FBAR Enforcement–An Update

By Steven Toscher and Michel R. Stein

Steven Toscher and Michel Stein discuss IRS enforcement of compliance with FBAR rules and stress the importance of taxpayer education.

Taxpayers can expect to see a continuing trend in IRS enforcement of compliance with Foreign Bank Account Report (FBAR) rules. Following the enactment of The USA PATRIOT Act of 2001 (requiring the Treasury Department to study and report to Congress methods to improve FBAR compliance)[1], delegation of FBAR enforcement authority to the IRS in April 2003[2], the expiration of the Offshore Voluntary Compliance Initiative (OVCI) program (that provided, *inter alia*, amnesty to qualifying FBAR nonfilers) in 2003 and continuation of the IRS's Last Chance Compliance Initiative (LCCI), the IRS appears ready, willing and able to crackdown on the noncompliant.[3]

Improving FBAR compliance and enforcement, however, does not happen overnight. The U.S. Treasury Inspector General for Tax Administration (TIGTA) reported in 2004 that, while the IRS has improved its Bank Secrecy Act (BSA) compliance program (which includes FBAR compliance), the risk of undetected noncompliance still exists, and few penalties were being asserted.[4] One reason cited is that the IRS case files did not contain the documentation necessary to assess civil penalties.[5]

Responsibility for FBAR compliance now rests with the IRS's Small Business/Self-Employed Division (SB/SE).[6] In an effort to raise the dismal FBAR compliance rate, estimated to be less than 20 percent in 2001,[7] SB/SE established a new organization that will have end-to-end accountability for compliance with the BSA, including policy formation, operations and BSA data Management.[8]

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Congress also responded by including in the American Jobs Creation Act of 2004 ("Jobs Act"), a new civil penalty for a taxpayer's violation of FBAR reporting requirements, whether or not the violation was willful, and by increasing the penalty for willful violators.[9] Most recently, the Chief Counsel's Office issued important guidance with respect to the FBAR civil penalty for willful violations that, among other things, clarifies the IRS's interpretation of the willful standard.[10] These structural and legislative changes, in conjunction with the recent Chief Counsel guidance, should bring heightened awareness and increased IRS enforcement.

FBAR

The FBAR is not a tax return, but a report filed with the Treasury Secretary stating that the person filing has a financial interest in, or signatory authority over, financial accounts in a foreign country with an aggregate value exceeding $10,000 at any time during the tax year.[11] As part of the FBAR reporting requirement, persons are instructed to indicate on their Form 1040, Schedule B, Part III, whether the individual has an interest in a financial account in a foreign country by checking "Yes" or "No" in the appropriate box.[12] The Schedule B then directs the taxpayer to file the FBAR, which is used to report a financial interest in or authority over bank accounts in a foreign country. The deadline for filing an FBAR for each calendar year is on or before June 30 of the following year.[13] The instructions to the FBAR, which is based upon a Treasury Regulation,[14] explain how compliance with the statute is achieved, and sets forth in detail the required information and those persons obligated to comply with the FBAR reporting requirements.[15]

New Programs

In further recognition of the importance of the IRS's role in the fight against terror and money laundering, SB/SE established a new organization, the Office of Fraud/BSA, which reports directly to the Commissioner of SB/SE.[16] The Office of Fraud/BSA consists of four territories, with about 310 field examiners reporting to managers located in 33 field offices nationwide.[17] These examiners and their managers are fully trained and are dedicated full-time to the BSA program. In fiscal year 2004, the IRS devoted 1,112 full-time employees to the BSA programs (extending beyond just FBAR compliance) for enforcement, compliance and data management activities.[18]

The IRS has responsibility for processing and warehousing all BSA documents into the Currency Banking and Retrieval System (CBRS), including FBARs, Currency Transaction Reports, Forms 8300 (*Report of Cash Payments Over $ 10,000 Received in a Trade or Business*) and Suspicious Activity Reports (SARs).[19] All BSA forms are processed at the IRS Detroit Computing Center (DCC).[20]

As of September 2004, CBRS has approximately 173 million BSA documents on file, and approximately 14 million forms are received annually.[21] About 30 percent of the forms are filed on paper.[22] The IRS considers the currency information in CBRS extremely important for tax administration and law enforcement.[23] The information provides a paper trail or roadmap for investigations of financial crimes and illegal activities, including tax evasion, embezzlement, money laundering and for identifying cases for potential examination.[24]

Recent Amendments to FBAR Penalties

In order to increase voluntary compliance, Section 821 of the Jobs Act reorganized Title 31 USC §5321(a)(5) (the statute that contains the FBAR penalty) and added a new civil penalty for violations of FBAR reporting requirements, *whether or not the violation was willful*, and increased the existing penalty for willful violations.[25] The IRS now has at its disposal a more potent array of penalties to punish those who fail to comply.

