

# New Penalties for Undisclosed Foreign Accounts: Putting the Cart before the Horse?

*By Hale E. Sheppard*

Hale Sheppard discusses the unresolved issues about the FBAR that exist as a result of several things, including inconsistent legal standards and definitions, the interplay between the provisions in Title 31 and Title 26, mixed signals regarding the extent of IRS discretion, oversights in statutory language and ambiguity regarding when an FBAR violation occurs.

## Introduction

Obligating taxpayers to reveal their foreign financial accounts to the IRS is not necessarily a bad thing. Creating severe penalties to “encourage” taxpayers to disclose such accounts is not overly problematic either. What is troubling, though, is aggressively imposing new, severe penalties on taxpayers at a time when uncertainty about filing requirements abounds. This is precisely the case with Form TD F 90-22.1, an information return more commonly known as the “Foreign Bank Account Report” or “FBAR.”

In 1970, Congress enacted the Bank Secrecy Act.<sup>1</sup> 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.<sup>2</sup> Among the most important provisions of the Bank Secrecy Act was 31 USC §5314(a). This provision, along with the corresponding regulation, 31 CFR §103.24, require the filing of an FBAR in cases where a U.S. person had a financial interest in, or signature authority over, or other authority over one or more financial accounts located in a foreign

country, and the aggregate value of such account or accounts exceeded \$10,000 at any time during the calendar year.

Over the past several decades, the problem has been that few 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 recent congressional report indicated that from 1993 to 2002 the U.S. government only considered imposing monetary 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.<sup>3</sup> The congressional report further estimated that there are currently over one million U.S. taxpayers with foreign financial accounts, but fewer than 20 percent of them file FBARs.<sup>4</sup>

Annoyed by these figures, the U.S. government took action in two major ways. First, in April 2003, the Treasury Department transferred authority to enforce the FBAR provisions from its Financial Crimes Enforcement Network (“FinCEN”) to the IRS.<sup>5</sup> 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”

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for the enforcement of the FBAR-related provisions.<sup>6</sup> The second major governmental action was the enactment of new penalty provisions in the American Jobs Creation Act of 2004 (“Jobs Act”).<sup>7</sup> These new sanctions, which apply to willful and nonwillful violations, can be quite severe. In fact, the IRS is allowed to seize up to 50 percent of the amount in the undisclosed account in certain cases.

There are a number of unresolved issues regarding the FBAR that stem from inconsistent legal standards and definitions, the interplay between the provisions in Title 31 (Money and Finance) and Title 26 (Internal Revenue Code), mixed signals regarding the extent of IRS discretion, oversights in statutory language and ambiguity regarding when an FBAR violation occurs. These issues are examined in detail below. Notwithstanding this uncertainty, the IRS recently has been exercising its *new* authority to impose the *new* FBAR penalties. Doing so once the major issues have been resolved would be entirely rational, but doing so before then seems premature. In other words, asserting severe penalties for alleged FBAR violations in an environment replete with doubt will surely lead to numerous disputes at both the administrative and judicial levels. These disputes will force the IRS and taxpayers alike to (unnecessarily) spend large amounts of time, effort and money. Clarifying the FBAR-related issues, and then asserting penalties, makes sense. The converse is simply putting the cart before the horse.

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## Out With the Old, In With the New

Under the law in effect until late 2004, the Secretary of the Treasury could assert a civil penalty on any person who “willfully” violated 31 USC §5314.<sup>8</sup> Meeting this burden required the Secretary to demonstrate that the taxpayer knew about the FBAR-related duties, yet intentionally ignored them.<sup>9</sup> If the Secretary managed to satisfy this high evidentiary standard, he or she was authorized to impose civil penalties ranging from \$25,000 to \$100,000, depending on the amount of the relevant transaction or the balance of the relevant account.<sup>10</sup> As mentioned above, FBAR compliance was quite low under the former legal regime. Indeed,

recent congressional reports indicate that less than 20 percent of U.S. persons with foreign accounts file an annual FBAR.<sup>11</sup>

In response to this widespread disobedience of the FBAR filing requirement, Congress enacted certain provisions in the Jobs Act on October 22, 2004.<sup>12</sup> Under the Jobs Act, the IRS may impose a civil penalty on any person who violates 31 USC §5314.<sup>13</sup> In the case of *nonwillful* violations, the government may impose a maximum penalty of \$10,000.<sup>14</sup> However, the IRS cannot impose such a penalty if two conditions are met: (1) the violation was due to “reasonable cause,” and (2) the amount of the transaction *or* the balance in the account at the time of the transaction was properly reported.<sup>15</sup> The new law allows for a higher maximum penalty where there is *willfulness*.

