FBAR Penalty Assessment and Enforcement

BY: Patrick J. McCormick
Kulzer & DiPadova

Introduction

For a number of years, offshore disclosures have been a point of heightened emphasis by the Service, with significant penalties assessable for failures to comply with relevant requirements. In the offshore realm, the source of greatest consternation from a penalty perspective is FinCEN Form 114, more commonly referenced as the FBAR. Willful failures to file the FBAR can statutorily cause assessment of an annual penalty of $100,000 or 50% of the total balance of the foreign account per violation, whichever is greater. Nonwillful failures to file carry a penalty of $10,000 per violation under statute. For both willful and nonwillful failures, a six-year statute of limitations exists for assessments based on failures to file required FBARs. Fear of these penalties (and others assessable for failures to meet requirements related to international holdings) has spurred tens of thousands of United States persons to make voluntary disclosures with the Service, with over $10 billion of revenue raised by the programs to date.

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

Given the increasing likelihood of a paradigm shift, an introduction to procedures for assessment and enforcement of FBAR penalties is of benefit. While case law in the FBAR realm is relatively sparse, the Service has developed assessment standards contained primarily in Internal Revenue Manuals. As to enforcement, procedures for collection of FBAR assessments differ markedly from tax assessments, as the FBAR penalty is not classified as a tax penalty. Fluency with the standards and collection methods is vital when advising clients of relative risks

Penalty Assessment

FBAR Background

Generally, United States persons with financial interests in or signature authority over foreign financial accounts must disclose their foreign holdings on the FBAR if the aggregate value of such accounts exceeds $10,000 during the calendar year. 31 C.F.R. § 1010.350(a). United States persons include citizens or residents of the United States and numerous types of entities (including corporations, trusts, partnerships, or limited liability companies created under United States law). 31 C.F.R. § 1010.350(b). Reportable accounts for FBAR purposes include savings accounts, deposit accounts, demand deposit accounts, checking accounts, securities accounts, and any other account maintained with a person engaged in the business of banking or securities. 31 C.F.R. § 1010.350(c). Additionally, mutual funds and insurance/annuity policies with cash values are also reportable. 31 C.F.R. § 1010.350(c). Stocks, bonds, or similar financial instruments held directly by a person (rather than in a financial account), real estate or an account holding solely real estate, and safety deposit boxes are not classified as reportable accounts. I.R.M. 4.26.16.3.2.3.

A financial interest exists in an account where a United States person is (1) the owner of record/holder of legal title or (2) has the beneficial interest in the account. 31 C.F.R. § 1010.350(e). A "beneficial interest" can exist where, for example, the owner of record/holder of legal title is a person acting as an agent for the United States person, a corporation in which the United States person owns greater than a 50% interest, a trust in which a United States person is the trust grantor and has an ownership interest in the trust for tax purposes, or a trust in which a United States person either has a present beneficial interest in more than 50% of the assets or from which such person receives more than 50% of the income. 31 C.F.R. § 1010.350(e). A trust beneficiary is not required to report the trust's foreign financial accounts on the FBAR if the trust, trustee of the trust, or agent of the trust is a United States person and those person(s) file an FBAR disclosing the trust's foreign financial accounts. I.R.M. 4.26.16.4.3.2.

Signature authority exists where an individual (alone or in conjunction with another) can control the disposition of money, funds, or other assets held in a financial account by direct communication (in writing or otherwise) to the person with whom the financial account is maintained. 31 C.F.R. § 1010.350(f).

For purposes of determining whether the $10,000 threshold is met, aggregated values are used for all accounts in which any interest is maintained (including solely-owned accounts, jointly-owned accounts, direct financial interest accounts, indirect financial interest accounts, and signature authority accounts). I.R.M. 4.26.16.3.6.3.

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

Primary focus is typically given to reporting requirements in the FBAR context; however, record-keeping requirements also exist. Any person with a financial interest in or signature authority over a reportable account must keep the following records: (1) the name in which the account is maintained, (2) the number or other designation identifying the account, (3) the name and address of the foreign financial institution or other person with whom the account is maintained, (4) the type of account, and (5) the maximum value of each account during the reporting period. 31 C.F.R. § 1010.420. Such records must be kept for five years, and must also be kept available for inspection. 31 C.F.R. § 1010.420.