Under the changes, which apply to violations after October 22, 2004 (the date of Jobs Act enactment), that is, FBAR forms due on or after June 30, 2005, the IRS may now impose a civil monetary penalty not exceeding $10,000 on anyone who violates, or causes any violation of, the FBAR reporting requirement rules.[26] This penalty, which did not previously exist, eliminates the need for the IRS to prove willfulness—a main barrier to its ability to impose any FBAR civil penalty in the past. The penalty may be waived, however, if *both* of the following are met: (1) "such violation was due to reasonable cause"; and (2) "the amount of the transaction or the balance in the account at the time of the transaction was properly reported."[27]

It seems clear that waiver of the nonwillful civil FBAR penalty requires satisfying both reasonable cause and the reporting requirements.

With respect to the first part of the waiver provision—the "reasonable cause" requirement, the IRS will most likely turn to the reasonable cause standard set forth in the existing Internal Revenue Code (the "Code") sections, regulations and internal revenue manual provisions.[28] It is less certain what Congress meant by the reporting requirement—that is, "the amount of the transaction or the balance in the account at the time of the transaction was properly reported."

The Senate Finance Committee Report[29] sheds some light on congressional intent by stating that "[t]he penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report." However, it is unclear what actions, besides the reporting of income, will satisfy the reporting requirement, and there are many unanswered questions. Would checking "yes" on the Form 1040, Schedule B, Part III, be sufficient to satisfy the reporting requirement? Does prior year reporting of income from the account or FBAR reporting satisfy this requirement? Also, how does one report the amount of the transaction in the context of the FBAR? Upon whom does the burden of proof rest with respect to nonwillful penalty? Is reporting some, but not all, of the income from a foreign account sufficient to satisfy the reporting requirement? At least for the last question, it would appear that reporting "any" of the income would be sufficient.[30]

It seems clear that waiver of the nonwillful civil FBAR penalty requires satisfying both reasonable

cause and the reporting requirements. However, if one reports the income from a foreign account, but fails to file an FBAR with respect to that account, would that be sufficient to satisfy the reasonable cause requirement? Given the lack of knowledge of the FBAR reporting requirement in the general taxpayer population and even the professional tax community, care must be taken before imposing what amounts to a very hefty penalty (*i.e.*, $10,000) on an otherwise compliant taxpayer for the mere failure to file a piece of paper. The statute provides for the imposition of a penalty *not exceeding* $10,000, and the IRS should establish guidelines setting forth a sliding scale for the amount of the penalty, which should be imposed based on different factual circumstances. The history of IRS penalties suggests that a penalty properly tailored to fit the noncompliant conduct has a much greater chance of being imposed by IRS personnel and achieving the desired effect on taxpayer compliance.[31]

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The Jobs Act also increased the civil penalty for willful violations. Under the changes, the civil penalty for willful violations has been increased to the *greater of* $100,000 or 50 percent of the amount of the transaction, or the balance in the account at the time of the violation.[32] The reasonable cause exception does not apply to willful violations.[33] This is a significant increase from the penalty that applies to violations existing on or before October 22, 2004, where the civil penalty amount is limited to the greater of $25,000 or the balance in the account at the time of violation, up to a maximum of $100,000 per violation. For example, under the new statute, if an individual with a foreign financial account containing $1 million is found to be in willful violation of the statute, the penalty could be as much as $500,000— a very steep penalty indeed.

Senate Finance Committee Report[34] provides the rationale for the change is the rules:

> 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.

As evident above, the War on Terror and preventing abusive tax schemes remain the main driving forces for enhanced FBAR enforcement.

The statute states that the civil penalty can be imposed, despite the fact that a criminal penalty is imposed with respect to the same violation.[35] The Secretary has six years to assess a FBAR civil penalty,[36] and once assessed, a limitation period of two years from the date of assessment to bring an action to recover an unpaid penalty.[37]

Recognizing its discretionary authority, and in order to promote consistency by IRS employees in exercising this discretion, the IRS has adopted (prior to the changes reflected in the Jobs Act) internal Guidelines for Calculation of FBAR Civil Penalty for Willful Violations for its personnel, which, if the following four conditions are satisfied, would subject a person to less than the maximum authorized FBAR penalty:

- The person has no history of past FBAR penalty assessment.
- No money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose.
- The person cooperated during the examination.
- The IRS did not determine a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account.