In the case of willful violations involving a “transaction,” the IRS may impose a penalty of \$100,000 or 50 percent of the amount of the “transaction,” whichever is greater.<sup>16</sup> In situations involving a “failure to report the existence of an account or any identifying information required to be provided with respect to 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.<sup>17</sup>

In summary, the Jobs Act makes three principal changes. First, it adds a new penalty for cases involving nonwillful 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, yet intentionally 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 previous 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, this new FBAR pen-

alty could have serious consequences for taxpayers holding large sums of money in undisclosed foreign financial accounts. According to commentators, the message from Congress is unmistakable: “taxpayers must disclose, disclose, disclose, or suffer the consequences.”<sup>18</sup>

## Unresolved Issues

While FBAR penalties have dramatically increased, many issues surrounding this form remain unresolved. Some of these issues are discussed below.

### Who Must File an FBAR?

An issue of tremendous importance is the scope of the FBAR filing requirement. Simply stated, who must file an FBAR? The lack of clarity on this issue is largely due to the fact that there are three applicable, yet seemingly inconsistent, standards.

First, 31 USC §5314(a) states that the Secretary shall require “a resident or citizen of the United States or a person in, and doing business in, the United States” to file certain forms and/or retain certain records. For purposes of 31 USC §5314, the term “person” includes not only individuals, but also corporations, companies, associations, firms, partnerships, societies, joint stock companies, trustees and representatives of an estate.<sup>19</sup> In the end, 31 USC §5314 appears to have a broad reach, applying to certain individuals based on their nationality or residence (*i.e.*, U.S. citizens and U.S. residents), as well as to all persons (individuals and entities) based on their business activities within the United States.

The critical regulation, 31 CFR §103.24, contains a slightly different standard. It applies to “each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person).” As with 31 USC §5314(a), the term “person” encompasses more than just individuals for purposes of this regulation. It also includes corporations, partnerships, trusts, estates, joint stock companies, associations, syndicates, joint ventures, other unincorporated organizations or groups, Indian Tribes and all entities cognizable as legal personalities.<sup>20</sup> A detailed discussion of U.S. jurisdiction over foreign persons is beyond the scope of this article. Suffice it to say that it is quite broad, especially in the context of tax-related issues.<sup>21</sup> Thus, while 31 USC §5314 limits itself to those persons located in and doing business in the United States, 31 CFR §103.24 imposes the FBAR filing requirement on any person (individual or entity) that is subject to

the far-reaching jurisdiction of U.S. courts, regardless of the person’s nationality or residence.

Finally, the instructions to the FBAR indicate that they apply to each “U.S. person” with a foreign financial account. The instructions further state that the term “U.S. person” includes only U.S. citizens, U.S. residents, domestic partnerships, domestic corporations, domestic estates and domestic trusts. Unlike 31 USC §5314 and 31 CFR §103.24, these instructions impose the FBAR filing requirement only on U.S./domestic persons. Foreign persons (both individuals and entities) seem to avoid this obligation, irrespective of their physical location, business activities in the United States or susceptibility to the jurisdiction of U.S. courts.

### Will Normal IRS Procedures and Taxpayer Protections Apply?

The IRS historically had the authority to *investigate* potential FBAR violations, but the U.S. Department of Justice and the U.S. Treasury Department’s FinCEN retained the authority to *enforce* the law. This all changed in April 2003, though, when the IRS and FinCEN signed a Memorandum of Agreement, whereby FinCEN delegated its *enforcement* authority to the IRS.<sup>22</sup> The IRS is now empowered to investigate potential violations, issue summonses, assess and collect civil penalties, issue administrative rulings and take “any other action reasonably necessary” for the enforcement of the FBAR-related provisions.<sup>23</sup>

This delegation raises a number of unresolved issues. For instance, 31 USC §5321(b)(1) provides that the Secretary may assess a civil penalty under 31 USC §5321(a). This authority is derived from Title 31 of the U.S. Code, not Title 26 (*i.e.*, the Code), which makes it different from that of the IRS. Code Sec. 6201(a) 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 raises several immediate questions: What procedures will (and must) the IRS follow in imposing the FBAR penalty? Do taxpayers have a right to a review of any unresolved FBAR penalties by the IRS Appeals Office? If the taxpayer is dissatisfied with the decision from the IRS Appeals Office, will he or she have the right to judicial review by petitioning the U.S. Tax Court?<sup>24</sup>

