The Continuing Evolution of FBAR Enforcement

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Steven Toscher and Michel Stein have provided us with several articles updating this important topic and do so again by providing us with the latest developments in the area of FBAR enforcement.

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I. Introduction

The U.S. government continues to aggressively act against taxpayers who have undeclared foreign assets and accounts overseas. The government's war against offshore accounts has ended traditional notions of bank secrecy and has created a new paradigm of transparency among nations. The dedication of increased IRS enforcement resources and the vulnerability of electronic information, as recently reported about the Panamanian law firm Mossack Fonseca, have changed the enforcement landscape.

For more than a decade, we have been advising clients that if they do not correct foreign asset noncompliance, either through participation in an announced voluntary disclosure program or another appropriate response, they can face nasty IRS examinations and draconian penalties, and worse—criminal investigations, prosecutions and imprisonment.[1]

From the government's perspective, it would seem that enough time has passed and the noncompliant taxpayer has been forewarned. It has been seven years since the turnover of secret account information from UBS pursuant to an agreement with the U.S. Department of Justice along with the announcement of the IRS's first formal Offshore Voluntary Disclosure Program (OVDP). The IRS, through its delegation of authority from the Treasury Department's Financial Crimes Enforcement Network (FinCen), has developed many tools and is well suited to shift its resources from OVDP-type certifications to active examinations. The U.S. government through a whole host of mechanisms, including possession of treaty request bank documents and "leaver" lists originating from cooperating Swiss banks, is making an active push to investigate those who have still failed to take appropriate corrective action at this late stage.

This article is the next in the series of articles we have written on the Foreign Bank Account Report (FBAR) and international compliance topic going back more than a decade and sets forth the latest developments in the area of FBAR enforcement.

II. New Proposed FBAR Regulations

On March 1, 2016, FinCEN issued a Notice of Proposed Rulemaking intended to eliminate duplicate reporting for financial professionals who file FBARs due to their employment responsibility and remove the limitation on information reporting with respect to 25 or more foreign financial accounts filers. The proposed rules attempt to strike a balance between providing law enforcement with useful information and imposing less burdensome reporting requirements. The proposed regulations also reflect that beginning with the 2016 tax year (as changed by recent legislation), the due date for FBAR reporting will be April 15 of the subsequent year, not June 15.

As the government refines the FBAR reporting rules, we expect continued attention in this area.

1. FBAR Background

FBAR filings with the U.S. government surpassed the 1 million mark during 2015.[2] In 2015, FinCen received a record high 1,163,229 FBARs, up more than eight percent from the prior year.[3] FBAR filings have grown on average by 17 percent per year during the last five years, according to FinCen.[4]

In the past, FBAR compliance was meager. IRS enforcement has been successful to a large extent. By way of comparison, for calendar year 2001, the number of FBARs filed with the Treasury was 177,151.[5] In 1991, there were approximately 116,600 filings.[6] The 2001 figure represented a 51.9-percent increase from the number of FBARs filed in 1991, but FBARs were still grossly under-reported.[7] Government officials knew as far back as 2003 that annual FBAR filings should have numbered in the millions.[8] While years of government enforcement in this area has been a success, its work is not complete.

Filings of IRS Form 8938, *Statement of Specified Foreign Financial Assets*, have generally remained consistent in recent years, hovering around 300,000 filings for 2013 and 2014, and up from about 200,000 for tax year 2011, the first year Form 8938 was required to be filed.[9] The implementation of Hire Act Provision of 2010 continues to fill an important enforcement need by placing foreign account and asset information squarely on the face of an income tax return, in a manner that did not exist for tax years prior to 2011.

2. FBAR Statute

The potential misuse of foreign financial accounts to evade domestic tax and regulatory rules has been a long-held congressional concern.[10] The Bank Secrecy Act[11] authorizes the Secretary of Treasury to issue regulations requiring persons to keep records and file reports that are determined to have a high degree of usefulness in criminal tax, regulatory and counter-terrorism matters.[12] The Secretary is authorized to require any "resident or citizen of the United States or a person in, and doing business in, the United States, to … keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency."[13] The Secretary is also authorized to prescribe exemptions to the reporting requirement and other matters the Secretary considers necessary to carry out section.

The prescribed form, known as a Report of Foreign Bank and Financial Accounts FinCEN Form 114 (FBAR), is a report filed with the Treasury (which since July 1, 2013, must be filed electronically) 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.[14] 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. The Schedule B then directs the taxpayer to file the FBAR, which is used to report a financial interest in or signatory authority over bank accounts in a foreign country. Foreign assets must also be disclosed on IRS Form 8938, *Statement of Specified Foreign Financial Assets*, which is filed as part of the income tax return.

The rules require records of foreign financial accounts to be maintained for each U.S. person having a financial interest in or signature or other authority over such accounts. The records must be maintained for a period of five years.[15]

The authority to enforce the provisions of 31 USC §5314 and its implementing regulations were re-delegated from FinCEN to the IRS by Memorandum of Agreement dated April 2, 2003.[16] With this delegation, FinCEN conferred upon the IRS the authority to enforce the FBAR provisions of the BSA and its implementing regulations. FinCen however retained the jurisdiction to promulgate regulations. It is no coincidence that increased compliance in this area follows on tails of this re-delegation. Included among the reasons cited for the delegation of enforcement authority are the greater resources available to the IRS to devote to FBAR compliance.[17] Without question, the IRS has dedicated many resources to these enforcement efforts. On May 3, 2016, the Commissioner of Internal Revenue announced the hiring of between 600 and 700 new enforcement employees, the first significant enforcement hiring in more than five years. In his announcement, the Commissioner states that the new hiring will assist with "high-profile enforcement areas, including international tax issues … "[18]

The willful failure to disclose foreign accounts, or to report all of the information required on an FBAR, can result in severe civil[19] and criminal penalties.[20] 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 the statute 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.[21] 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 shall not exceed $10,000 per year, for up to six tax years.[22] However, no penalty shall be imposed if such nonwillful conduct was due to reasonable cause and the amount of the transaction or balance in the account at the time of the transaction was properly reported.[23] The Secretary has six years to assess an FBAR civil penalty,[24] and once assessed, a limitation period of two years from the date of assessment to bring an action to recover an unpaid penalty.[25]

Criminal violations of the FBAR rules can result in a fine of not more than $250,000 or five years in prison or both.[26] Where the failure to file an FBAR is part of a pattern of illegal activity, the fine is up to $500,000 and up to 10 years in prison, or both.[27] The statute of limitations for criminal BSA violations is five years.[28] The civil penalty can be imposed in addition to a criminal penalty imposed with respect to the same violation.[29]

3. Signatory Authority Exemption for Employees and Officers

A welcomed change to the rules is that FinCEN, in consultation with the IRS, has made a policy decision to provide a simplified and expanded exemption for certain employees required to file the FBAR form.[30] The proposed exemption would eliminate the requirement for officers, employees and agents of U.S. entities to report on accounts owned by the entity over which that person has signature authority solely due to their employment when those accounts are already required to be reported by their employer, or any other U.S. entity within the same corporate or other business structure as their U.S. employer.

The IRS has made great strides in enhancing FBAR compliance.

This proposed exemption is intended to address instances in which employees have overlapping signature authority with respect to U.S. parent and subsidiary accounts within the same corporate or other business structure. However, the exemption for employees to report their signature authority over the foreign financial accounts of their employer would not extend to U.S. persons in instances in which no entity within their employer's corporate or other business structure has an obligation to report to FinCEN its financial interest in such accounts.[31]

For example, in instances in which a U.S. person is employed by a non-U.S. entity with no obligation to report its foreign financial accounts, and the foreign entity is not included as a subsidiary of a U.S. entity that is filing, the U.S. person would continue to have an obligation to report his or her signature authority over the non-U.S. entity's foreign financial accounts.[32] In this regard, the scope of the reporting obligation remains unchanged.

To maintain transparency, employers would be required to keep information identifying all officers, employees or agents with signature authority over, but no financial interest in, those same accounts. FinCEN proposes to require that this information be made available to FinCEN upon request and that such records be maintained for a period of five years.[33]

About 11,600 FBARs were filed by U.S. persons in 2013 solely due to reporting on signature authority, but no financial interest.[34] Of these, about 280 were filed by a U.S. person who was reporting signature over foreign financial accounts of an account owner with a foreign address.[35] FinCen estimates that about half the difference between 11,600 and 280 or 5,660 would be affected by this rule.

4. Accounts of 25 or More Exception

While FinCen proposes to liberalize in terms of an exemption for employees and officers, it proposes to increase the reporting requirements and change another FBAR exemption on fliers having 25 or more accounts. For what appears to be for good reason, FinCEN proposes to repeal the limitation with respect to situations where a filer has 25 or more foreign financial accounts.

