Practice

Determining "Reasonable Cause" for Nonwillful FBAR Violations

By Charles P. Rettig

For years, the IRS has been pursuing—with mixed success—the disclosure of information regarding undeclared interests of U.S. taxpayers (or those who ought to be U.S. taxpayers) in foreign financial accounts. Numerous taxpayers with previously undisclosed interests in foreign financial accounts and assets have been seeking participation in the current IRS offshore voluntary disclosure program (the OVDP, which began in 2012 and was modified in 2014), modeled after similar programs in 2009 and 2011. Since the launch of the first OVDP in 2009, more than 48,000 taxpayers have come into compliance voluntarily, paying about $6.5 billion in taxes, interest and penalties.

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2014 OVDP

Taxpayers participating in the ongoing 2014 OVDP generally agree to file amended returns and file Report of Foreign Bank and Financial Accounts (FinCEN Form 114, formerly Form TD F 90-22.1), commonly referred to as the "FBAR," for eight tax years, pay the appropriate taxes and interest together with an accuracy-related penalty equivalent to 20 percent of any income tax deficiency and an "FBAR-related" penalty (in lieu of all other potentially applicable penalties associated with a foreign financial account or entity) of 27.5 percent of the highest account value that existed at any time during the prior eight tax years.[1] The 2014 OVDP does not have a stated expiration date but can be terminated by the IRS at any time as to specific classes of taxpayers or as to all taxpayers.

The OVDP is designed for taxpayers seeking certainty in the resolution of their previously undisclosed interest in a foreign financial account. For those who might be considered to have "willfully" failed to timely file an FBAR or similar, the OVDP avoids exposure to numerous additional penalties associated with the income tax returns and various required foreign information reports, a detailed examination and limits the number of tax years at issue while also providing certainty with respect to the avoidance of a referral for criminal tax prosecution.

The test for willfulness is generally whether there was a voluntary, intentional violation of a known legal duty.[2] The mere fact that a person checked the wrong box, or no box, on a Form 1040, Schedule B is not sufficient, by itself, to establish that the FBAR violation was willful.[3] Taxpayers considering the OVDP should carefully review the recent court decisions on the issue of determining "willfulness" for assertion of the more significant FBAR penalties (of up to 50 percent of the account balance, per year).[4]

Streamlined Procedures for Nonwillful Violations

In addition to the OVDP, the IRS maintains other more streamlined procedures designed to encourage *nonwillful* taxpayers to come into compliance. Taxpayers using either the Streamlined Foreign Offshore Procedures (for those who satisfy the applicable non-residency requirement)[5] or the Streamlined Domestic Offshore Procedures[6] are required to certify that their failure to report all income, pay all tax and submit all required information returns, including FBARs (FinCEN Form 114, previously Form TD F 90-22.1), was due to "nonwillful" conduct.

Taxpayers having undisclosed interests in foreign financial accounts must consult competent tax professionals before deciding to the appropriate method of coming into compliance.

For these Streamlined Procedures, "nonwillful conduct" has been specifically defined as "conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law." For eligible U.S. taxpayers residing outside the United States, all penalties will be waived under the Streamlined Foreign Offshore Procedures. For eligible U.S. taxpayers residing in the United States, the only penalty will be a miscellaneous offshore penalty equal to five percent of the foreign financial assets that gave rise to the tax compliance issue under the Streamlined Domestic Offshore Procedures.

Even if returns properly filed under the Streamlined Procedures are subsequently selected for audit under existing IRS audit selection processes, the taxpayer will not be subject to failure-to-file and failure-to-pay penalties or accuracy-related penalties with respect to amounts reported on those returns, or to information return penalties or FBAR penalties, unless the examination results in a determination that the original tax noncompliance was fraudulent and/or that the FBAR violation was willful. Any previously assessed penalties with respect to those years, however, will not be abated. Further, as with any U.S. tax return filed in the normal course, if the IRS determines an additional tax deficiency for a return submitted under these procedures, the IRS may assert applicable additions to tax and penalties relating to that additional deficiency.