A similar issue is raised by 31 USC §5321(b)(2), which provides that the Secretary may commence a civil action to recover FBAR penalties assessed pursuant to 31 USC §5321(b)(1). Again, this authority

originates in Title 31, not Title 26. Section 6301 of the Internal Revenue Code states that the IRS “shall collect the taxes imposed by the internal revenue laws.” This begs yet another question: Will the normal IRS procedures and taxpayer protections regarding notices, liens and levies apply in the context of FBAR penalties?<sup>25</sup>

The IRS has yet to make a definitive statement on the issue, but it appears that this agency is taking the position that the provisions of Title 26 do not apply in the FBAR context. For example, in a recent internal legal memorandum providing guidance on the application of civil FBAR penalties (“Guidance Memo”), IRS attorneys reached the following conclusion: “Please note that under Section 7491(c) [of the Internal Revenue Code], the Service bears the burden of production with respect to all penalties and additions to tax asserted under Title 26. The FBAR penalty is not asserted under that Title, so section 7491(c) will have no bearing here.”<sup>26</sup>

### Will the IRS Exercise Discretion?

The law is fairly clear in the sense that the IRS has full discretion when deciding whether to impose the FBAR penalty and, if so, what penalty amount is appropriate. For instance, 31 USC §5321(a)(5)(A) provides that the Secretary “may” impose a civil penalty. The federal courts have consistently held that when Congress uses the word “may,” it means “may,” not “must” or “shall.”<sup>27</sup> Moreover, in terms of the size of the penalty for *nonwillful* violations, 31 USC §5321(a)(5)(B)(i) states that the fine “shall not exceed” \$10,000 per violation; it does not mandate a \$10,000 penalty. Similarly, in the case of *willful* violations, 31 USC §5321(a)(5)(C)(i) merely states that the “maximum penalty shall be increased to” a certain amount; nowhere does it require the penalty to fall within a certain range.

There are indications that the IRS appreciates the discretionary nature of its authority. For example, the Guidance Memo makes it absolutely clear that asserting FBAR penalties indiscriminately may backfire. In this regard, the Guidance Memo explains that “examiners have discretion not to impose the FBAR penalty,” “the examiner has discretion to not assert the FBAR penalty if the examiner determines the penalty is not warranted based on the facts and circumstances of the case,” and “[t]here is no requirement to assert a separate FBAR penalty for every possible technical violation encountered and doing so could lead, in some cases, to an absurd result.”<sup>28</sup>

Despite the clarity of the law and the Guidance Memo, certain IRS personnel tend to automatically

assert the maximum penalties permitted under 31 USC §5321.

### Can Taxpayers Prove Their Ignorance?

Depending on the severity of the violation and the amount of evidence thereof, the IRS may claim that a taxpayer acted nonwillfully or willfully in not complying with the FBAR requirements. In the case of the former, the taxpayer's defense will consist of showing that there was “reasonable cause” for the violation. In the case of the latter, the taxpayer must prove that the violation was not willful. Many times, the key in both cases will be to demonstrate that the taxpayer was oblivious to the FBAR-related requirements, that he or she was understandably ignorant of the law. The Internal Revenue Manual recognizes that ignorance of the law in conjunction with other facts and circumstances, such as the complexity of the tax or compliance issue, may constitute “reasonable cause.”<sup>29</sup> Likewise, the IRS conceded this point in its recent Guidance Memo:

[I]n order for there to be a voluntary intentional violation of a known legal duty, the account holder would just have to have knowledge that he had a duty to file an FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR. A corollary of this principle is that there is no willfulness if the accountholder has no knowledge of the duty to file the FBAR.<sup>30</sup>

There are several reasons why people find themselves unaware of the FBAR filing requirement. First, the relevant law is located in Title 31 of the U.S. Code, not in Title 26 (*i.e.*, Internal Revenue Code). Thus, even if a person were to examine the two huge volumes comprising the Internal Revenue Code and the six volumes of Treasury regulations promulgated under the Internal Revenue Code, he or she would never find the FBAR filing requirement. Second, the common name for the relevant form, “FBAR,” is a misnomer. The filing requirement applies to foreign “financial” accounts, a broadly defined term that purports to encompass bank accounts, checking accounts, savings accounts, securities accounts, mutual funds, certificates of deposits, secured credit cards, debit cards and more. By consistently referring to the form as the FBAR, taxpayers get the false impression that the filing requirement applies only to “bank” accounts. Third, the instructions to the FBAR are extremely confusing and ambiguous, even