If *all* four criteria are satisfied, the Guidelines generally provide that the amount of the penalty imposed would be limited to a percentage (*i.e.*, either five or 10 percent) of the maximum amount in the foreign account (up to a maximum penalty of $100,000) for each foreign account that should have

been reported, depending upon the amount in each account. In contrast, for situations where a person does not qualify for the FBAR penalty reduction (*i.e.*, where the taxpayer fails to satisfies any one of the four conditions), then generally the maximum penalty authorized will be asserted.

The method of calculating the penalty under the Guidelines varies from account to account, depending upon the applicable penalty level involved. The Guidelines set forth four penalty levels. A Level I penalty applies if the maximum aggregate balances for all unreported foreign accounts that should have been reported does not exceed $20,000. For Level I cases, the penalty will be five percent of the maximum balance during the calendar year for each of the foreign accounts that should have been reported.

A Level II penalty applies if the maximum balance during the year for an unreported account that should have been reported is not more than $250,000 (and the Level I penalty is not applicable). For Level II cases, the penalty will be 10 percent of the maximum balance during the calendar year for each of the foreign accounts that should have been reported.

A Level III penalty applies if the maximum balance during the year for an unreported account that should have been reported is greater than $250,000 but not more than $1 million. For Level III cases, the penalty will be the *lesser* of (1) 10 percent of the maximum balance during the calendar year for each of the foreign accounts that should have been reported or (2) the amount in the account as of the last day for filing the FBAR (unless this amount is less than $25,000, in which case the penalty is $25,000).

A Level IV penalty applies if the maximum balance during the year that should have been reported exceeds $1 million. For Level IV cases, the penalty will be the *lesser* of (1) $100,000 or (2) the amount in the account as of the last day for filing the FBAR (unless this amount is less than $25,000, in which case the penalty is $25,000).

There have been no changes made to criminal FBAR penalties. Criminal violations of the FBAR rules can still result in a fine of not more than $ 250,000, or five years in prison, or both.[38] Where the failure to file an FBAR is part of a pattern of illegal activity, the statute provides for a fine of up to $500,000 and imprisonment of up to 10 years, or both. The statute of limitations for criminal BSA violations is five years.[39]

Willful Standard/Burden of Proof Discussed

Recognizing much clarification is necessary in context of FBARs, IRS Chief Counsel's Office, in a partially redacted legal memorandum (CCA)[40] has recently offered significant guidance with respect to the civil FBAR penalty for willful violations. While the CCA offers guidance relating specifically to OVCI and LCCI cases, the Chief Counsel's views should be applicable to all FBAR reporting situations.

The CCA offers guidance in two areas: (1) the proper interpretation of the willful standard; and (2) the status of offshore credit card accounts that are not associated with bank accounts.[41]

With respect to the willful standard, the CCA queried whether the willful violation in the civil penalty statute has the same meaning and interpretation as under the criminal penalty statute. The CCA concludes that it does, citing that the same word "willful" is used in both sections, and statutory construction rules suggest that the same word used in related sections should be consistently construed.[42]

There are no cases construing "willful" in the civil FBAR penalty context.[43] The CCA looked to Justice Blackman's dissent in *W. Ratzlaf*[44] in which the Supreme Court addressed the standard for willfulness in the context of a criminal violation of a structuring provision of the BSA as requiring "a voluntary intentional violation of a known legal duty."[45] The CCA concludes that the known legal duty means the account holder would merely have to have knowledge of the duty to file the FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR.[46] The CCA admits that the corollary of this principal would also apply—that is that there is no willfulness if the account holder has no knowledge of the duty to file the FBAR.

The CCA next queried whether the criteria for assertion of the of the civil FBAR penalty is the same as the burden of proof that IRS has when asserting the civil fraud penalty under Code Sec. 6663. The CCA states that although there are no cases that address this issue, the CCA expects the answer would be that the same standard will apply. That is, the IRS will have to prove willful by the "clear and convincing standard," rather than the mere "preponderance of the evidence."

The CCA goes on to state that the burden that the IRS carries, with respect fraud cases, represents an exception to the general presumption of correctness

that the courts have afforded to tax assessments. However, because the FBAR penalty is neither a tax nor a tax penalty, the presumption of correctness with respect to the tax assessments would not apply to an FBAR penalty assessment for a willful violation—another reason that the IRS will need to meet the higher clear and convincing standard.[47]

The CCA further states that, in criminal cases, the government would have to establish willfulness "beyond a reasonable doubt." Although the same definition for willfulness applies ("a voluntary intentional violation of a known legal duty"), the IRS would have a lesser burden (*i.e.*, clear and convincing) to meet with respect to the civil FBAR penalty, than the criminal penalty.