Penalties Under the BSA

Under the Bank Secrecy Act (BSA), U.S. taxpayers who have a financial interest in, or signature authority over, a financial account in a foreign country with an aggregate value of more than $10,000 at any time during a particular calendar year are required to file an FBAR.[7] The FBAR for any calendar year is required to be filed on or before June 30 of the following calendar year, without extension.[8]

Taxpayers comply with their U.S. reporting requirements by noting the account on their income tax return and by filing the FBAR.[9] In general, the FBAR requires that the U.S. taxpayer filing the form identify the financial institution with which the financial account is held, the type of account (bank, securities or other), the account number and the maximum value of the account during the calendar year for which the FBAR is being filed.[10]

The FBAR penalty under 31 USC § 5321(a)(5) can attach when (1) a U.S. person (2) has a financial interest in or signature or other authority over (3) at least one foreign financial account, (4) the aggregate value of which exceeded $10,000, and which (5) was not properly reported to the Treasury Department. Civil penalties for the failure to comply with the FBAR reporting requirements of 31 USC § 5314 can be imposed under 31 USC § 5321(a)(5).[11]

The Internal Revenue Manual (IRM) acknowledges that FBAR "penalties should be asserted only to promote compliance with the FBAR reporting and recordkeeping requirements. In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future."[12] "FBAR civil penalties have varying upper limits, but no floor. The examiner has discretion in determining the amount of the penalty, if any. Examiner discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation."[13] Further, "Examiners are expected to exercise discretion, taking into account the facts and circumstances of each case, in determining whether penalties should be asserted and the total amount of penalties to be asserted."[14]

For violations involving the *willful* failure to report the existence of an interest in a foreign account, the maximum amount of the penalty that may be assessed under Code Sec. 5321(a)(5)(C) is the greater of $100,000 or 50 percent of the balance in an unreported foreign account, per year, for up to six tax years. For violations involving the *nonwillful* failure to report the existence of an interest in a foreign account, the maximum amount of the penalty that may be assessed under Code Sec. 5321(a)(5)(B) shall not exceed $10,000, *per year*, for up to six tax years. However, no penalty shall be imposed if such nonwillful violation was due to reasonable cause *and* the amount of the transaction or the balance in the account at the time of the transaction was properly reported.[15]

Defining "Reasonable Cause" for Nonwillful FBAR Violations

"Reasonable cause" is not defined in the BSA (31 USC) or in the regulations interpreting it. However, the term is fairly well defined in regulations and cases interpreting the Code.[16] In 1985, in *Boyle,*[17] the Supreme Court noted that the meaning of the terms "reasonable cause" and "willful neglect" "ha[d] become clear over the near-70 years of their presence in the statutes" and that the term "willful neglect" may be read as meaning a "conscious, intentional failure or reckless indifference" while "reasonable cause" calls on the taxpayer to "demonstrate that he exercised "ordinary business care and prudence"[18]

Recently, in *Moore,* a federal District Court determined that "a person has 'reasonable cause' for an FBAR violation when he committed that violation despite an exercise of ordinary business care and prudence."[19] In 1989, Mr. Moore moved to the Bahamas and subsequently opened an account at Bank of Bahamas in Nassau with $300,000 of after-tax funds. In the early 1990s these funds were transferred from Bank of the Bahamas to the Bahamas branch of United Bank of Switzerland (UBS) purportedly as a result of advice from the money manager of Bank of Bahamas.

Through 2005, Mr. Moore prepared his own returns and did not report income from the foreign account (apparently believing it was held in an entity that was separate from Mr. Moore for reporting purposes). In some years, Mr. Moore did not respond on his return to the question on Line 7 of Schedule B to the effect "At any time during (tax year), did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?" In some years, a Schedule B was not attached to the return.

A return preparer provided a tax organizer and prepared the returns for tax years 2006–2008. Apparently, Mr. Moore responded "No" on the organizer with respect to the question "Did you have an interest in or signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?" which response was also reflected in the returns. The return preparer was not otherwise advised of the existence of a possible reportable foreign account.

Mr. Moore had apparently failed to timely file FBARs regarding a foreign financial account having a high balance in 2005 of $440,070; in 2006 of $471,098; in 2007 of $517,893 and in 2008 of $408,990. Within a month of learning about FBAR filing requirements, Mr. Moore took action to come into compliance with his filing and reporting obligations for 2003 to 2008. In 2009, Mr. Moore entered the then applicable IRS OVDP and submitted amended returns setting forth additional tax liabilities for 2005 that were $2,878; for 2006 were $3,205; for 2007 were $3,443 and for 2008 were $2,728. In 2010, as part of disclosing the UBS account to the IRS, Mr. Moore filed FBARs for the years 2003 through 2008.