Assessment Types

Various provisions of the Internal Revenue Manual contain detailed information on the process of penalty assessment in the FBAR context. The Service is delegated authority to enforce civil FBAR matters, despite the requirement to report foreign accounts being codified in Title 31 of the United States Code rather than Title 26 (discussed in greater detail in the context of collection procedures, contained herein). I.R.M. 4.26.16.2.3. FinCEN retains rule-making authority for the FBAR. I.R.M. 4.26.16.2.3.

Assessable penalties for FBAR violations are delineated in Section 5321 of Title 31, with standards and guidance for these penalties further developed in the Internal Revenue Manuals. Four primary civil penalties are used for FBAR violations: penalties for (1) negligence, (2) a pattern of negligent activity, (3) nonwillful violations, and (4) willful violations. 31 U.S.C. § 5321(a). As to the first two, failures due to negligence can subject an institution failing to comply with FBAR rules and regulations to penalties; if such an institution engages in a pattern of negligent activity, a penalty of $50,000 may be imposed. 31 U.S.C. § 5321(a)(6). Importantly, these penalties apply only to trades and businesses, not to individuals. I.R.M. 4.26.16.6.3.2. No mitigation guidelines exist for the “pattern of negligence” penalty; the Service states this penalty is only to be imposed in “egregious” cases. I.R.M. 4.26.16.6.3.5.

Nonwillful Penalties

As to the penalties assessable against individuals, nonwillful failures to file FBARs can be penalized up to $10,000 per account per year. 31 U.S.C. § 5321(a)(5)(B)(i). An exception to nonwillful penalty imposition is applicable if the relevant violation was due to reasonable cause and the amount of the transaction or the balance of the account at the time of the transaction was properly reported. 31 U.S.C. § 5321(a)(5)(B)(ii). For this penalty, mitigation guidelines are applicable, and examiners are given discretion in determining the penalty amount. I.R.M. 4.26.16.6.4.3.

The Service states that, after May 12, 2015, in most cases examiners will recommend one penalty per open year (regardless of the number of accounts), despite its ability to assess on a "per account" basis; the penalty will normally be limited to $10,000. I.R.M. 4.26.16.6.4.1.1. This position appears to originate in an Interim Guidance Memorandum issued by the Service on May 13, 2015, which provided recommended limitations on FBAR penalties. *See* SBSE-04-0515-0025. The Service does maintain that, in some circumstances, assessing separate nonwillful penalties on a per-account basis will still be appropriate. I.R.M. 4.26.16.6.4.1.3. In no case, however, should nonwillful penalties exceed 50 percent of the highest aggregated balance of all accounts to which the violations relate during the years at issue (as this is the level of penalty appropriate for willful violators, as discussed below). I.R.M. 4.26.16.6.4.1. In certain instances, examiners may determine multiple $10,000 nonwillful penalties are inappropriate despite nonwillful failures covering multiple years; when this is the case, a one-year $10,000 penalty may be assessed. I.R.M. 4.26.16.6.4.1.2. The Service has indicated that, where markers of willfulness exist but do not rise to the required level to assert a willful penalty, assertion of a higher nonwillful penalty (compared to a case where no indicia of willfulness existed) may occur.

Willful Penalties

Willful violations of FBAR requirements create assessable penalties in the amount of the greater of $100,000 or 50% of the amount of the balance of unreported accounts at the time of the violation. 31 U.S.C. § 5321(a)(5)(D). The penalty applies to both the reporting and recordkeeping requirements; the Service notes that there may be both a reporting and recordkeeping violation regarding each account. I.R.M. 4.26.16.6.5.4. The Service indicates that, for penalty computation purposes, the amount in the account as of June 30 (the historical FBAR due date) is the amount to use in calculating the violation. I.R.M. 4.26.16.6.5.5. Presumably, given the recent FBAR deadline modifications (and extension availability), penalties for prospective failures will be assessed based on the value as of April 15 (or, if the FBAR requirement is extended but not filed, as of October 15).