The CCA also queries whether it is possible to shift the burden of proof for uncooperative witnesses, but answers this in the negative, acknowledging that there is no provision in Title 31 for shifting the burden for willfulness. Failure to cooperate would be a factor reflecting on willfulness together with other circumstantial evidence in favor of imposing an FBAR penalty. In cases where it is known that a violation occurred, but the amount in the foreign account is *unknown*, the maximum dollar limitations under 31 USC §5321 (*i.e.*, $25,000 for violations before October 21, 2004, and $100,000 after that date) will apply. This might present taxpayers with some difficult choices during an investigation, *vis-à-vis* providing account information to the IRS that they could not otherwise obtain and that could have the effect of substantially increasing the penalty amount.

Is a Foreign Credit Card a Financial Account?

With respect to the issue of whether offshore credit cards require the filing of an FBAR, the CCA generally states that credit card accounts would not be a financial account for FBAR reporting purposes. While the definition of financial account in the FBAR instructions includes a reference to "any other account maintained with a financial institution," the instructions do not mention credit cards and, thus it is unclear whether credit card accounts are included—making assertion of the FBAR penalty for willful failure to a report a credit card account with a foreign bank inappropriate. While not specifically addressed in the CCA, the nonwillful penalty would appear equally inappropriate since the lack of clarity in this area makes it difficult to conform conduct. However, if by making an advanced payment, the card holder is using the credit card account as a debit card or a checking account, then an argument could be made on the facts and circumstances of a particular case that the credit card account is a financial account for purposes of the FBAR reporting requirements.

Ignorance, Education and Outreach

In the world of willful violations of the tax law—including willful FBAR violations, ignorance is bliss, and remains an excuse and a defense to the imposition of any penalty requiring willful conduct. It is this rather high hurdle that explains the very small number of willful FBAR penalties that have been imposed in the past. The enactment of the nonwillful penalty seems necessary, but it is only one strategy for increased compliance.

Effective IRS communication on the FBAR reporting requirements will serve as an important component in the IRS'S battle to obtain better compliance in this area. The SB/SE Commissioner has recognized the importance of education and outreach to enhance the BSA program.[48] Notwithstanding the fact that ignorance seems to have some benefits in this area, for those who want to know, the IRS website, *www.irs.gov*, hosts a number of informational bulletins on its site including "FAQs regarding FBARs" and "Report of Foreign Bank Financial Accounts" that address many basic, and not so basic questions pertaining to FBAR compliance.[49] The IRS also offers the following e-mail address: *FBARquesitons@irs.gov* that the public can use to ask the IRS questions regarding FBAR reporting. With these efforts, it is expected that FBAR compliance will continue to improve.

Endnotes

1 Act Sec. 361(b) of The USA PATRIOT Act of 2001 (P.L. 107-56) mandated the Secretary of the Treasury to study methods to improve compliance with the FBAR reporting requirements.

2 IRS News Release, IR 2003-48, Apr.10, 2003.

3 For a more complete history of FBAR enforcement, *see* Steven Toscher and Michel R. Stein, *FBAR Enforcement is Coming!*, J. Tax Practice & Procedure, December 2003–January 2004, at 27 ("Toscher & Stein, FBAR Enforcement").

4 TIGTA Reviews IRS BSA Compliance Program (March 18, 2004) ("TIGTA Report").

5 *Id.* The TIGTA Report states that for 2002, examiners in the BSA compliance program conducted approximately 3,400 compliance checks. Of these, only three were referred to the Criminal Investigation function for potential criminal investigation and two

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were referred to FinCen for civil penalty consideration.

[6] Written Statement of Kevin Brown, Commissioner, SB/SE Division of IRS Before Committee on Banking, Housing and Urban Affairs, United States Senate (September 28, 2004) ("Written Statement of Kevin Brown"); *See generally*, Lee Sheppard, *Offshore Investments: Don't Ask, Don't Tell*, TAX NOTES, July 11, 2005.

[7] U.S. Treasury Department, Report to Congress in Accordance Act Sec. 361(b) of P.L. 107-56 (April 26, 2002) ("Treasury Report").

[8] Written Statement of Kevin Brown, *supra* note 6.

[9] Act Sec. 821 of the American Jobs Creation Act of 2004 (P.L. 108-357), amending 31 USC §5321(a)(5).