Mr. Moore ultimately opted out of the OVDP because he did not agree to the miscellaneous offshore penalty assessed on the highest aggregate balance of his UBS account and was later subjected to an IRS examination that included tax years 2005, 2006, 2007 and 2008. During the post-OVDP examination, Mr. Moore asserted, in part, that reasonable cause existed on the basis that he "established a Bahamian Corporation, Dornlas Hardick Ltd[.,] through Graham Thompson Ltd. and capitalized it with $300,000 previously taxed in the United States. [I] believed the establishment of a legal Bahamian Corporation was sufficient to isolate the corporate assets from [my] personal assets, and that [I] was not required to disclose it on [my] personal tax return." Ultimately, the IRS assessed the maximum *nonwillful* penalty under Code Sec. 5321(a)(5)(B) of $10,000 for *each* of tax 2005, 2006, 2007 and 2008.[20]

The district court held that Mr. Moore did not, as a matter of law, have reasonable cause for his failure to file FBARs prior to 2009 noting:

> No fact finder could conclude that ignoring the question on Schedule B of his 2003 tax return was an exercise of ordinary business care or prudence.
>
> The Schedule B question asked if he had 'signature or other authority over a financial account in a foreign

country ... .' That phrase is not difficult to understand. As a matter of law, it placed Mr. Moore at least on notice that he should inquire further as to whether his corporation's foreign account was subject to disclosure. His decision to avoid further inquiry is not an exercise of ordinary business care or prudence.

Even when Mr. Moore employed a tax preparer, a person whose expertise clearly exceeded his own in terms of determining his legal obligations to the IRS, Mr. Moore declined to disclose the existence of his foreign account.

If discovered before any voluntary disclosure submission, the results can be devastating. Waiting is not a viable option.

That he did not inquire further into his legal obligations is evidence that he did not have reasonable cause for his FBAR violations, not that he was too old to know better.

Evidence that a taxpayer ignored relevant questions on Schedule B and in tax organizers is evidence of willful conduct. In this court's view, it suffices as a matter of law to demonstrate a lesser FBAR violation – one made without 'reasonable cause.'

The IRS FBAR Penalty Summary Memorandum

The statutory penalty computation provides a ceiling on the FBAR penalty. The actual amount of the penalty is left to the discretion of the IRS examiner. Attachments to the pleadings in *Moore* include an internal IRS FBAR Penalty Summary Memorandum prepared by the IRS examiner reflecting the government viewpoint on "nonwillfulness" and "reasonable cause":

Reasons for Assertion of Penalty

Mr. Moore never reported earnings in the UBS account since it was first established back in 1980s and earnings have accumulated over the years; the amount of the unreported income on the foreign account was "significant, and generated substantial tax liabilities and accuracy-related penalties" (the aggregate unpaid tax for the years at issue was $12,254); there was a "pattern" of noncompliance (schedule B response to the foreign account question was either left blank or "No"); and Mr. Moore responded "No" on the tax organizer provided by the preparer.

Penalty Determination

For most FBAR cases, the IRS has determined that if a person meets four threshold conditions then the person may be subject to less than the maximum FBAR penalty depending on the amounts in the person's accounts.[21] There are four threshold conditions which vary slightly depending on the date of the violation. For violations occurring after October 22, 2004, the four threshold conditions are: (1) the person has no history of past FBAR penalty assessments; the person has no history of criminal tax or BSA convictions for the preceding 10 years; (2) 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; (3) the person cooperated during the examination (Mr. Moore responded to reasonable requests for documents; meetings and interviews, *etc.*); and (4) the IRS did not sustain 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.[22] There are three penalty levels depending on the highest amount in the account during the period for which the FBAR should have been filed. For violations regarding an account exceeding $250,000, the penalty per violation is the statutory maximum of $10,000.

In determining application of the maximum nonwillful penalty for each year at issue, the FBAR Penalty Summary Memorandum states "multiple FBAR penalties are appropriate for this case in view of the nature of the violations, a long-history of non-compliance, and amounts involved. The taxpayer has not established reasonable cause for his failure to file, and the taxpayer's actions indicate that certain elements of willfulness and willful blindness[23] may exist to support application of the maximum nonwillful penalties for these periods."