The Service notes that, in this context, "willfulness" is defined as a voluntary, intentional violation of a known legal duty; the burden of establishing willfulness rests with the Service. I.R.M. 4.26.16.6.5.1. The Service states, "Willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements. In the FBAR situation, the person only need know that a reporting requirement exists. If a person has that knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR." I.R.M. 4.26.16.6.5.1.3.

Many (if not the majority of) individuals who become aware of retroactive failures indicate they previously had no familiarity or direct knowledge of the FBAR form itself; where this is the case, the concept of willful blindness becomes relevant. Under the Service's standards, willfulness is attributed to individuals who exhibit willful blindness, defined as circumstances where a person makes a "conscious effort" to avoid learning of FBAR requirements. I.R.M. 4.26.16.6.5.1.5. In its discussion of willful blindness, the Service references questions concerning financial accounts at foreign banks on Schedule B of Form 1040. Noting that this section of the income tax return refers individuals to instructions which provide FBAR information, the Service states, "It is reasonable to assume that a person who has foreign bank accounts should read the information specified by the government in tax forms. The failure to act on this information and learn of the further reporting requirement, as suggested on Schedule B, may provide evidence of willful blindness on the part of the person." I.R.M. 4.26.16.6.5.1.5. However, the Service also notes that the "mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, in itself, to establish that the FBAR violation was attributable to willful blindness." I.R.M. 4.26.16.6.5.1.5.

The above position is largely consistent with the Fourth Circuit Court's position on willfulness as espoused in Williams v. Commissioner, a case decided in 2012 (and one of the primary sources of guidance in the FBAR context). Williams's 2000 tax return contained the aforementioned Schedule B inquiry; Williams answered the question "no." Though his return for 2000 was prepared by his accountant, the Court stated that, by filing his 2000 tax return, Williams had declared "under penalty of perjury that he had examined [the] return and accompanying schedules and statements and that, to the best of his knowledge, the return was true, accurate, and complete." The Court stated that signing the return creates constructive knowledge of the return's contents, and provides prima facie evidence that the signing party knew the contents of the return. The Court then stated that the question regarding foreign accounts put him on inquiry notice of the FBAR requirement. Though Williams testified he never read that part of the return, the Court stated his failure to read that portion of the return constituted "a conscious effort to avoid learning about reporting requirements," and his answer on the return that he had no foreign accounts evidenced "conduct that was meant to conceal or mislead sources of income or other financial information." This conduct constituted willful blindness of the FBAR requirement. Ultimately (after consideration of other factors also evidencing willfulness by Williams), the Court found that Williams had acted willfully in failing to file the required FBAR.

The Service concedes that willfulness typically cannot be proven by direct evidence; thus, reasonable inferences are to be drawn from available facts. I.R.M. 4.26.16.6.5.2. In its list of factors evidencing willfulness, the Service emphasizes the weight given to efforts by an individual to conceal his/her foreign account (i.e. if the individual uses funds for daily living expenses in a manner that conceals the source of the funds). I.R.M. 4.26.16.6.5.2.2. Curiously, another factor stated as evidencing willfulness is where costs associated with foreign investment management firms are significantly higher than they would be for the same services domestically. I.R.M. 4.26.16.6.5.2.2. Additional items which support a willful FBAR penalty include nondisclosure of a foreign account to a return preparer, lack of business reasons for the account, and lack of family/business connection to the country where the account is located. Conversely, factors not supporting a willful FBAR penalty include the account being inherited, disclosure of the foreign account to the return preparer, and a legitimate connection to the country where the account is held. Representations have also been made that white collar workers can be held to a higher standard/expected degree of knowledge than others (rightly or wrongly). Fraud technical advisors can be utilized in development of the rationale for the willful FBAR penalty.

While statutory authority for penalty imposition is enormous, relevant manual provisions provide significant limitations. The Service notes that, in accordance with SBSE-04-0515-0025, in most cases the total penalty amount for all years under examination will be limited to 50% of the highest aggregate balance of all unreported foreign financial accounts during all years under examination. I.R.M. 4.26.16.6.5.3. A higher penalty can be recommended based on the facts and circumstances presented; however, the Service explicitly states that in "**no event** will the total penalty amount exceed 100 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination." I.R.M. 4.26.16.6.5.3.3 (emphasis added). At least a portion of the Service's desire to limit penalty assessment likely comes from concerns (already raised by practitioners) that FBAR penalties could be found to violate the Eighth Amendment's Excessive Fines Clause (whereby civil penalties cannot be grossly disproportionate to the violation at issue).

