle of proportionality: The amount of the forfeiture must bear some relationship to the gravity of the offense that it is designed to punish."[33] The standard, as articulated by the Supreme Court, follows: "[A] punitive forfeiture violates the Excessive Fines Clause if it is

grossly disproportional to the gravity of a defendant's offense."[34] In finding the forfeiture grossly disproportional to the gravity of Bajakajian's offense, the Court stated: "Respondent's crime was solely a reporting offense. It was permissible to transport the currency out of the country so long as he reported it."[35] Also, the "violation was unrelated to any other activities" and "[he] does not fit into the class of persons for whom the statute was principally designed: He is not a money launder, a drug trafficker, or a tax evader."[36] In addition, the maximum sentence that could have been imposed on Bajakajian was six months with the maximum fine being $5,000.[37]

The lower courts have been applying the Supreme Court's proportionality analysis in an effort to place some constitutional limits on the government's ability to exact forfeitures. For example, in *M. Varrone*,[38] in an opinion written by Judge (now Justice) Sotomayor, the following *Bajakajian* factors were used in evaluating the amount of the forfeiture:

- "The essence of the crime" of the [defendant] and its relation to other criminal activity
- Whether the [defendant] fit into the class of persons for whom the statute was principally designed
- The maximum sentence and fine that could have been imposed
- The nature of the harm caused by the [defendant's] conduct

Following *Bajakajian,* Congress amended the statute governing forfeitures to include a proportionality analysis. Title 18, Section 983 (g) provides:

> (g) Proportionality.(1) The claimant under subsection (a)(4) may petition the court to determine whether the forfeiture was constitutionally excessive.(2) In making this determination, the court shall compare the forfeiture to the gravity of the offense giving rise to the forfeiture.(3) The claimant shall have the burden of establishing that the forfeiture is grossly disproportional by a preponderance of the evidence at a hearing conducted by the court without a jury.(4) If the court finds that the forfeiture is grossly disproportional to the offense it shall reduce or eliminate the forfeiture as necessary to avoid a violation of the Excessive Fines Clause of the Eighth Amendment of the Constitution.

The IRS has promulgated mitigation guidelines in the Internal Revenue Manual to promote consistency and guide its agents in administering the FBAR penalty.[39] The mitigation guidelines were originally developed before the increase in the amount of the willful penalty to up to 50 percent of the unreported account. And while updated, the mitigation guidelines do not take into account how excessive the FBAR penalty can be on large accounts in comparison to the conduct, *i.e.*, the tax loss sought to be punished. The mitigation guidelines need to be further updated to take into account the proportionality analysis required by the Excessive Fines Clause of the Eighth Amendment which includes consideration of the nature and amount of tax loss involved.

Conclusion

There is no doubt that increased tax compliance for foreign transactions is a laudable goal. When one taxpayer pays less, we all pay more. However, the punishment must fit the crime and the civil penalty must be proportionate to the conduct involved.

The IRS has the discretion under the statute to insure that the penalty imposed fits the conduct involved and should insure that its discretion is exercised consistent with the Excessive Fines Clause of the Constitution.

Endnotes

1 The FBAR reporting requirement is part of the Bank Secrecy Act, 31 USC §5311 *et seq.* For a more detailed discussion of the FBAR reporting requirements, penalties, procedures and defenses, *see* Steve Toscher and Michel R. Stein's articles: *FBAR Enforcement is Coming!* J. Tax Practice & Procedure, Dec. 2003–Jan. 2004; *FBAR Enforcement—An Update,* J. Tax Practice & Procedure, Apr.–May 2006; and *FBAR Enforcement—Five Years Later,* J. Tax Practice & Procedure, June–July 2008.

2 *See* 31 USC §5322 and 31 USC §5321(a)(5).

3 31 USC §5321(a)(7)(D).

4 American Jobs Creation Act of 2004 (P.L. 108-357).

5 31 USC §5321(a)(5)(C)

6 Senate Committee Report (S. Rep. No. 108-192, Pub. Law 108-357).

7 *R.L. Austin,* 509 US 602, at 609–10 (1993) (citations omitted).

8 *Id.*, at 610 (*citing Halper*, 490 US 435,447–48 (1989)).

9 *H.K. Bajakajian,* 524 US 321, 334 (1998) (*citing, Austin, supra* note 7, at 622–23).

10 *Austin, supra* note 7, 509 US, at 604.

11 *Id.*, at 610.

12 *Id.*, at 619.

13 *Bajakajian, supra* note 9, 524 US, at 324.

14 *Id.*, at 334.

15 *Id.*, at 329.

16 *Id.*, at 324.

17 For purposes of the Eighth Amendment analysis, we can assume the government can establish that the failure to file the FBAR was willful and even that the taxpayer was convicted of a felony for his or her failure to file the form and to evade the tax on the income from the account.

18 *Halper, supra* note 8.

19 *Id.*, at 448–49.

Endnotes

[20] *Id.*, at 452.
[21] *J. Hudson*, 522 US 93 (1997).
[22] *Id.*, at 95–96.
[23] *Id.*, at 116 (Breyer's concurrence).
[24] *C.E. Mitchell v. Helvering*, SCt, 38-1 USTC ¶9152, 303 US 391 (1938).
[25] *Id.*, at 401.
[26] *P.L. Thomas*, CA-4, 95-2 USTC ¶50,439, 62 F3d 97, 99. *See also W.D. Little*, CA-9, 97-1 USTC ¶50,207, 106 F3d 1445; *T.H. McNichols*, CA-1, 94-1 USTC ¶50,005, 13 F3d 432.
[27] *Little, supra* note 26, at 1454 (citations omitted).
[28] *Thomas, supra* note 26, at 103.
[29] *Id.*
[30] *Austin, supra* note 7, at 610, 618, note 12.
[31] *Id.*
[32] *See Austin, supra* note 7, 619.
[33] *Bajakajian, supra* note 9, at 334 (citations omitted).
[34] *Bajakajian, supra* note 9, at 334.
[35] *Bajakajian, supra* note 9, at 337.
[36] *Bajakajian, supra* note 9, at 338.
[37] *Id.*
[38] *M. Varrone,* CA-2, 554 F3d 327 (2009).
[39] *See* Internal Revenue Manual §4.26.16.4.6 (July 1, 2008) (Mitigation).