Under existing regulations, when a person or entity has a financial interest in, or signature authority over, 25 or more foreign financial accounts, the filer is only required to report the number of accounts and the filer's identifying information (name, address, taxpayer identification number and for individual filers date of birth).[36] However, these filers are exempted from providing detailed account information on each of their foreign financial accounts, including account number, the name of the foreign financial institution that holds the account, the address of the foreign financial institution, the maximum value of the account during the calendar year or the type of account.[37]

Taxpayers choosing to remain noncompliant should be forewarned. FBAR enforcement is here to stay.

According to the Explanation accompanying the Proposed Regulations, in 2013, approximately 10,800 FBARs were filed by individuals or entities with financial interest in 25 or more foreign financial accounts.[38] Those individuals or entities had a combined total of approximately 5,366,000 foreign financial accounts, which represents approximately 56 percent of the total number of all foreign financial accounts reported in 2013.[39] As a result, FinCEN and law enforcement could only obtain detailed account information on these accounts by making a specific request to the filer. The practical effect of this exemption severely limited FinCen's ability to obtain the information needed to fulfil its mission.

The provisions limiting information reported with respect to situations where a filer has 25 or more foreign financial accounts has created a significant gap in FinCEN's and law enforcement's ability to analyze a comprehensive set of data on all otherwise reportable foreign financial accounts.[40] A lack of account numbers limits the applicability and efficacy of link analysis that can be done to expand investigations of potential criminal and civil violations of law.[41] Moreover, the enhancement of FinCEN's analytical tools allows it to analyze larger amounts of data more effectively, therefore making account information reported on FBARs that much more accessible. [42]

For these reasons, FinCEN is proposing to remove the provisions that limit the information reported with respect to situations when a filer has financial interest in, or signature authority over, 25 or more foreign financial accounts.[43] Instead, all U.S. persons will be required to report detailed account information on all foreign financial accounts for which they have a financial interest or signature authority, even where the filer has 25 or more accounts.[44] This will enable FinCEN and law enforcement to automatically receive detailed account information on all foreign financial accounts in which a U.S. person has financial interest for the first time since 1977.[45]

FinCen's recognition of the significant gap in its ability to carry out its mission is not surprising, given the large percentage of filings (56 percent) of the total reported accounts in 2013 affected by limitation.

5. New Filing Date and Electronic Filing Mandate

Many practitioners along with their clients were often surprised to learn that the FBAR carried with it its own and distinct filing deadline of June 30 of the succeeding year. Accountants and their client typically operate with an April 15 or extended due date of October 15, and at times may have inadvertently overlooked the June 30 filing deadline. Given the severe penalty regime surrounding FBARs, this can serve as a trap for the unwary.

Congress remedied this problem last year, when President Obama signed into law H.R. 3236, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which, among other things, modifies the due dates for several common tax returns and forms, including FBARs. For 2016 and later FBARs, the due date for FinCEN Form 114 is changed from June 30 to April 15, and taxpayers will be allowed a six-month extension to October 15. For any taxpayer required to file an FBAR for the first time, any penalty for failure to timely request for, or file, an extension may be waived by the IRS for failing to file.

Generally, all FinCEN forms now must be filed electronically. E-filers will receive an acknowledgment of each submission. The online FinCEN Form 114 allows the filer to enter the calendar year reported, including past years. The FinCEN system also offers an option to "explain a late filing," or to select "Other" to enter up to 750 characters within a text box where the filer can provide a further explanation of the late filing or indicate whether the filing is made in conjunction with an IRS compliance program.[46] For longer explanations, some practitioners provide an online statement indicating that a more in-depth factual explanation is in the possession of the filers' counsel and is available upon request.

III. Revised IRS Examination Guidance

Taxpayers with international tax issues are fertile ground for IRS examination, and we anticipate continued heightened IRS enforcement efforts in this area. Practitioners should familiarize themselves with the latest IRS audit guidelines to better able them to represent clients in this area.

The most significant change in this area relates to Interim Guidance Memorandum for FBAR penalties, SBSE-04-05-150-0025, released on May 5, 2015, which places restraints on power of IRS Examiners. The Interim Guidance has since been incorporated into the Internal Revenue Manual (IRM).

IRM §4.26.16, discussing substantive FBAR rules, was updated on November 16, 2015, to incorporate relevant provisions of the Interim Guidance Memorandum for FBAR penalties. The IRM provisions relating to the Bank Secrecy Act Chapter (IRM §4.26.17), setting forth FBAR examination procedures, remain otherwise unchanged.

The statutory FBAR penalty provisions only establish *maximum* penalty amounts, leaving the IRS to determine the appropriate FBAR penalty amount below that threshold based on the facts and circumstances of each case. In this regard, IRS examiners are instructed to use their best judgment when proposing FBAR penalties, taking into account all the available facts and circumstances of a case.

(a) Willful FBAR Violations. For cases involving willful violations over multiple years, IRS examiners will recommend a penalty for each year for which the FBAR violation was willful. Assuming six years is still open under the statute of limitations, the IRS examiner could assert a total penalty of 300 percent of the amount of the account. Notwithstanding the large potential penalty, examiners are now instructed that in most cases, 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 the years under examination*. In such cases, the penalty for each year will be determined by allocating the total penalty amount to all years for which the FBAR violations were willful based upon the ratio of the highest aggregate balance for each year to the total of the highest aggregate balances for all years combined, subject to the maximum penalty limitation in 31 USC §5321(a)(5)(C) for each year.

Examiners may recommend a penalty that is higher or lower than 50 percent of the highest aggregate account balance of all unreported foreign financial accounts based on the facts and circumstances. The new IRS guidance however provides *that in no event will the total willful penalty amount exceed 100 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination.*

The new guidance places a very important limitation on the examining agent's ability to assert these draconian penalties. Before release of the guidance, multiple-year, 50-percent willful FBAR violations were a real possibility and not uncommon. Even more significant, the mere threat of the imposition of multiple penalties would force many taxpayers to accept a settlement to avoid financial devastation. For example, in *Zwerner*,[47] the IRS imposed four willful penalties, only to have three willful penalties sustained in jury trial. In this case, the assessed FBAR penalties upheld by the jury aggregated $2,241,809 on an offshore account that had an apparent high balance of $1,691,054 during the years at issue.

Multiple-year, maximum penalties are unnecessarily punitive. To redress unfairness, and likely in recognition that the imposition of multiple year FBAR penalties could run counter to Excessive Fines Clause of the Eighth Amendment,[48] the new Guidelines attempt to make the FBAR penalties more proportional to the tax offense committed. In almost all FBAR-related cases, the amount of unreported income tax obligation pales in comparison to the potential FBAR penalties that could potentially be imposed. By restricting the agent's ability to impose multiple-year penalties, the IRS is attempting to avoid constitutional limitations and perhaps level the playing field.

(b) Nonwillful Violations. For most cases involving multiple nonwillful violations, examiners are told to recommend one penalty for each open year, regardless of the number of unreported foreign financial accounts. In those cases, the penalty for each year will be determined based on the aggregate balance of all unreported foreign financial accounts, and the penalty for each year will be limited to $10,000.

For some cases, the facts and circumstances (considering the conduct of the person required to file and the aggregate balance of the unreported foreign financial accounts) may indicate that asserting nonwillful penalties for each year is not warranted. In those cases, examiners, with the group manager's approval, may assert a single penalty, not to exceed $10,000, for one year only.

For other cases, the facts and circumstances (considering the conduct of the person required to file and the aggregate balance of the unreported foreign financial accounts) may indicate that asserting a separate nonwillful penalty for each unreported foreign financial account, and for each year, is warranted. In those cases, examiners, with the group manager's approval, may assert a separate penalty for each account and for each year.

The IRS guidance provides that in no event will the total amount of the penalties for nonwillful violations exceed 50 percent of the highest aggregate balance of all unreported foreign financial accounts for the years under examination. A nonwillful penalty will not be recommended if the examiner determines that the FBAR violations were due to reasonable cause and the person failing to timely file correct and complete FBARs later files correct and complete FBARs.

The new guidance in the context of the nonwillful penalty places another real limitation on agents. Imposition of multiple-year, $10,000 nonwillful penalties, per account, was not uncommon. This was nevertheless seen contrary to the statute, which speaks in terms of per filing violation. The new guidance makes clear that for most cases, only one nonwillful per year is appropriate.

(c) Co-owned Accounts. Where there are multiple owners of an unreported foreign financial account, the IRS guidance provides that examiners must make a separate determination with respect to each co-owner of the foreign financial account as to whether there was a violation and, if so, whether the violation was willful or nonwillful. For each co-owner against whom a penalty is determined, the penalty will be based on the co-owner's percentage ownership of the highest balance of the foreign financial account. If examiners are unable to determine a co-owner's percentage ownership, the penalty will be based on the amount determined by dividing the highest account balance equally among the co-owners.

This provision is particularly significant in cases where the co-owner is a non-U.S. person. In such situations, agents appear to now have authority to parse out a portion of the account from the penalty base on non-U.S. persons' share. Before this, there was little, if any, formal guidance to assist with this position, and practitioners were left to argue the issue on common sense and on *ad hoc* basis, and in many cases faced resistance from agents. The IRS appears to now have a mechanism in place to allow agents to parse out some if not all of an asset from the OVDP penalty, where the taxpayer has established co-ownership of an account or asset by a foreigner.