MITIGATION/EXAMINER DISCRETION

Mitigation guidelines are provided for FBAR penalties; where mitigation threshold conditions are met, an assessed individual can be subject to a penalty less than the maximum amount permissible. Examiners maintain additional discretion to determine that a penalty provided in the Manual is not appropriate or that a lesser penalty amount should be imposed. I.R.M. 4.26.16.6.7. In some cases, warning letters (rather than a financial penalty) may be issued. I.R.M. 4.26.16.6.7. The Service states that amounts at issue will be a factor as to whether examiner discretion for penalties is appropriate. I.R.M. 4.26.16.6.7. Where no financial penalty is assessed, a warning letter is required. I.R.M. Ex. 4.26.16-1. Importantly, the Service explicitly states that, while FBAR penalties have upper limits, no floor exists for minimum penalty requirements. I.R.M. 4.26.16.6.4.4. This (accurate) statement is worthy of note, as it gives further discretion in determining penalty amounts to the Service. Ample grounds thus exist for arguing a client's specific facts with the intention of minimizing penalty assessment.

Penalty Enforcement

Post-Assessment

As part of the assessment process, the examiner is to discuss penalties with his/her group manager; where penalties are deemed appropriate (but where a criminal referral is unrequired), penalties are asserted in accordance with the aforementioned guidelines. I.R.M. 4.26.17.4.3.1. After determination of penalties, the examiner submits his/her case to a Counsel FBAR Area Coordinator; Counsel normally renders legal advice on the appropriateness of the penalty recommended within 45 days (in some instances, more time for advice can be required). I.R.M. 4.26.17.4.3.5. Counsel's ultimate role is to determine whether the evidence gathered by the examiner is sufficient to support the penalty asserted by the examiner (and his/her group manager). To this end, the examiner normally prepares a memorandum for Counsel outlining the relevant facts. Counsel can recommend either a higher or lower penalty, and can also advise to assert no penalty. In some instances, Counsel will consult with an Associate Chief Counsel in making a determination. I.R.M. 4.26.17.4.3.5.

If an agreement is reached that penalties are proper, the examiner issues the FBAR 30-day letter (Letter 3709) and the FBAR Agreement to Assessment and Collection (Form 13449). I.R.M. 4.26.17.4.3.6. No interest accrues on FBAR penalties prior to assessment; thus, if full payment is made within 30 days after the date a notice of the penalty amount due is first mailed to the filer, only the penalty amount will be owed. I.R.M. 4.26.17.4.3.6.5. A six percent delinquency penalty applies to amounts remaining unpaid ninety days from the date a notice of the penalty amount due is first mailed to the filer (in addition to interest on the amount owed). I.R.M. 4.26.17.4.3.6.5.

Where an FBAR penalty is proposed but not agreed to by the individual against whom it is asserted, the examiner must wait to see if the penalized individual will appeal the assessment; the individual is given 45 days to appeal. I.R.M. 4.26.17.4.6.1. To appeal, the individual must mail a written protest (containing all the information indicated as required under Letter 3709) in duplicate to the examiner that is postmarked before the designated response date listed in Letter 3709. I.R.M. 4.26.17.4.6.2. If an appeal is received, the group manager reviews the case file then forwards the case to Appeals. I.R.M. 4.26.17.4.7.3.

Post-assessment FBAR cases are priority cases which require expedited handling by Appeals. I.R.M. 8.11.6.8.3.1. Importantly, post-assessment FBAR cases in excess of $100,000 cannot be compromised by Appeals without approval by the Department of Justice. I.R.M. 8.11.6.1.6. Functionally, this provides limitations on the ability of Appeals to settle FBAR matters.

Where an FBAR penalty is proposed but not agreed to by the penalized party, and the penalized party does not respond to the Letter 3709, the penalty is assessed and the collection process begins. I.R.M. 4.26.17.4.6.3. If penalties have not been paid in full, Letter 3708 (Notice and Demand for Payment) is issued; the collection information is then forwarded to the Financial Management Service. I.R.M. 4.26.17.4.6.6.