by IRS standards. This issue is particularly important since many of the key terms, including “U.S. person,” “financial account” and “financial interest,” are *only* defined in the instructions to the FBAR, not in the relevant law or regulations. Fourth, the FBAR is not filed as an attachment to an individual’s income tax return; rather, it must be sent separately to the Treasury Department in Michigan. Fifth, the deadline for filing the annual FBAR is not April 15, as it is for individual income tax returns. Instead, it must be filed by June 30 of each year. To make it even more confusing, a taxpayer may request an automatic extension of six months to file his or her income tax return, but no extensions whatsoever are available for filing the FBAR.<sup>31</sup> Sixth, questions about foreign accounts are difficult to locate on the tax return. They are not raised on the first page of Form 1040 (*U.S. Individual Income Tax Return*), nor are they raised on the second. Indeed, such questions are only raised on an attachment to the return, Schedule B, where taxpayers report the amount of interest and dividends they received during a year. Finally, many tax return preparers are often unaware of the FBAR rules, thereby triggering a “blind-leading-the-blind” scenario. As one practitioner explains, “often the accountants, attorneys, financial planners, and other professionals who advise such individuals do not think about the FBAR . . . .”<sup>32</sup>

Based on the preceding, it is obvious that many people are honestly ignorant of the FBAR filing requirement. This, alone, should combat any claim by the IRS that a person acted willfully. It should also suffice to deflate any nonwillful penalty, since unawareness of the law may give rise to “reasonable cause.” Nevertheless, this issue will likely depend on whether the IRS manages to impute knowledge to the taxpayer; that is, whether the IRS can deny the existence of “reasonable cause” based on the taxpayer’s constructive, as opposed to actual, knowledge of the FBAR rules.

In an attempt to demonstrate constructive knowledge, the IRS will almost certainly point to three main sources: IRS forms, IRS publications and the IRS Web site. With respect to forms, the individual income tax return (*i.e.*, Form 1040) will surely receive the most attention. Part III on Schedule B of Form 1040 asks the following question: “At any time [during the relevant

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 so, the taxpayer must check the “yes” box, and then disclose the name of the foreign country in which the account is located. The taxpayer is also told to consult the Instructions to Schedule B for requirements related to foreign financial accounts. There, a taxpayer to whom no exception applies is instructed to file an FBAR by

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June 30 with the Treasury Department. Many other IRS forms contain similar questions and instructions regarding foreign accounts, including Form 990-T (*Exempt Organization Business Income Tax Return*), Form 1041 (*U.S. Income Tax Return for*

*Estates and Trusts*), Form 1065 (*U.S. Return of Partnership Income*) and Form 1120 (*U.S. Corporation Income Tax Return*). It is also likely that the IRS will point to its own publications in attacking a taxpayer’s claim that he or she was genuinely unaware of the FBAR filing requirement. In particular, the IRS will likely cite Publication 54 (*Tax Guide for U.S. Citizens and Resident Aliens Abroad*), Publication 516 (*U.S. Government Civilian Employees Stationed Abroad*) and Publication 593 (*Tax Highlights for U.S. Citizens and Residents Going Abroad*), all of which discuss the FBAR filing requirement. More likely still, the IRS will emphasize one of its newer items, Publication 4261 (*Do You Have a Foreign Bank Account?*), which is more directly on point. Finally, the IRS will probably rely on information available on its Web site, such as the page entitled “FAQs regarding Report of Foreign Bank and Financial Accounts.”<sup>33</sup>

Those who deal with taxpayers on a regular basis understand that most have neither actual nor constructive knowledge of the FBAR filing requirement, but demonstrating this fact will continue to be a challenge.

### Can Taxpayers Meet the “Reasonable Cause” Exception?

As explained above, the law related to the FBAR dramatically changed with the enactment of the Jobs Act in 2004. The new law dictates that, in cases of *nonwillful* violations, the IRS may impose a maximum penalty of \$10,000.<sup>34</sup> The IRS cannot impose such a

penalty, however, if two conditions are met: (1) the violation was due to “reasonable cause,” and (2) the amount of the “transaction” or the balance in the account at the time of the “transaction” was properly reported.<sup>35</sup> This exception appears relatively simple, but it is fraught with complexities.

The first prong of the exception seems straightforward enough for those who regularly deal with U.S. tax law; the taxpayer simply must demonstrate that there was “reasonable cause” for not filing an FBAR. The concept of “reasonable cause” is addressed primarily in Part 20 of the Internal Revenue Manual, which constitutes the IRS’s Penalty Handbook. According to Penalty Handbook, the IRS must broadly construe the term “reasonable cause” based on all of the information relevant to a particular case.<sup>36</sup> The Penalty Handbook also indicates that a taxpayer’s unawareness may give rise to reasonable cause. Indeed, it acknowledges that reasonable cause may be established if the taxpayer shows “ignorance of the law in conjunction with other facts and circumstances,” such as the level of complexity of a tax or compliance issue.<sup>37</sup> The Penalty Handbook would embolden most taxpayers; they could raise several legitimate arguments to demonstrate there was “reasonable cause” for not filing an obscure form like the FBAR, and the IRS would actually entertain them. What could dishearten taxpayers, though, is the potential inapplicability of the Penalty Handbook. The FBAR penalties are derived from Title 31 of the U.S. Code, not from Title 26. The favorable guidelines regarding “reasonable cause” are found in the Penalty Handbook, which professes to have limited applicability: “The purpose of the consolidated penalty handbook is to provide guidance to all areas of the Service for all penalties imposed by the Internal Revenue Code.”<sup>38</sup> Logic dictates that since the IRS has been delegated authority to investigate and enforce FBAR violations, the IRS would consult its own Penalty Handbook in carrying out these responsibilities, regardless of the fact that the FBAR penalties originate in Title 31, instead of Title 26. This conclusion, however, has not yet been confirmed by the IRS.

Even if the IRS relies on the Penalty Handbook and the taxpayer is thereby able to persuade the IRS that “reasonable cause” exists, that is only one-half of the equation. In order to meet the exception to the new FBAR penalty, the taxpayer must also meet the second condition. Specifically, the taxpayer must show that the amount of the “transaction” or the balance in the account at the time of the “transaction” was properly

reported. Simply put, in its current form, the second condition seems difficult to satisfy. This argument, which is predicated on theory that the new 31 USC §5321(a)(5)(B)(ii)(II) contains erroneous language, is explained below.

The IRS has recently developed several initiatives designed to encourage taxpayers involved in offshore activities to “come clean” with the IRS in exchange for reduced penalties. One such program was the Offshore Voluntary Compliance Initiative.<sup>39</sup> After this settlement initiative concluded in 2003, the U.S. Government Accountability Office issued a study (“GAO Report”).<sup>40</sup> Perhaps the most interesting observation in the GAO Report was that the majority of the taxpayers who participated in the Offshore Voluntary Compliance Initiative had always filed their tax returns, properly reported all of their income (including the income from their foreign financial accounts), but failed to file the requisite FBARs.<sup>41</sup> In other words, most taxpayers were not attempting to conceal income or evade taxes, they were simply unaware of the need to file an FBAR. It is evident that lawmakers were aware of the GAO Report and similar studies as they were crafting the new FBAR-related language. For instance, the legislative history to the Jobs Act states that the penalty for nonwillful violations may be waived “if any income from the account was properly reported on the income tax return and there was reasonable cause for failure to report.”<sup>42</sup> Based on the GAO Report and legislative history, congressional intent seems fairly plain: the IRS should not penalize taxpayers who maintain foreign financial accounts, properly report the income generated by such accounts on their annual income tax returns, yet fail to file FBARs due to their ignorance of the law.

To benefit from the penalty exception under the new law, the taxpayer must demonstrate that either “the amount of the *transaction*” or “the *balance* in the account *at the time of the transaction*” was properly reported. Meeting this second condition of the exception is troublesome for three reasons.

First, in the case of a person who simply holds a foreign financial account, there is no “transaction” to report. To grasp this argument, one must understand that, for purposes of the FBAR, the terms “transaction” and “relation” (or “relationship”) are distinct. This distinction is clear from 31 USC §5314(a), which requires certain persons to file reports when they either “make a transaction” with a foreign financial agency or “maintain a relation” for any person with a

foreign financial agency. The distinction is also clear from 31 CFR §103.24, which mandates the filing of an FBAR where a certain “relationship” exists with respect to a foreign financial account. The relevant regulations generally define the term “transaction” as a “purchase, sale, loan, pledge, gift, transfer, delivery or other disposition.”<sup>43</sup> Put differently, to be a “transaction” for FBAR purposes, something beyond merely holding a foreign financial account must occur. Accordingly, for taxpayers who engage in no actions involving an account, it seems unfeasible to properly report the amount of the “transaction.”

Second, forcing the taxpayer to report the balance of the account “at the time of the transaction” makes no sense. Clearly, the language in new 31 USC §5321(a)(5)(B)(ii)(II) is erroneous and incompatible with legislative history. This conclusion finds support in two places. New 31 USC §5321(a)(5)(D)(ii) determines *when* the penalty amount is calculated. In cases involving failures to file FBARs, the amount is figured at the time of the “violation,” not at the time of the “transaction.” Former 31 USC §5321(a)(5)(B)(ii) also set the maximum penalty for FBAR violations. It, too, based its calculation on the balance in the account at the time of the “violation,” not the “transaction.”