Another attachment to the pleadings in Moore includes a declaration from the IRS Appeals Officer who was assigned to review the administrative appeal of the FBAR penalties stating "One of the issues discussed was reasonable cause, and whether it was applicable in this case considering Mr. Moore did not inquire or seek professional advice regarding his reporting requirements in connection with his foreign bank account." The foregoing seems to reflect an IRS feeling that a reasonable cause determination requires a taxpayer to "inquire or seek professional advice regarding his reporting requirements in connection with his foreign bank account" or possibly at least inform their return preparer of the existence of an interest in a foreign financial account.

Additional "Nonwillful" Inquiries

Those pursuing a nonwillful resolution of potential FBAR or related violations should anticipate questions relating to the opening of the account often inquire about who advised and assisted in opening the account; whether the advisor was a bank employee of an employee of an outside asset management company; where did the account opening(s) take place; how often the taxpayer traveled to the foreign institution or their advisor and for what reason; documents provided by the taxpayer to open the account (*i.e.,* passport(s), identification card, *etc.*; note that it is not a good fact for a taxpayer having dual passports to open an account with their non-U.S. passport); whether the taxpayer was asked to sign any documents or forms, including Form W-9; and identification of the advisors and representatives involved at the foreign financial institution and all communications with such individuals.

Additional inquiries might relate to the use of foreign entities to hold title to the account(s). Specifically, why the entity created (*i.e.,* insurance products, trust, foundation, corporation, annuity, *etc.*); who formed the entity; who managed the entity; and whether the entity still in existence. The taxpayer will be asked to disclose all communications with their domestic and foreign advisors, including when, where and in what form the communications took place; who was present and/or participated in the communications; what communications were had with the representative about the IRS OVDP or Streamlined Procedures; communications, if any, that occurred regarding bank secrecy, taxation, and/or disclosure of any foreign accounts; and whether letters, postcards or other personal mailings were ever sent or received.

The government may inquire about various services offered by the foreign institution and/or client advisor, including whether the creation of a foreign company, entity or foundation ever recommended; was a credit card or debit card linked to the offshore account ever offered; was there ever a recommendation to repatriate funds to the United States using a foreign relative or entity; were there any offers to deliver or accept currency in the United States; was there any advice given on how to transport currency into the United States; were calling cards or cell phone services ever provided; and whether there were offers to move assets to another institution.

Management and administration of the foreign financial account is likely of interest to the government. Taxpayers should anticipate questions regarding any instructions received regarding contacting the bank or the representative; instructions or advice received regarding receiving mail from the bank; instructions or advice received regarding taking bank statements or other bank documents from the bank; instructions or advice did received regarding withdrawing funds; instructions or advice received regarding the formation of a foreign entity to hold the account and who to contact regarding formation of an appropriate entity.

Those who think too long may be sorely surprised at the high level of ultimate cooperation of their institution with the U.S. government.

Deposits and withdrawals to the foreign account can reveal intentions and knowledge of various individuals involved. The government can be expected to inquire about the manner in which deposits and/or withdrawals were made to/from the foreign account(s); the mechanics of how deposits/withdrawals were made; the form in which deposits/withdrawals occurred (*i.e.,* cash, check, wire, travelers' check, *etc.*); amounts that were withdrawn/deposited each time; when such deposits/withdrawals occurred; where such deposits/withdrawals occurred; whether there were there limitations on the amounts that could be deposited/withdrawn; and documents received a deposit/withdrawal occurred (*i.e.,* receipt, credit memo, debit memo, *etc.*)? There will also be inquiries into the documentation received by or shown to the taxpayer regarding their accounts (*i.e.,* account statements, account opening documents, *etc.*); whether such documents contained names of entities or the financial institution or account numbers; and whether the taxpayer retained the documentation.

Lastly, taxpayers should anticipate the government inquiring as to whether the foreign accounts remain open and if not, where the funds were transferred when the account(s) were closed. Some taxpayers closed accounts and wire transferred the funds directly to a domestic account. Others closed accounts and transferred the funds through various means to other foreign accounts. Further questions often lay within the responses to each of the foregoing questions.

Waiting Is Not a Viable Option

Appropriately, the ability of a U.S. taxpayer to maintain an undisclosed, "secret" foreign financial account is fast becoming nonexistent.