[10] CCA 200603026 (September 1, 2005). The IRS also provided guidance in the form of a "Headliner" (June 15, 2005), which clarified that officers or employees of domestic subsidiaries of domestic corporations generally are not to report signature authority over the foreign financial accounts of the subsidiaries.

[11] Instructions to FBAR.

[12] Treasury Report, at 5, *supra* note 7.

[13] Instructions to FBAR.

[14] 31 CFR §103.24

[15] For a detailed discussion of the FBAR civil and criminal penalties, FBAR compliance, and FBAR initiatives see Toscher & Stein, *FBAR Enforcement, supra* note 3.

[16] Written Statement of Kevin Brown, *supra* note 6.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Memorandum for Commissioner, SB/SE Division, The Detroit Computing Center Adequately Processed Paper BSA Documents, But Quality Reviews Should be Implemented to Ensure Compliance with Quality Standards,* March 9, 2004.

[23] Written Statement of Kevin Brown, *supra* note 6.

[24] *Id.*

[25] See 31 USC §5321(a)(5), as amended by P.L. 108-357. *See also*, AMERICAN JOBS CREATION ACT OF 2004, LAW, EXPLANATION AND ANALYSIS, at ¶655.

[26] 31 USC §5321(a)(5)(A) & (B)(i), as amended by P.L. 108-357.

[27] 31 USC §5321(a)(5)(B)(ii), as amended by P.L. 108-357.

[28] *See, e.g.*, Code Secs. 6664, 6724; Treas. Reg. §§1.6664-4; 301.6724-1.; Internal Revenue Manual Provision 20.1.1.3.1.

[29] S. REP. NO. 108-192.

[30] The language of Senate Finance Committee Report indicates that it would be sufficient. S. REP. NO. 108-192.

[31] Prior to the Jobs Act, the IRS had adopted internal Guidelines for Calculation of FBAR Civil Penalty for Willful Violations (see discussion that follows *infra*).

[32] See 31 USC §5321(a)(5), as amended by the Jobs Act; See also American Jobs Creation Act of 2004, Law, Explanation and Analysis, ¶655.

[33] 31 USC §5321(a)(5)(C)(ii), as amended by P.L. 108-357.

[34] S. REP. NO. 108-192.

[35] 31 USC §5321(d); See discussion of possible double jeopardy clause violation in *U.S. v. Halper, 490 US 435, 109 SCt 1892 (1989).*

[36] 31 USC 5321(b)(1).

[37] 31 USC 5321(b)(2).

[38] 31 U.S.C. 5322(a); Advisory Federal Sentencing Guideline §2S1.3 governs sentencing for criminal FBAR violations, which lists the violation as a Base Offense Level "6 plus the number of offense levels from the table in §2B1.1 (Theft, Property, Destruction, and Fraud) corresponding to the value of the funds . . ." An Offense Level reduction is available under Guideline §2S1.3(b)(2) if the defendant did not act with reckless disregard, the funds were the proceeds of lawful activity, and the funds were to be used for a lawful purpose.

[39] 31 USC §5321(b).

[40] CCA 200603026, with Release Date September 1, 2005

[41] CCA 200603026; For a general overview *see Washington Items, The Climate of Current Thinking on New Developments,* Tax Management Memorandum, p 115-116 (2006).

[42] CCA 200603026, *supra* note 38; Where the standard is the same, it is difficult to tell what is criminal and what is civil. For a detailed analysis *see* Bruce I. Hochman and Steven R. Toscher, *More Than Bad Luck: Differences in Civil and Criminal Fraud Sanctions Under the Internal Revenue Code*J. TAX PRAC. & PROC., Dec. 1999–Jan. 2000, at 28.

[43] *Id.*

[44] *W. Ratzlaf,* SCt, 94-1 USTC ¶50,015, 114 SCt 655, 510 US 135. This is the long established definition for criminal tax violations. See *P. Pomponio,* SCt, 76-2 USTC ¶9695, 429 US 10, 97 SCt 22.

[45] CCA 200603026, *supra* note 38.

[46] *Id.*

[47] *Id.* The CCA refers to the 31 USC §5321 penalty in effect prior to the changes reflected in the Jobs Act (see note 1 to the CCA) and, therefore, it is unclear who must carry the burden with respect to the nonwillful penalty or its reasonable cause exception.

[48] Written Statement of Kevin Brown, *supra* note 6.

[49] *See also* Publication 4261 (Rev. 01-2004), *Do You Have a Foreign Bank Account?*