Third, even if the language in new 31 USC §5321(a)(5)(B)(ii)(II) were corrected to require the taxpayer to properly report “the balance in the account *at the time of the violation*,” this would still not be enough to allow taxpayers to satisfy the second condition. More legislative changes would have to be made. The “balance” of a foreign financial account is *not* reported on a taxpayer’s individual tax return. As explained earlier, Part III of Schedule B to the individual income tax return (*i.e.*, Form 1040) asks whether the taxpayer had an interest in, or authority over, a foreign financial account at any time during the calendar year. If so, the taxpayer must check the “yes” box and then disclose the name of the foreign country in which the account is located. Nowhere on the tax return is the taxpayer obligated to indicate the “balance” of the account. The *only* place where the “balance” of a foreign financial account must be revealed is on the FBAR itself, which asks for the maximum value of the account. As discussed above, both the GAO Report and legislative history make the rationale for the penalty exception clear: the IRS should not penalize taxpayers who maintain foreign financial accounts, properly report the income generated by such accounts on their annual income tax returns, yet fail to submit an FBAR because they

are unaware of this filing requirement. Based on the GAO Report and legislative history, it is evident that new 31 USC §5321(a)(5)(B)(ii)(II) should not focus on the “balance” of the account at the time of the violation. Doing so makes sense in new 31 USC §5321(a)(5)(D)(ii), which determines the *amount* of the penalty. However, having such a focus in new 31 USC §5321(a)(5)(B)(ii)(II), which deals with the conditions under which penalty waiver is appropriate, is completely illogical.

In sum, to fulfill legislative intent, new 31 USC §5321(a)(5)(B)(ii)(II) would need to be amended such that the IRS shall not impose FBAR penalties in cases where there is reasonable cause, and the taxpayer properly reported the income from the foreign financial account (not the “balance” in the account) on his or her annual income tax return (not “at the time of the transaction”). Congress recently passed the Tax Technical Corrections Act of 2005.<sup>44</sup> This curative legislation contained many modifications to the Jobs Act; however, changes related to the FBAR provisions were not among them. Accordingly, taxpayers must await further congressional action.

### When Does an FBAR Violation Occur?

The applicable regulation explains that FBARs must be filed “with respect to foreign financial accounts exceeding \$10,000 maintained during the previous calendar year.”<sup>45</sup> Expanding on this language, the FBAR instructions say that each U.S. person with the requisite relationship with foreign financial accounts must file an FBAR if the aggregate value of the accounts exceeds \$10,000 “at any time during the calendar year.” The breadth of this requirement is evident; an FBAR must be filed if the combined value of the foreign financial accounts surpasses the \$10,000 threshold at any time from January 1 to December 31. The relevant regulation further explains that the deadline for filing FBARs related to the preceding calendar year is June 30.<sup>46</sup> Thus, if a U.S. person had a financial interest in certain foreign financial accounts during calendar year 2005, and the value of the property in those accounts topped \$10,000 at any time during 2005, then the person must file an FBAR by June 30, 2006.

In isolation, the mechanics of filing an FBAR seem rather mundane. They become quite interesting, however, when contrasted with the penalty provisions. As explained above, the new law under the Jobs Act imposes severe penalties for willful failures to file an FBAR.<sup>47</sup> In terms of timing, the new law provides that

the amount of the penalty is determined by looking at the balance in the relevant account “at the time of the violation.”<sup>48</sup> In particular, the new law states that the maximum penalty that the IRS may impose is \$100,000, or 50 percent of the balance in the account “at the time of the violation,” whichever amount is larger. The regulations calculate the penalty amount based on the balance in the account “at the time of the violation,” too.<sup>49</sup>

This raises an obvious question: When does the violation occur? June 30 (the deadline for filing the FBAR)? December 31 (the last day of the calendar year)? Any other day on which the balance in the account exceeds \$10,000? Neither the law nor the regulations specifically address this issue, but other IRS documents reveal the government’s position. For example, the Guidance Memo makes the following declaration:

**Taking such steps to persuade taxpayers to file FBARs may be appropriate in due course. Doing so while numerous open issues remain, however, seems inopportune.**

The decision to base the FBAR penalty on the highest balance in the account during the year was a policy decision made during the development of the FBAR mitigation guidelines. Section 5321(a)(5), however, limits the amount of the penalty to [a particular amount] or the balance of the account *at the time of the violation which, for failure to report accounts, is June 30 of the succeeding year.*<sup>50</sup>