Taxpayers having undisclosed interests in foreign financial accounts must consult competent tax professionals before deciding to the appropriate method of coming into compliance. If discovered before any voluntary disclosure submission, the results can be devastating. Waiting is not a viable option. Those who think too long may be sorely surprised at the high level of ultimate cooperation of their institution with the U.S. government.

ENDNOTES

1 *See www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program*.

2 IRM, pt. 4.26.16.4.5.3.1 (July 1, 2008).

3 IRM, pt. 4.26.16.4.5.3.6 (July 1, 2008).

4 *See J.B. Williams,* CA-4, 2012-2 USTC ¶50,475, 489 FedAppx 655; *J. McBride*, DC-UT, 2012-2 USTC ¶50,666, 908 FSupp2d 1186; and *C.R. Zwerner,* DC-FL, Case # 1:13-cv-22082-CMA (June 11, 2013).

5 *See* U.S. Taxpayers Residing Outside the United States, Eligibility for the Streamlined Foreign Offshore Procedures, *available online at www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-Outside-the-United-States*.

6 *Id.*

7 31 USC § 5314(a).

8 *See* 31 CFR § 103.27(c), (d), (e) (2009).

9 The instructions for Form 1040, Schedule B require "Yes" to be checked on Line 7a if the filer owned more than 50 percent of the stock in a corporation that owned one or more foreign accounts or if the filer had authority to sign or direct the use of a foreign account. And if the "Yes" box on Line 7a is checked, the person must also file a separate report on Form TD F 90-22.1—the FBAR. Furthermore, the Form 1040 instructions refer the reader to the FBAR form "to find out if you are considered to have an interest in or signature or other authority over a financial account in a foreign country." In turn, the instructions for the FBAR lay out the filing requirements, including that any U.S. person with signature authority over an account, or more than a 50-percent interest in a corporation that holds the account, must file the FBAR.

10 31 USC § 5314(a).

11 Once the penalty is assessed, the United States may take steps to try to collect it. *See* 31 USC § 3711(a)(1), (g)(1). Interest begins to accrue after assessment. *See* 31 USC § 3717(a). Penalties accrue if the penalty isn't timely paid. *See* 31 USC § 3717(e). Possible collection actions include administrative offsets, tax refund offsets and wage garnishment. *See* 31 USC § 3711(g)(9). The assessment also starts a two-year period in which the United States may file suit to obtain a judgment. *See* 31 USC § 5321(b)(2).

12 IRM, pt. 4.26.16.4 (July 1, 2008).

13 *Id.*

14 *Id.*

15 31 USC § 5321(a)(5)(B)(ii). However, the reasonable cause exception does not apply to willful violations. 31 USC § 5321(a)(5)(C)(ii). As of April 8th, 2003, IRS was delegated the authority to assess and collect FBAR civil penalties, per 31 CFR §1 03.56(g). 31 CFR § 103.56(g) (2009); *see also* 31 CFR § 1010.810(g) (2014). The delegation includes the authority to investigate possible FBAR civil violations, provided in Treasury Directive No. 15-41 and the authority to assess and collect the penalties for violations of the reporting and record keeping requirements.

16 For example, 26 USC § 6664(c)(1) prohibits penalties for any portion of an underpayment of tax "if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." Another statute, applicable to foreign trusts, prohibits penalties for "any failure which is shown to be due to reasonable cause and not due to willful neglect." 26 USC § 6677(d). And, in the statute that the Government identifies as an analogue, Congress prohibited monthly penalties for failing to file tax returns where "such failure is due to reasonable cause and not due to willful neglect … ." 26 USC § 6651(a)(1).

17 *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 245, 105 SCt 687.

18 *Id. See also* IRM, pt. 20.1.1.3.1 (Aug. 20, 1998).

19 *J. Moore*, DC-WA, 2015-1 USTC ¶50,258.

20 Note that the aggregate $40,000 in penalties was far less than what would have been determined under the 2009 OVDP—$103,578, likely representing 20 percent of the $517,893 account value that existed in 2007.

21 IRM, pt. 4.26.16. (July 1, 2008). Many have wondered whether these mitigation guidelines had any continuing effect following the OVDP and Streamlined Procedures but, in *Moore*, the IRS was applying the FBAR mitigation guidelines in determining the appropriate penalty in November 2011.

22 *Id.*

23 Under the concept of "willful blindness," willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements.