

Two More Blows to Foreign Account Holders: Tax Court Lacks FBAR Jurisdiction and Bankruptcy Offers No Relief from FBAR Penalties

By Hale E. Sheppard

Hale Sheppard discusses two recent cases with significant impact on FBAR issues.

Introduction

The holiday season depresses many people; it causes them to focus on what they lack, as opposed to what they have. This gloominess is likely to be more widespread than normal this year given the struggling economy, mortgage meltdown, rising unemployment rate, ongoing war, *etc.* While the situation is understandably grim for most Americans, it must be downright bleak for a certain segment of the population, *i.e.*, those who have financial accounts in foreign countries that they failed to properly report to the IRS. In other words, the days may be the darkest for those U.S. taxpayers who did not file, whether inadvertently or intentionally, an annual Form TD F 90-22.1 (*Report of Foreign Bank and Financial Accounts*), or “FBAR” as it is more commonly known.

For those with undisclosed foreign accounts, 2008 was filled with events that changed the circumstances from bad to worse. The U.S. government took numerous steps designed to halt taxpayers from placing assets abroad in order to avoid paying U.S.

taxes. These efforts included launching an aggressive campaign to criminally prosecute employees of UBS and other foreign banks accused of facilitating tax evasion; issuing summonses to recalcitrant foreign financial institutions to obtain the identities of U.S. clients holding accounts; participating in various congressional hearings on tax havens; appointing two senior attorneys to solely pursue cases involving tax evasion and FBAR violations; signing a tax information exchange agreement with a country famous for bank secrecy and client confidentiality; suggesting that there will be no further settlement initiatives for noncompliant taxpayers by which they could avoid criminal prosecution and/or civil penalties; severely downgrading the reasonable-reliance-on-a-qualified-tax-professional justification for avoidance of FBAR penalties; and increasing rewards for whistleblowers willing to reveal the identities of tax scofflaws in exchange for a percentage of the amounts recovered. Recent judicial rulings did their part in making conditions precarious for FBAR violators, too. In 2008, the Tax Court held that it did not have jurisdiction to resolve FBAR matters, and a federal district court determined that FBAR penalties could not be discharged in bankruptcy.

This article demonstrates that, with all of the developments in 2008, it is now more important than ever for those with undisclosed foreign accounts to consult a tax professional with significant FBAR experience

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and to take other actions to place themselves in the best possible position under the circumstances.

Overview of FBAR Filing Requirements and Penalties

Congress enacted the Bank Secrecy Act in 1970.¹ One purpose of this legislation was to require the filing of certain reports, like the FBAR, where doing so would be helpful to the U.S. government in carrying out criminal, tax and regulatory investigations.² Among the most important provisions of the Bank Secrecy Act was 31 USC §5314. This provision requires the filing of an annual FBAR with the Treasury in cases where (i) a U.S. person (ii) had a financial interest in, signature authority over, or other authority over (iii) one or more financial accounts (iv) located in a foreign country (v) whose aggregate value exceeded \$10,000 (vi) at any time during the calendar year.³

Over the past several decades the main problem has been that few U.S. taxpayers filed an FBAR, and they had little incentive to do so. Compliance was not rewarded, and noncompliance generally went unpunished. In terms of statistics, one congressional report indicated that from 1993 to 2002 the U.S. government only considered imposing FBAR penalties in 12 cases. Of those dozen, only two taxpayers ultimately received penalties, four were issued “letters of warning,” and the remaining six were not pursued for various reasons.⁴

Annoyed by estimates that FBAR compliance was less than 20 percent, the U.S. government took two major actions. First, in April 2003, the Treasury transferred authority to enforce the FBAR provisions from its Financial Crimes Enforcement Network (“FinCEN”) to the IRS.⁵ Thanks to a Memorandum of Agreement between FinCEN and the IRS, the latter is now empowered to investigate potential violations, issue summonses, assess and collect civil penalties, issue administrative rulings and take “any other action reasonably necessary” to enforce the FBAR provisions.⁶

The second major governmental action was the enactment of new penalty provisions in the American Jobs Creation Act (“Jobs Act”), which took effect October 22, 2004.⁷ Under the old law, the Secretary of the Treasury could assert a civil penalty on any person who “willfully” violated the FBAR rules.⁸ Meeting this burden was challenging, as it required the Secretary to demonstrate that the taxpayer in question knew about the FBAR-related duties, yet intentionally ignored them.⁹ If the Secretary managed to satisfy this high evidentiary standard, he was authorized to assert

civil penalties ranging from \$25,000 to \$100,000, depending on the amount of the relevant transaction or the balance of the relevant account.¹⁰

Under the Jobs Act, the IRS may impose a civil penalty on any person who fails to file an FBAR when required.¹¹ In the case of non-willful or unintentional violations, the government may impose a maximum penalty of \$10,000.¹² However, the IRS cannot assert this penalty if two conditions are met: the violation was due to “reasonable cause” and the balance in the account was properly reported.¹³ The Jobs Act calls for a higher maximum penalty where there is *willfulness*. In situations where a taxpayer deliberately failed to report an account, the IRS may assert a penalty of \$100,000 or 50 percent of the balance in the account at the time of the violation, whichever is larger.¹⁴

In summary, the Jobs Act made three principal changes. First, it added a new penalty of \$10,000 for cases involving nonwillful FBAR violations. Second, it essentially changes the burden of proof in certain situations. Under the old law, all penalties required the IRS to demonstrate willfulness; that is, the IRS had to show by clear and convincing evidence that the taxpayer knew about the FBAR filing requirement and deliberately failed to comply. The new law, by contrast, allows the IRS to assert the penalty any time an FBAR is not properly filed. This shifts the burden to the taxpayer to meet the “reasonable cause” exception. Third, the new law increases the maximum penalty that may be imposed for willful violations. The former penalty ranged from \$25,000 to \$100,000, depending on the amount of the transaction or the balance in the account. Now, however, these penalties have increased substantially. The low range of the penalty has jumped by \$75,000 per violation, and the high range has no monetary ceiling whatsoever, just a percentage cap. As a result, the FBAR penalty under the Jobs Act could have serious consequences for U.S. taxpayers holding large sums of money in undisclosed foreign financial accounts. According to tax practitioners, the message from Congress in passing the Jobs Act was unmistakable: “taxpayers must disclose, disclose, disclose, or suffer the consequences.”¹⁵

From Bad to Worse for the Noncompliant

In presenting new information, people often ask the question: What do you want to hear first, the good news or the bad news? In the case of U.S. taxpayers with undisclosed foreign accounts, a slight variation

seems warranted. The appropriate inquiry might be the following: What do you want to hear first, the bad news or the really bad news? Let's take them in order.

Bad News

Bad News for Taxpayers

One of the biggest challenges with FBAR compliance in recent years has been ambiguity. Simply put, neither taxpayers nor their advisors tended to understand the complex rules, and the IRS issued little in the way of guidance. Things have improved somewhat in this regard recently. For instance, the IRS held "webinars" at which FBAR issued were addressed,¹⁶ created a new section in the INTERNAL REVENUE MANUAL containing FBAR standards and procedures¹⁷ and released a revised FBAR form and instructions for use beginning in 2009.¹⁸ For the most part, however, there has been nothing but bad news for noncompliant foreign account holders in the past year. Some of the more notable items are discussed below.

In February 2008, the IRS announced that it was taking enforcement action against more than 100 U.S. taxpayers "to ensure proper income reporting and tax payment in connection with accounts in Liechtenstein."¹⁹

Approximately three months later, in May 2008, the U.S. Department of Justice (DOJ) unsealed the indictment against Bradley Birkenfeld, a former UBS banker. Mr. Birkenfeld and others allegedly helped a California real estate mogul, Igor Olenicoff, evade millions in U.S. income taxes and hide significant assets in Switzerland and Lichtenstein. Mr. Olenicoff pled guilty, paid back taxes and fines, performed community service, and, importantly, cooperated with U.S. authorities.²⁰ Mr. Birkenfeld eventually pled guilty to his involvement, too, and agreed to cooperate with the U.S. authorities in their ongoing investigation.²¹

In July 2008, the IRS filed a John Doe summons against UBS to get the names of some 20,000 U.S. taxpayers with undisclosed accounts at the financial institution in Switzerland. Later that month, Congress held two hearings in which they analyzed, among other things, FBAR noncompliance and the roles of Lichtenstein, Switzerland and the Cayman Islands in

tax avoidance by U.S. taxpayers.²² As part of those hearings, a high-ranking executive of UBS's global wealth management division testified that UBS would obligate U.S. clients to close existing accounts, refuse to open new accounts, and prohibit Swiss advisors from traveling to the United States for purposes of meeting with U.S. clients.²³

Officials from the DOJ and IRS confirmed in September 2008 that they intend to begin prosecuting taxpayers for FBAR violations soon. To demonstrate that this is more than mere a threat, they appointed two senior prosecutors to specialize in FBAR violations and tax evasion, which often go hand in hand.²⁴

For those with undisclosed foreign accounts, 2008 was filled with events that changed the circumstances from bad to worse.

Still beating the enforcement drum, the assistant attorney general and head of the DOJ Tax Division announced in November 2008 that there is "no free bite of the apple" for taxpayers violating the FBAR requirements and warned

that the DOJ intends to "publicize and leverage every single case" as a deterrence mechanism for others.²⁵ He also clarified that tax-exempt organizations are not immune from FBAR prosecution because the "warning shots" from the IRS have already been fired.²⁶ Again emphasizing the high-profile-prosecution-as-a-deterrent theme, the assistant attorney general announced that the DOJ intends to "leverage every [FBAR] case to ensure honest people understand there are consequences when you don't do it properly and don't feel like schnooks for doing it properly."²⁷

In mid-November 2008, the DOJ revealed that it had obtained the names of 70 U.S. clients at UBS in response to the John Doe summons served earlier in that year. In addition, the DOJ claimed that it had received another 30 names from whistleblowers intent on the claiming the reward money.²⁸

There were a series of happenings in December 2008. The U.S. government announced that it was expanding its international investigation to cover not only UBS, but also Credit Suisse and HSBC in London, Europe's largest bank.²⁹ It also made it known that it had signed a tax information exchange agreement with Liechtenstein,³⁰ a country that has already yielded a large number of fraud referrals to IRS Criminal Investigation.³¹ Spreading his own brand of holiday cheer, IRS Commissioner Shulman, speaking at an international tax conference, vowed to take tough actions to stop

wealthy U.S. individuals from hiding taxable income in offshore accounts. He stated that “[w]e cannot allow this corrosive behavior to undermine the fundamental confidence in the fairness of the tax system, which could prompt more and more taxpayers to cross over that dangerous line into noncompliance.”³² Mr. Shulman also reminded the crowd that more tax enforcement is likely on its way because President-elect Obama, who sponsored the “Stop Tax Haven Abuses Act” as a senator, made a campaign promise of shutting down offshore tax havens.³³

Bad News for Return Preparers

Lest anyone feel excluded, it is worthwhile noting that the IRS’s actions in the FBAR arena are not limited to taxpayers; they also apply to return preparers. After many months of controversy, Congress recently modified Code Sec. 6694, which provides for potentially severe return preparer penalties.³⁴ This provision generally calls for sanctions where a return preparer completes all or a substantial portion of certain returns or refund claims, such returns or claims contain an understatement of tax liability, and the tax position leading to the understatement was an “unreasonable position.” The IRS may not assert the penalty, though, if the return preparer demonstrates that there was reasonable cause for the understatement and she acted in good faith.³⁵

Part III of Schedule B to Form 1040 asks the following question: “At any time during [the relevant 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?” If the taxpayer checks the “yes” box, then she is required to report the name of the foreign country in which the account is located. Moreover, she is directed to consult the IRS instructions to Schedule B to determine whether it is necessary to file an FBAR with the proper Treasury office.

The Office of Professional Responsibility (OPR), which is in charge of ensuring that tax practitioners adhere to the rules set forth in Circular 230, released a statement explaining that many noncompliant foreign account holders blame their return preparers for their failure to file annual FBARs. Citing the reasonable-reliance-on-a-qualified-tax-professional excuse, taxpayers claim that they should be immune from penalties because their return preparer did not inquire about or adequately explain the foreign account requirements. The OPR statement reminds all tax practitioners that Section 10.22 of Circular 230

imposes a duty of due diligence (i) in preparing or assisting in the preparation of, approving and filing returns, documents, affidavits or other papers relating to IRS matters; and (ii) in determining the accuracy of representations (oral or written) made to the IRS. According to the OPR, this does not require practitioners to “audit” their clients, but it does obligate them to make reasonable inquiries when a client provides information that suggests possible participation in overseas transactions or accounts. It also mandates that they advise the client of potential penalties for noncompliance.³⁶

Reports from the U.S. Joint Committee on Taxation (JCT) also demonstrate that some of the international tax compliance burden will likely be borne by return preparers. The JCT suggested subjecting return preparers to a statutory due diligence requirement in determining whether the client is required to file an FBAR (relating to foreign financial accounts) or a Form 3520 (relating to foreign trusts). Under this proposal, a return preparer would be required to (i) fully understand the requirements and penalties for noncompliance, (ii) explain these complex issues to the client, (iii) document the client’s responses, and (iv) retain these responses for potential use by the IRS in any subsequent audit.³⁷

Based on the documents from the OPR and JCT, various practitioners have predicted that the IRS will target not only taxpayers, but also their return preparers, in the battle against FBAR noncompliance. According to certain tax professionals, “[t]he IRS would no doubt like to enlist tax preparers in their effort to increase FBAR compliance and given increased IRS enforcement focus on preparers and preparer penalties, it is not too far afield to anticipate that if a taxpayer violation is found, the focus could turn to the preparer as to whether due diligence was exercised under Circular 230.”³⁸ Echoing this sentiment, other tax attorneys have speculated that “[w]hile failure to determine whether the form should be filed is not currently a ground for preparer penalties (as with the earned income tax credit), this step has already been proposed and is probably just around the corner.”³⁹ The IRS recently confirmed the suspicions of the tax community, announcing in September 2008 that return preparers whose preparation software automatically defaults to “no” with respect to the foreign account question in Part III of Schedule B to Form 1040 will face stiff penalties under the revised Section 6694. In particular, senior IRS officials warned that preparers simply cannot rely

on the reasonable-cause-and-good-faith defense to avoid penalties. This is because, in the IRS's view, "[p]reparers do not have reasonable cause for not asking the foreign bank account question or including the extra form [*i.e.*, FBAR] if there is a bank account."⁴⁰

Really Bad News

The previous portion of this article demonstrates that things have been bad in 2008, both for taxpayers with undisclosed foreign accounts and for the return preparers who fail to adequately advise or inquire about such accounts. The reality is that the situation could be even worse in subsequent years because of two recent cases that passed largely unnoticed, *J.B. Williams III*⁴¹ and *Simonelli*.⁴²

Williams

Relevant Background. A little background is necessary to appreciate the impact of *Williams*. As explained above, the IRS historically had the authority to *investigate* potential FBAR violations, but the DOJ and FinCEN retained the authority to *enforce* the law. That completely changed in 2003 when the IRS and FinCEN signed a Memorandum of Agreement delegating all enforcement authority to the IRS.⁴³ The IRS was thereby empowered to investigate potential FBAR violations, issue summonses, assess and collect penalties, issue administrative rulings and take "any other action reasonably necessary" to enforce the FBAR provisions.⁴⁴

This delegation raised a number of issues, which require a brief review of the key provisions. Title 31, §5314 of the U.S. Code requires certain U.S. persons to file an annual FBAR; 31 USC §5321(a)(5) (A) empowers the Treasury Secretary to assert civil penalties against those who fail to file the necessary FBAR, and, if the taxpayers do not voluntarily pay the FBAR penalties, 31 USC §5321(b)(2) allows the Treasury Secretary to bring a civil collection action within two years of assessing the FBAR penalty. The preceding provisions all have one thing in common, they derive their authority from Title 31 of the U.S. Code, not Title 26 of the U.S. Code (*i.e.*, the Internal Revenue Code). Thus, the delegation of FBAR authority from FinCen to the IRS in 2003 effectively transferred nontax issues to a tax agency.

Here is why it matters. Section 6201(a) of the Internal Revenue Code authorizes the IRS to make determinations and assessments of all taxes, including penalties, "imposed by title [26] or accruing under any former internal revenue law." This provision does

not account for any non-tax-related actions, which raises three immediate questions: (i) What procedures will the IRS follow in imposing the FBAR penalty? (ii) Do taxpayers have a right to a review of any unresolved FBAR penalties by the IRS Appeals Office? (iii) Assuming taxpayers have the right to review by the IRS Appeals Office, will they also have the right to judicial review by the Tax Court if they are dissatisfied with the decision from the IRS Appeals Office?⁴⁵

Additional questions arise once an FBAR penalty gets assessed. Under 31 USC §5321(b)(2), the Treasury Secretary may commence a civil action to recover unpaid FBAR penalties. Again, this authority originates in Title 31 of the U.S. Code, not Title 26 (*i.e.*, the Internal Revenue Code). Section 6301 of the Internal Revenue Code states that the IRS "shall collect the taxes imposed by the internal revenue laws." Therefore, will the normal IRS procedures and taxpayer protections regarding collection notices, liens, and levies apply in the context of FBAR penalties?⁴⁶

These pivotal questions have now been answered, either by the FBAR guidance in the INTERNAL REVENUE MANUAL or by the Tax Court in *Williams*.

Dealing Administratively with the IRS. In July 2008, the IRS introduced a new portion of the INTERNAL REVENUE MANUAL dealing exclusively with FBAR issues. As discussed earlier, there is considerable flexibility with the current penalties. In the case of *nonwillful* violations, the IRS "may" (not "must" or "shall") assert a penalty of up to \$10,000.⁴⁷ When it comes to *willful* violations, the maximum penalty the IRS may impose increases to the larger of \$100,000 or the amount in the unreported account at the time of the violation.⁴⁸ Clearly, the IRS has significant discretion regarding, first, whether to assert a penalty and, second, what amount the penalty should be.

The INTERNAL REVENUE MANUAL devotes considerable attention to the fact that the FBAR rules are complex, the reasons leading to FBAR noncompliance vary, and penalties theoretically can be enormous. On this last point, the INTERNAL REVENUE MANUAL clarifies that the penalties are determined on a per-unreported-account, per-year basis, and that "[g]iven the magnitude of the maximum penalties permitted for each violation, the assertion of multiple penalties and the assertion of separate penalties for multiple violations with respect to a single FBAR form should be considered only in the most egregious cases."⁴⁹

Several methods to close an FBAR case are described in the INTERNAL REVENUE MANUAL. In the best case scenario, the IRS could either decide that no penalty is

warranted or simply issue the taxpayer a “warning letter.”⁵⁰ If the taxpayer is not so fortunate, the IRS may assert a civil penalty. This penalty will be set forth in an FBAR 30-day letter (Letter 3709) and an FBAR Agreement to Assessment and Collection (Letter 13449).⁵¹

Issuance of an FBAR penalty renders three main options for the taxpayer. First, she can agree to the assessment by executing the Letter 13449, filing the delinquent FBARs with the revenue agent, and paying the penalty in a timely manner. The IRS would then close the case.⁵² Second, she could simply not respond to the IRS, or respond but refuse to sign an assessment-period extension. If the taxpayer opts for this course of action, the IRS will assess the FBAR penalty and the collection process will begin.⁵³ The third option available to the taxpayer is to file a timely written protest requesting review by the IRS Appeals Office. This final option seems promising, but it may be more limited than it initially appears. The IRS has categorized FBAR penalties as a “coordinated issue,” which means that the Appeals Officers, who generally have wide latitude and discretion, must follow certain guidelines to ensure IRS-wide uniformity and consistency. Specifically, the Appeals Officers must contact the “Appeals FBAR Coordinator” before scheduling an initial conference with the taxpayer and/or her representative.⁵⁴ The Appeals Officers also are obliged to follow the procedures found in “Foreign Bank and Financial Account Requirements Guidance for Appeals Officers,” which is accessible only by authorized IRS personnel.⁵⁵ Applying these standards, the Appeals Officers would make the IRS’s final determination regarding whether an FBAR penalty is warranted and, if so, the size of the penalty.⁵⁶

It is important to note that the IRS plans to bifurcate cases involving tax adjustments and tax penalties asserted by the Internal Revenue Code (*i.e.*, Title 26 issues), and FBAR penalties (*i.e.*, Title 31 issues). The INTERNAL REVENUE MANUAL indicates that the standard Appeals process, as described in the preceding paragraph, will be utilized where a taxpayer protests the FBAR penalties and “there is no related Title 26 case or the related Title 26 case is agreed.”⁵⁷ If, however, a case involves tax adjustments, tax penalties and FBAR penalties, the revenue agent, group manager and Appeals Offices are instructed to discuss whether all of the issues should be addressed simultaneously or separately.⁵⁸ The potential separation of issues can lead to troubles and expenses for the taxpayer, as seen in *Williams*.

Facts in the Case. The facts in *Williams* are somewhat convoluted, but those regarding the relevant

issue, the FBAR penalty, are straightforward: (i) The taxpayer had a reportable interest in two Swiss accounts; (ii) the taxpayer did not file a timely FBAR disclosing those accounts to the IRS; (iii) the IRS audited the taxpayer for multiple years; (iv) the IRS issued a standard 30-day letter proposing adjustments to income, accuracy-related penalties and civil fraud penalties; (v) the IRS also issued an FBAR 30-day letter asserting the maximum penalty for each of the two accounts, which totaled \$200,000; (vi) the taxpayer filed a timely protest letter as to all matters; (vii) the IRS Appeals Office in Richmond, Virginia partially accepted the taxpayer’s protest as to the tax issues; (viii) the IRS Appeals Office in Baltimore, Maryland denied the taxpayer’s protest and upheld the imposition of the full FBAR penalties; (ix) the IRS issued a notice of deficiency proposing adjustments to income, accuracy-related penalties and civil fraud penalties (but not FBAR penalties); and (x) The taxpayer filed a timely petition with the Tax Court contesting all the proposed changes in the notice of deficiency, as well as the FBAR penalties.

In his petition, the taxpayer raised two main arguments as to why FBAR penalties were improper. First, it was unnecessary to file an FBAR to alert the IRS of the two Swiss accounts because the IRS, in fact, already had knowledge of such accounts. This is because Swiss authorities, acting at the direction of the U.S. government, froze the accounts during the relevant year in connection with a criminal investigation. Second, the taxpayer claimed that the IRS was heavy-handed and abusive in imposing the FBAR penalties; it only penalized him because he “refused to agree to the erroneous conclusions contained in the audit.” It was, according to the petition, a “vindictive act intended to deprive the taxpayer of his right to appeal and contest his tax liability.”

Rulings on Jurisdictional Issues. The IRS filed a motion to dismiss for lack of jurisdiction and to strike as to the FBAR penalties.⁵⁹ The IRS’s theory was that the provision under which FBAR penalties are asserted, *i.e.*, 31 USC §5321, does not fall within the Tax Court’s jurisdiction. This is based on Section 7422 of the Internal Revenue Code, which provides that the Tax Court and its divisions “shall have such jurisdiction as is conferred on them by this title [26]”

The Tax Court began in *Williams* by explaining that Section 6212(a) of the Internal Revenue Code authorizes the IRS to issue a Notice of Deficiency in certain situations. For its part, Section 6213(a) provides that the tax in question may not be assessed until the IRS

has issued the requisite Notice of Deficiency. It further provides that the tax assessment must be delayed pending a possible redetermination by the Tax Court if the taxpayer files a timely petition. The Tax Court pointed out, however, that these two provisions expressly state that the Notice of Deficiency is to be sent in the case of taxes imposed by subtitle A of Title 26 (*i.e.*, income taxes), by subtitle B of Title 26 (*i.e.*, estate and gift taxes), or chapters 41, 42, 43 or 44 in subtitle D of Title 26 (*i.e.*, miscellaneous excise taxes). Therefore, by negative implication, any other taxes, even those imposed by Title 26, fall outside the limited deficiency jurisdiction of the Tax Court. Extending this logic, the Tax Court reasoned as follows with respect to FBAR penalties:

The IRS and DOJ took numerous actions in 2008 to thwart international tax noncompliance, with a special focus on FBAR violations.

The same conclusion must be reached as to the FBAR penalties imposed in Title 31: The Secretary of the Treasury is authorized by 31 USC sec. 5321(b)(1) to assess the FBAR penalty; no notice of deficiency is authorized by Section 6212(a) nor required by Section 6213(a) before that assessment may be made; and the penalty therefore falls outside our jurisdiction to review deficiency determinations.

Collection of FBAR penalties was not raised in the taxpayer's petition, nor was it broached in the IRS's motion to dismiss and strike. Nevertheless, the Tax Court addressed this issue, too. A quick overview on the normal tax collection process helps put this second issue into perspective.

Within five days after filing a lien, the IRS must provide the affected taxpayer a Notice of Federal Tax Lien informing her of the amount of the unpaid tax and her right to request a collection due process (CDP) hearing.⁶⁰ Likewise, the IRS is required to send the taxpayer a Notice of Intent to Levy at least 30 days before it seizes her property to satisfy tax debts.⁶¹ To request a CDP hearing under either scenario, the taxpayer must file a timely Form 12153 (*Request for a Collection Due Process Hearing*) with the IRS. At the CDP hearing concerning a proposed levy, the Appeals Officer is charged with deciding whether the levy "balances the need for efficient collection of taxes with the legitimate concern of the person that any collection action be no

more intrusive than necessary."⁶² The Appeals Officer ultimately issues a so-called Notice of Determination, which represents the IRS's final administrative decision regarding the propriety of the levy. If the Notice of Determination upholds the levy, the taxpayer still has the right to seek further review, this time from the judiciary. She exercises this right by filing a petition with the U.S. Tax Court.⁶³

In *Williams*, the Tax Court explained that the provisions under which the IRS

may place a lien or effectuate a levy are narrow. They apply to only to "taxes," as well as the additions to tax, additional amounts, and penalties described in Chapter 68 of Title 26 (*i.e.*, Sections 6651 through 6751 of the Internal Revenue Code).⁶⁴ The Tax Court then made three points as to why it lacked jurisdiction: (i) there is no statute expanding the definition of "tax" as used in the lien and levy provisions of the Internal Revenue Code to include the FBAR penalty; (ii) the collection mechanism in the applicable FBAR statute, 31 USC §5321(b)(2), is not a lien or levy, but rather a "civil action to recover a civil penalty"; and (iii) even if the FBAR penalty were a tax subject to the IRS's lien and levy provisions, the requisite Notice of Determination had not been issued.

Simonelli

The taxpayer in *Simonelli* had three accounts in the Bahamas, none of which he reported to the IRS by filing an FBAR for 1999. The IRS later audited the taxpayer. As part of an administrative settlement, the taxpayer agreed to a \$25,000 penalty. Approximately one month later, the IRS officially assessed the penalty and demanded full payment. The taxpayer failed to pay the agreed amount. Consequently, the DOJ, acting for the IRS, filed a timely civil suit against the taxpayer in U.S. District Court to collect the FBAR penalty.⁶⁵

After the IRS assessed the FBAR penalty but before the DOJ filed the collection suit in U.S. District Court, the taxpayer filed for bankruptcy and obtained a general discharge. During the collection suit, the taxpayer had two main theories to support the proposition that the amounts assessed by the IRS with respect to the FBAR had already been discharged in bankruptcy: the FBAR penalty was either a dischargeable "tax" or a dischargeable "tax penalty." The DOJ disagreed,

of course, and filed a motion for summary judgment. The court deemed this an issue of first impression.

The taxpayer's first argument was that, regardless of what it is labeled in the pertinent statute and regulations, the FBAR "penalty" was actually a "tax" of the type that could be discharged in bankruptcy under 11 USC §523(a)(1). The taxpayer suggested that the IRS uses FBARs to track foreign accounts of which the IRS would otherwise have no knowledge. After reviewing the information in the FBAR, the taxpayer claims that the IRS can determine how much a person owes in U.S. taxes and assesses a "tax" in this amount. The taxpayer goes on to state that the IRS is unable to calculate the amount of taxes due if a taxpayer fails to file an FBAR. Therefore, reasons the taxpayer, instead of pursuing the taxes, the IRS asserts the FBAR penalty "as a rough approximation of those taxes it has lacked sufficient information to assess." The taxpayer concludes that the FBAR penalty is imposed in lieu of taxes and thus is a "tax."

The taxpayer further argues that the FBAR "penalty" is a really a "tax" based on judicial precedent. Citing a Supreme Court case involving the dischargeability of trust fund recovery penalties under Section 6672 of the Internal Revenue Code, the taxpayer contends that a pecuniary burden placed on a debtor can be characterized as a "tax" for bankruptcy purposes, even though the provision under which it is imposed refers to it as a "penalty." The taxpayer also advocated the application of a four-part test adopted by several courts. This test provides that an item is a "tax" if it (i) is an involuntary pecuniary burden, regardless of its name, on individuals or property, (ii) that is imposed by or under the legislature, (iii) for public purposes, (iv) under the police or taxing power of the state.⁶⁶

The court set forth three principal reasons for rejecting the taxpayer's initial argument. First, the court pointed to the applicable law and regulations, including 31 USC §5321(a)(5), 31 CFR §103.56, and 31 CFR §103.57. The court stated that these authorities refer to the imposition of "civil penalties" and "civil monetary penalties," not taxes, in the case of FBAR violations. Moreover, the court emphasized that these provisions "say nothing about the Bank Secrecy Act serving as a mechanism to collect otherwise uncollected taxes." Second, the court concluded that the FBAR penalty does not constitute a "tax" under the four-part test advanced by the taxpayer. The court focused on the first element of the test, which requires the item to be an "involuntary pecuniary burden." The court reasoned that the FBAR penalty is not a "tax" because a taxpayer would not be subject to any

"involuntary pecuniary burden" if she were to simply file the requisite FBAR. Finally, the court found that the statutory and regulatory framework governing FBAR penalties has no traits of a "tax." For instance, the court explained that there is a legal presumption that a tax assessment is correct, whereas the U.S. government has the burden of establishing the *mens rea*, or intent element, in both civil and criminal FBAR violation cases.

The taxpayer's second argument was that FBAR penalty fell within the definition of "tax penalty" and was thus wiped away. The key bankruptcy provision, 11 USC §523(a)(7), states that bankruptcy does not relieve an individual debtor from any debt "to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit ... *other than a tax penalty* ... imposed with respect to a transaction or event that occurred before three years before the date of the filing of the [bankruptcy] petition."

The taxpayer's second argument shared the fate of the first, rejection. According to the court, in order for the FBAR penalty to be considered a "tax penalty," it would have to be linked in some fashion to the underlying tax liability. Because there is no tax underlying the FBAR penalty, reasoned the court, it should not be considered a dischargeable "tax penalty."⁶⁷

Conclusion

The IRS and DOJ took numerous actions in 2008 to thwart international tax noncompliance, with a special focus on FBAR violations. Among other things, they began to criminally prosecute employees of UBS and other foreign banks, issued summonses to acquire the identities of U.S. clients holding foreign accounts, testified at high-profile congressional hearings, appointed two senior attorneys to devote their full resources to cases involving tax evasion and FBAR violations, signed a tax information exchange agreement with a country long known for its bank secrecy laws and utter discreetness, disabused the public of the possibility of a taxpayer-favorable settlement initiative for FBAR violators, and imposed new FBAR burdens on return preparers that eviscerate the reliance-on-a-qualified-tax-professional defense.

Those with undisclosed foreign accounts also felt some additional pressure as the result of two important court decisions in 2008. The Tax Court in *Williams* held that it does not have jurisdiction to resolve FBAR disputes, despite the fact that the tax issues (derived from Title 26 issues) and FBAR issues (originating in Title 31) frequently overlap during international audits. The U.S. District Court, for its part,

determined in *Simonelli* that the FBAR penalty was not a “tax” or “tax penalty” that could be discharged in bankruptcy.

The actions by the IRS and the DOJ, as well as the recent judicial decisions, garner additional significance when one realizes—as those who regularly work in the international tax arena do—just how often the government utilizes the prospect of large

FBAR penalties as a tool to “encourage” taxpayers to quietly settle legitimate tax disputes that they would otherwise pursue.⁶⁸ With all of the developments in 2008, it is more important than ever for those with undisclosed foreign accounts to consult a tax professional with significant FBAR experience and to take other actions to place themselves in the best possible position under the circumstances.

ENDNOTES

¹ Bank Secrecy Act of 1970 (P.L. 91-508), Title I and Title II (Oct. 26, 1970).

² *Id.*, at §202.

³ 31 USC §5314; 31 CFR §103.24.

⁴ U.S. Treasury Department, *A Report to Congress in Accordance with §361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* (Apr. 26, 2002), at 9–10.

⁵ 68 FR 26489 (May 16, 2003).

⁶ 31 CFR §103.56(g), 68 FR 26489 (May 16, 2003).

⁷ American Jobs Creation Act of 2004 (P.L. 108-357).

⁸ 31 USC §5321(a)(5)(A) (as in effect before Oct. 22, 2004).

⁹ The courts have consistently held that the term “willfulness” means a “voluntary, intentional violation of a known legal duty.” *J.L. Cheek*, SCt, 91-1 USTC ¶ 50,012, 498 US 192, 201 (1991); *D.A. Sturman*, 951 F.2d 1466, 1476 (6th Cir. 1991); *C.J. Bishop*, SCt, 73-1 USTC ¶ 9459, 412 US 346, 360 (1973).

¹⁰ 31 USC §5321(a)(5)(B)(i) and (ii) (as in effect before Oct. 22, 2004).

¹¹ 31 USC §5321(a)(5)(A) (as in effect after Oct. 22, 2004).

¹² 31 USC §5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).

¹³ 31 USC §5321(a)(5)(B)(ii) (as in effect after Oct. 22, 2004). The second condition means that the taxpayer agrees to file delinquent FBARs with the revenue agent as part of the audit. IRM §4.26.16.4.4 (July 1, 2008).

¹⁴ 31 USC §5321(a)(5)(C)(i), (D)(ii) (as in effect after Oct. 22, 2004).

¹⁵ RIA’s Complete Analysis of the American Jobs Creation Act of 2004 (P.L. 108-357), at 361.

¹⁶ A series of questions and answers derived from a webinar in June 2007 are printed in Steven Toscher & Michel R. Stein, *FBAR Enforcement—Five Years Later*, J. TAX PRACTICE & PROCEDURE, June–July 2008, at 23.

¹⁷ IRM §4.26.16—Report of Foreign Bank and Financial Accounts.

¹⁸ Form TD F 90-22.1 (Report of Foreign Financial and Bank Account) (Rev. Oct. 2008).

¹⁹ IR-2008-26 (Feb. 26, 2008).

²⁰ Randall Jackson, *Former UBS Banker In-*

dicted in Tax Evasion Case, 2008 TNT 95-9 (May 15, 2008).

²¹ *Banker Pleads Guilty to Helping American Real Estate Developer Evade Income Tax on \$200 Million*, 2008 TNT 120-48 (June 19, 2008).

²² See Senate Homeland Security Subcommittee Reports on Tax Haven Banks, 2008 TNT 139-15 (July 17, 2008); U.S. Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities*, JCX-65-08 (July 23, 2008); U.S. Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GAO-08-778 (July 2008); Randall Jackson *et al.*, *Finance Committee Members Slam IRS Efforts to Fight Offshore Tax Evasion*, 2008 TNT 144-1 (July 25, 2008).

²³ David D. Stewart and Dillon White, *UBS to Discontinue Offshore Banking for U.S. Clients*, 2008 TNT 139-1 (July 18, 2008).

²⁴ Lee A. Sheppard, *How Do U.S. Holders of Swiss Accounts Come Clean?* 2008 TNT 188-5 (Sept. 26, 2008).

²⁵ Jeremiah Coder, *Officials Highlight Foreign Bank Account Reporting in International Enforcement*, 2008 WORLDWIDE TAX DAILY 221-5 (Nov. 14, 2008).

²⁶ Sam Young, *Foreign Account Concealment Prosecutions Coming Soon, Justice Official Says*, 2008 TNT 218-2 (Nov. 10, 2008).

²⁷ *Id.*

²⁸ Randall Jackson, *Justice Obtains List of 70 U.S. Clients of Swiss Bank*, 2008 TNT 219-7 (Nov. 12, 2008).

²⁹ Randall Jackson, *U.S. Expands Offshore Tax Evasion Investigation to Zurich’s Credit Suisse, London’s HSBC*, 2008 WORLDWIDE TAX DAILY 233-1 (Dec. 3, 2008).

³⁰ David D. Stewart, *Liechtenstein Reaches Agreement with U.S. on Information Sharing*, 2008 WORLDWIDE TAX DAILY 234-5 (Dec. 4, 2008).