The impact of the preceding rules could be significant. Say a U.S. person had a financial interest in certain foreign financial accounts during calendar year 2005, and the aggregate value of the property in those accounts was \$5 million at some point during 2005. This person would be required to file an FBAR regarding those accounts because the balance exceeded \$10,000 “at any time” during 2005. Assume further that the person closed the account on June 29, 2006, thereby making the balance in the account \$0 as of the filing deadline, June 30, 2006. The person did not file an FBAR. According to 31 USC §5321(a)(5)(D)(ii), the maximum penalty

is \$100,000, or 50 percent of the balance in the account “at the time of the violation,” whichever amount is larger. The government’s position, as set forth in the Guidance Memo, is that the time for determining the penalty amount is the FBAR filing deadline, *i.e.*, June 30, 2006. On this date, the balance in the account was \$0. Therefore, it is arguable that although the person violated the law by not filing an FBAR for a foreign financial account whose balance

surpassed \$10,000 during the year, the maximum penalty that the IRS could impose would be \$100,000, *not* 50 percent of the highest balance in the account (*i.e.*, \$2.5 million).

## Conclusion

FBAR compliance has been low since this form was introduced decades ago. Aware of this pervasive noncompliance, Congress reacted by enacting a new penalty for nonwillful violations and harsher penalties for willful ones. The Treasury Department also reacted, delegating full authority to the IRS to investigate and take “any action reasonably necessary” to enforce the FBAR filing requirement. Taking such steps to persuade taxpayers to file FBARs may be appropriate in due course. Doing so while numerous open issues remain, however, seems inopportune. As this article demonstrates, unresolved issues about the FBAR exist as a result of several things, including inconsistent legal standards and definitions, the interplay between the provisions in Title 31 and Title 26, mixed signals regarding the extent of IRS discretion, oversights in statutory language and ambiguity regarding when an FBAR violation occurs. Costly disputes and widespread aggravation could largely be avoided if actions are taken to resolve the open issues *before* the IRS hastily asserts the new FBAR penalties. In other words, all would benefit by not putting the cart before the horse.

### ENDNOTES

<sup>1</sup> Title I and Title II of the Bank Secrecy Act of 1970 (P.L. 91-508).  
<sup>2</sup> *Id.* at §202.  
<sup>3</sup> U.S. TREASURY DEPARTMENT, A REPORT TO CON-

GRESS IN ACCORDANCE WITH §361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 (April 26,

2002), at 9-10.  
<sup>4</sup> *Id.* at 6.  
<sup>5</sup> 68 FR 26489 (May 16, 2003).  
<sup>6</sup> 31 CFR §103.56(g).



## ENDNOTES

- <sup>7</sup> American Jobs Creation Act of 2004, (P. L. 108-357).
- <sup>8</sup> 31 USC §5321(a)(5)(A) (as in effect before Oct. 22, 2004).
- <sup>9</sup> 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, 111 SCt 604; *D.A. Sturman*, CA-6, 951 F2d 1466, 1476 (1991), *C.J. Bishop*, SCt, 73-1 USTC ¶ 9459, 412 US 346, 93 SCt 2008.
- <sup>10</sup> 31 USC §5321(a)(5)(B)(i) and (ii).
- <sup>11</sup> *Supra* note 4, at 6.
- <sup>12</sup> *Supra* note 8.
- <sup>13</sup> 31 USC §5321(a)(5)(A) (as in effect after Oct. 22, 2004).
- <sup>14</sup> 31 USC §5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).
- <sup>15</sup> 31 USC §5321(a)(5)(B)(ii) (as in effect after Oct. 22, 2004).
- <sup>16</sup> 31 USC §5321(a)(5)(C)(i), (D)(i) (as in effect after Oct. 22, 2004).
- <sup>17</sup> 31 USC §5321(a)(5)(C)(i), (D)(ii) (as in effect after Oct. 22, 2004).
- <sup>18</sup> RIA’S COMPLETE ANALYSIS OF THE AMERICAN JOBS CREATION ACT OF 2004, pg. 361 (comment by Jasper L. Cummings, Jr. of Alston & Byrd LLP, and Robert P. Hanson of Ernst & Young LLP).
- <sup>19</sup> 31 USC §5312(a)(5).
- <sup>20</sup> 31 CFR §103.11(z).
- <sup>21</sup> See, e.g., *W. Germann*, CA-2, 370 F2d 1019 (1967), *A.R. Field*, CA-5, 76-1 USTC ¶ 9469, 532 F2d 404, *In Re Anschuetz & Co.*, CA-5, 754 F.2d 602 (1985), *World-Wide Volkswagen Corp. v. Woodson*, SCt, 444 US 286, 100 SCt 559 (1980), *United States v. Toyota Motor Corp.*, DC Calif., 83-1 USTC ¶ 9302, 561 FSupp 354..
- <sup>22</sup> *Supra* note 6.
- <sup>23</sup> *Supra* note 7CFR.
- <sup>24</sup> Steven Toscher and Michael R. Stein. *FBAR Enforcement is Coming!* J. TAX PRAC. & PROC., Dec. 2003-Jan. 2004, at 31.
- <sup>25</sup> *Id.*
- <sup>26</sup> *Service Discusses Foreign Bank and Financial Accounts Report Penalty*, 2006 TAX NOTES TODAY 14-14 (Jan. 20, 2006).
- <sup>27</sup> *In re Davenport*, DC Calif., 175 BR 355, 358 (1994) (“Congress used both “may” and “shall” throughout the Code, and the clear inference is that they recognized the import of their word choice.”); *McMullen*, 50 FedCl 718, 725 (2001) (“As a matter of statutory construction, the word “may” usually connotes permissive discretion, as opposed to the word “shall,” which connotes a mandatory task.”)
- <sup>28</sup> *Id.*
- <sup>29</sup> IRM §20.1.1.3.1.2.1 (Aug. 20, 1998).
- <sup>30</sup> *Service Discusses Foreign Bank and Financial Accounts Report Penalty*, 2006 TAX NOTES TODAY 14-14 (Sept. 1, 2005).
- <sup>31</sup> See Question 10 of “FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR)” available at [www.irs.gov](http://www.irs.gov) (as visited Feb. 26, 2006).
- <sup>32</sup> Charles M. Bruce and Lewis J. Saret. *Always-Tricky Reporting of Foreign Bank Accounts Turning Dangerous with Patriot Act, Increased Enforcement Efforts*, No. 110 DAILY TAX REPORT J-1 (June 9, 2003).
- <sup>33</sup> Available at [www.irs.gov](http://www.irs.gov).
- <sup>34</sup> 31 USC §5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).
- <sup>35</sup> 31 USC §5321(a)(5)(B)(ii) (as in effect after Oct. 22, 2004).
- <sup>36</sup> See, e.g., IRM §20.1.1.3.1 (Aug. 20, 1998) (“Reasonable cause is based on all the facts and circumstances in each situation and allows the [IRS] to provide relief from a penalty that would otherwise be assessed.”)
- <sup>37</sup> IRM §20.1.1.3.1.2.1 (Aug. 20, 1998).
- <sup>38</sup> IRM §20.1.1.1.2 (Aug. 20, 1998) (emphasis added).
- <sup>39</sup> Rev. Proc. 2003-11, 2003-1 CB 311.
- <sup>40</sup> U.S. GOVERNMENT ACCOUNTABILITY OFFICE. DATA SHARING AND ANALYSIS MAY ENHANCE TAX COMPLIANCE AND IMPROVE IMMIGRATION ELIGIBILITY DECISIONS. GAO-04-972T (July 21, 2004).
- <sup>41</sup> *Id.* at 32.
- <sup>42</sup> H.R. REP. 108-548 (PART 1), 108 TH CONG., 2 ND SESS. 276 (June 16, 2004).
- <sup>43</sup> 31 CFR §103.11(ii). This regulation expands the definition of “transaction” with respect to “financial institutions.” Under 31 CFR §103.11(n), the term “financial institution” refers exclusively to agents, branches or offices *within* the United States. The FBAR filing requirement deals only with foreign financial accounts, *i.e.*, those located *outside* the United States. Accordingly, the expanded definition of “transaction” does not apply.
- <sup>44</sup> The Gulf Opportunity Zone Act of 2005 (P.L. 109-135), Title V; U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions of H.R. 4440, The “Gulf Opportunity Zone Act of 2005,” As Passed by the House of Representatives and the Senate, JCX-88-05 (2005), pgs. 75-93.
- <sup>45</sup> 31 CFR §103.27(c).
- <sup>46</sup> *Id.*
- <sup>47</sup> 31 USC §5321(a)(5)(C), (D)(ii) (as in effect after Oct. 22, 2004).
- <sup>48</sup> *Id.* The amount of penalty was calculated on the basis of the balance of the account “at the time of the violation” under the old law, too. See 31 USC §5321(a)(5)(B)(ii) (as in effect before Oct. 22, 2004).
- <sup>49</sup> 31 CFR §103.57(g)(2).
- <sup>50</sup> *Service Discusses Foreign Bank and Financial Accounts Report Penalty*, 2006 TAX NOTES TODAY 14-14 (Sept. 1, 2005) (emphasis added).

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