Collection

FBAR penalties are classified as debts owed to the United States government; standards for collection of non-tax penalties are expounded by statutes and regulations. *See* 31 C.F.R. § 5.1. Government entities will send at least one, but normally no more than two, notices of a debt owed to an individual before commencing collection action. 31 C.F.R. § 5.4. Such notices are required to explain in full the debt(s) owed and enforcement measures authorized for use in collection. 31 C.F.R. § 5.4. Where debtors cannot pay amounts owed in full, regular installment payments can be made instead. 31 C.F.R. § 5.6. In certain instances, debts can be compromised. 31 C.F.R. § 5.7. Where a debt is determined to be uncollectible, collection activity can be suspended or terminated. 31 C.F.R. § 5.8.

Collection of FBAR penalties is primarily done through two methods: the government (1) can offset payments due to a penalized individual and (2) can file civil actions to collect the penalty. I.R.M. 8.11.6.3.1.1.2. The ability to offset payments has no limitation period, but any civil action filed to recover an FBAR penalty must be done within two years. I.R.M. 8.11.6.3.1.1.2; *see also* 31 U.S.C. §3716(e)(1). The two-year period begins on the later of the date of penalty assessment or the date a judgment becomes final in a criminal action. 31 U.S.C. §5321(b)(2).

It is vital to juxtapose the collection methods available for FBAR penalties with those for traditional tax penalties under Title 26. Under Title 26, levies and liens can be obtained without court approval. In the FBAR context, this is not the case, since FBAR penalties are not classified as tax penalties. *See* United States v. Simonelli, 614 F.Supp. 2d 241 (2008). Penalty collection methods are more restrictive, as the "special" provisions in Title 26 related to collection are not applicable. Since Title 26's methods cannot be used, collection is done through the procedures generally used to collect debts owed to the United States.

Methods for collection by the government through offset of payments include (1) administrative offsets, (2) tax refund offsets, (3) federal salary offsets, (4) referrals to private collection contractors, (5) referrals to agencies operating a debt collection center, (6) reporting delinquencies to credit reporting bureaus, (7) garnishing the wages of delinquent debtors, and (8) litigation or foreclosure. 31 U.S.C. § 3711(g)(9).

Administrative offsets may be used only after the debtor receives written notice of the claim, an opportunity to inspect and copy records related to the claim, an opportunity for review within the agency for the claim, and an opportunity to make a written agreement with the head of the agency to repay. 31 U.S.C. § 3716(a). For tax refund offsets, no agency may take action until they notify the person incurring the debt of the proposed action, give the person at least 60 days to present evidence that such debt is either not past due or not legally enforceable, consider evidence related to the same, and certifies that reasonable efforts have been made to obtain debt payment. 31 U.S.C. § 3720A(b). Additional restrictions apply in the context of federal salary offsets and wage garnishments, with a general 15% imposition limitation applicable. *See* 31 U.S.C. §3720D(b)(1).

Treasury entities do not extend loans, loan guarantees, or loan insurance to any person delinquent on a debt owed to a federal agency. 31 C.F.R. § 5.17(a). Licenses, permits, and other privileges may also be revoked or suspended for inexcusable or willful failures of a debtor to pay debts owed. 31 C.F.R. § 5.17(b). Where debts are collected but then waived or otherwise found not to be owed, refunds are to be issued promptly; however, refunds do not bear interest unless otherwise required by law. 31 C.F.R. § 5.19.

Given limitations regarding offsets of payments, the government's best option to collect penalties in full is often to file a civil action; however, as stated above, a two-year statute of limitations is applicable. I.R.M. 8.11.6.3.1.1.2. Delinquent debts are referred to the Department of Justice for litigation after aggressive collection activities have been taken if such debts are ones where the debts should not be compromised and collection activity should not be suspended or terminated. 31 C.F.R. § 5.16(b). The venue for FBAR penalties in the United States District Court and the Federal Court of Claims (rather than the Tax Court). I.R.M. 8.11.6.1.18. Where a suit is filed and the government succeeds, an enforceable judgment exists, expanding collection options.

CONCLUSION

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