(d) Coordination with FBAR Coordinators and IRS Counsel. All FBAR cases must be reviewed by an Operating Division FBAR Coordinator after the examiner preliminarily determines the penalties to be asserted and before the examiner notifies the account holder of the results of the FBAR examination. Counsel review is no longer required once the penalties have been determined, except for which willful penalties have been determined. Counsel's review will be limited to providing advice on whether an FBAR violation has occurred, whether the FBAR violation was willful and whether the proposed penalty is within the statutory limitations of 31 USC §5321 (a)(5)(C).

IV. Conclusion

As the government refines the FBAR reporting rules, we expect continued attention in this area. The IRS has made great strides in enhancing FBAR compliance and international enforcement is and will remain a priority. Taxpayers choosing to remain noncompliant should be forewarned. FBAR enforcement is here to stay.

ENDNOTES

1 For in-depth analysis of the substantive requirements and history of FBAR enforcement, *see* Steven Toscher & Michel R. Stein, *FBAR Enforcement is Coming!*, J. TAX PRACTICE & PROCEDURE, Dec.–Jan. 2004, at 27; Toscher & Stein, *FBAR Enforcement–an Update*, J. TAX PRACTICE & PROCEDURE, Apr.–May 2006, at 57; Toscher & Stein, *FBAR Enforcement–Five Years Later*, J. TAX PRACTICE & PROCEDURE, June–July 2008, at 37; and Toscher & Stein, *FBAR Enforcement, Appeals and Collection Procedures in the Post-Amnesty World*, J. TAX PRACTICE AND PROCEDURE, Dec.–Jan. 2012, at 61.

2 IRS News Release, IR 2016-42, March 15, 2016.

3 *Id.*

4 *Id.*

5 *See* U.S. Treasury Department, Report to Congress in Accordance with §361(b) of the 2001 Patriot Act (April 26, 2002) ("Treasury Report"), at 6.

6 *Id.*

7 *Id.*

8 *Id.*

9 IRS News Release, IR-2016-42, March 15, 2016.

10 *See* Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations-Reports of Foreign Financial Accounts 31 CFR §1010; RIN 1505-AB26; at 12614 (Mar. 10, 2016) ("Proposed FBAR Regulations").

11 Codified as 23 USC §1829b, 12 USC §§1951-1959 and 31 USC §§5311-5314 and 5316-5332.

12 Proposed FBAR Regulations, at 12614.

13 31 USC §5314.

14 31 CFR §101.306.

15 31 CFR §1010.420.

16 31 CFR §1010.810(g); Final Rule (RIN 1506-AA45) (May 15, 2003).

17 Final Rule (RIN 1506-AA45) (May 15, 2003).

18 Email from Commissioner John A. Koskinen to all IRS Employees, May 3, 2016.

19 FBAR civil penalties are separate from those penalties that can arise with respect to unreported income from foreign accounts, such as the accuracy-related penalty under Code Sec. 6662 or, in extreme cases, the civil fraud penalty under Code Sec. 6663.

20 Willful violations of FBAR filing requirements can be prosecuted whether or not there is tax malfeasance. Related criminal exposure can result from failing to report offshore income under Code Sec. 7201 or filing a false tax return under Code Sec. 7206(1). The filing of a FBAR containing a false statement can also result in criminal exposure under 18 USC §1001.

21 31 USC §5321(a)(5)(C).

22 31 USC §5321(a)(5)(B).

23 31 USC §5321(a)(5)(B)(ii).

24 31 USC §5321(b)(1).

25 31 USC §5321(b)(2).

[26] 31 USC §5322(a).
[27] 31 USC §5322(b).
[28] 18 USC §3282.
[29] 31 USC §5321(d).
[30] Proposed FBAR Regulations, at 12615–16.
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*, at 12620.
[35] *Id.*
[36] 31 CFR §1010.350(g)(1)-(2).
[37] Proposed FBAR Regulations, at 12617.
[38] *Id.*, at 12617.
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] Information regarding registration for e-filing of an FBAR is available online at *www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Foreign-Bank-and-Financial-Accounts-FBAR*.
[47] *Zwerner*, Case No. 13-22082-CIV, Feb. 18, 2014 (S.D. Florida).
[48] Steven Toscher and Barbara Lubin, *When Penalties Are Excessive—The Excessive Fines Clause as a Limitation on the Imposition* of the Willful FBAR Penalty, J. TAX PRACTICE & PROC., Dec. 2009–Jan. 2010.