³¹ Jeremiah Coder, *U.S. Officials Address International Tax Enforcement Efforts*, 2008 WORLDWIDE TAX DAILY 235-5 (Dec. 5, 2008).

³² Michael Joe, *Shulman Talks Tough on International Taxes*, 2008 TAX NOTES TODAY 237-3 (Dec. 9, 2008).

³³ *Id.*

³⁴ Act Sec. 506 of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343)

(Tax Extenders and Alternative Minimum Tax Relief Act of 2008).

³⁵ For the latest on return preparer penalties and standards, see Section 6694 (as amended by Section 506 of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008); T.D. 9436 (Dec. 15, 2008); Notice 2009-5; and Rev. Proc. 2009-11, IRB 2009-3, Dec. 15, 2008.

³⁶ *Professional Responsibility and the Report of Foreign Bank and Financial Accounts*, available at www.irs.gov/taxpros/agents/article/0,,id=100709,00.html (last visited Aug. 14, 2008), republished in Steven Toscher & Michel R. Stein, *FBAR Enforcement—Five Years Later*, J. TAX PRACTICE & PROCEDURE June–July 2008, at 23.

³⁷ U.S. Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities*, JCX-65-08 (July 23, 2008), at 15–18.

³⁸ Steven Toscher & Michel R. Stein, *FBAR Enforcement—Five Years Later*, J. TAX PRACTICE & PROCEDURE, June–July 2008, at 23, 25.

³⁹ Charles M. Bruce *et al.*, *New U.S. Foreign Bank Account Report Makes Big Changes*, 2008 WORLDWIDE TAX DAILY 207-8 (Oct. 24, 2008).

⁴⁰ Lee A. Sheppard, *How Do U.S. Holders of Swiss Accounts Come Clean?* 2008 TNT 188-5 (Sept. 26, 2008).

⁴¹ *J.B. Williams, III*, 131 TC No. 6 (Oct. 2, 2008), 2008 WL 4443057.

⁴² *Simonelli*, 102 AFTR 2d 2008-6577 (D. Conn. Sept. 30, 2008).

⁴³ 68 FR 26489 (May 16, 2003).

⁴⁴ 31 CFR §103.56(g), 68 FR 26489 (May 16, 2003).

⁴⁵ These questions, raised years ago, have largely remained unanswered until recently. See Hale E. Sheppard, *New Penalties for Undisclosed Foreign Accounts: Putting the Cart before the Horse?* J. TAX PRACTICE & PROCEDURE, June–July 2006, at 29.

⁴⁶ *Id.*

⁴⁷ 31 USC §5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).

⁴⁸ 31 USC §5321(a)(5)(C)(i), (D)(ii) (as in effect after Oct. 22, 2004).

⁴⁹ IRM §4.26.16.4 (07-01-2008); IRM §4.26.16.4.7 (July 1, 2008).

⁵⁰ IRM §4.26.17.4.1 (Jan. 1, 2007); IRM §4.26.17.4.2 (Jan. 1, 2007).

ENDNOTES

⁵¹ IRM §4.26.17.3 (Jan. 1, 2007).

⁵² IRM §4.26.17.4.4 (Jan. 1, 2007).

⁵³ IRM §4.26.17.4.6 (Jan. 1, 2007). The INTERNAL REVENUE MANUAL demands that there are a minimum of 180 days remaining on the assessment statute of limitations before granting a taxpayer access to the IRS Appeals Office.

⁵⁴ IRM §4.26.17.4.7 (Jan. 1, 2007).

⁵⁵ *Id.*

⁵⁶ IRS Delegation Order 4-35 (Rev. 1), effective March 24, 2008, ¶¶ 23 through 28.

⁵⁷ IRM §4.26.17.4.7 (Jan. 1, 2007).

⁵⁸ *Id.*

⁵⁹ The motion raised other issues that are beyond the scope of this article.

⁶⁰ Code Sec. 6320(a).

⁶¹ *Id.*

⁶² Conference Report 105-599, 105th Cong.,

2d Sess., June 24, 1998, at 263; Code Sec. 6330(c)(3)(C).

⁶³ Code Sec. 6330(d); U.S. Tax Court Rule 331(b). This petition is called a "Petition for Lien or Levy Action Under Section 6320(c) or 6330(d)."

⁶⁴ Code Secs. 6301, 6230, 6231, 6330, 6331 and 6665.

⁶⁵ The DOJ filed suit under 31 USC §5321(b)(2)(A), which authorizes the U.S. government to commence a civil collection action within two years of assessing the FBAR penalty. This suit was filed approximately one month before the expiration of the two-year period.

⁶⁶ The taxpayer also argued that the negotiated FBAR penalty to which he agreed incorporated his tax liabilities. The court

dispensed with this argument without analysis because the taxpayer provided "no authority or evidence in support of this assertion."

⁶⁷ Because the court ruled that the FBAR penalty was not a "tax penalty," it clarified that the issue of whether the transaction or event on which the FBAR penalty was asserted occurred more than three years before the filing of bankruptcy petition, as required by 11 USC §523(a)(7), was moot.

⁶⁸ See, e.g., *C. Heydemann*, 101 AFTR 2d 2008-2275 (D. Md. 2008) (taxpayer "cooperated fully" with the IRS during the tax evasion investigation of her ex-husband, and the IRS did not pursue any FBAR violations in taxpayer's bankruptcy proceeding).

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