Dealing with FBARs

This article discusses the rules underlying FBAR reporting, the penalty regime for noncompliant taxpayers, administrative guidance that bears on treatment of FBAR violations by the IRS, and strategies for addressing failures to file FBAR reports.

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In the last few years, there has been considerable publicity about the efforts of the IRS and the U.S. Department of Justice (DOJ) to combat avoidance of U.S. income tax arising from financial accounts of U.S. taxpayers held overseas. In 2009, the DOJ compelled Swiss bank UBS AG to disclose the names of several thousand American clients who held as-yet-undisclosed accounts with the bank. The IRS has sponsored three amnesty programs, one in 2009, another in 2011 and the most recent in January 2012, designed to prompt delinquent taxpayers to voluntarily report income from their foreign accounts.[1] The programs offer relief from the multiple civil penalties and potential criminal prosecution that might result from the IRS's discovery of these accounts on examination.

The basic mechanism for a taxpayer to alert the IRS about the existence of a foreign financial account is Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) (FBAR). Particularly for U.S. citizens who live outside the United States, there may be a belief that failure to file a required FBAR report automatically results in the imposition of harsh penalties, even if the account involved generates little income subject to tax. While major penalties can flow from systematic noncompliance, there are factual circumstances under which late reporting may result in minimal, or even no, penalties.

This article discusses the rules underlying FBAR reporting, the penalty regime for noncompliant taxpayers, and the administrative guidance that bears on treatment of FBAR violations by the IRS. It also provides strategies for addressing failures to file FBARs.[2]

FBAR Filing Requirement

Under 31 U.S.C. section 5311 *et seq.* and its regulations,[3] a U.S. person that has a financial interest in or signature authority over one or more foreign financial accounts must file an FBAR if the total value of the accounts exceeds $10,000 at any time during the calendar year. The IRS must receive the FBAR on or before June 30 of the calendar year following the year for which the foreign financial account is being reported. An FBAR is currently to be filed at Department of the Treasury, P.O. Box 2621, Detroit, Michigan, 48232-0621.

For purposes of FBAR reporting, a U.S. person includes individuals who are citizens or residents of the United States; thus, U.S. citizens who are permanently living outside the U.S. need to file FBARs for accounts held in their country of residence and other foreign locations. The term also includes but is “not limited to” a corporation, partnership, trust, or limited liability company organized under the laws of the U.S., any state thereof, the District of Columbia, a U.S. territory or insular possession, or an Indian tribe.[4]

The scope of reportable financial accounts is broad. These include bank accounts,[5] securities accounts,[6] and other financial accounts. “Other financial accounts” cover mutual funds and other pooled funds that issue shares to the public, insurance policies and annuities with a cash value, accounts with brokers or dealers of futures or options in commodities, and accounts with persons whose business is accepting deposits as a financial agency.[7]

Penalties for Failing to File FBARs

There is a range of penalties for failing to file an FBAR. If a failure to file is due to negligence, a civil penalty up to $500 per account may be assessed. If there has been a pattern of negligent failures to file FBARs, a civil penalty up to $50,000 per account may apply. Imposition of these negligence penalties is rare.[8]

Non-willful failures to file.

A civil penalty of up to $10,000 per account may be imposed if the nonfiling is not willful.[9] This penalty can be avoided if two conditions are met: (1) the failure to file was due to reasonable cause, and (2) the balance in the account was properly reported on an FBAR.[10] Thus, if a taxpayer had reasonable cause regarding its failure to file for prior tax years and it now files the appropriate FBARs, the $10,000 penalty can be avoided.

For purposes of applying this rule, “reasonable cause” exists if a taxpayer exercises ordinary business care and prudence in determining its obligations but nonetheless is unable to comply with those obligations. In determining the existence of reasonable cause, each case must be judged individually, based on its own facts and circumstances. One important issue is whether, “once facts and circumstances changed, what attempt did the taxpayer make to comply?” Reasonable cause does not exist if, after the facts and circumstances that explain the noncompliant behavior cease to exist, the taxpayer fails to comply within a reasonable time.

Willful failures to file.

If a failure to file FBARs is willful, the maximum civil penalty per account is much higher. “Willfulness” means the “voluntary, intentional avoidance of a known legal duty.” [11] The ceiling for this penalty is the greater of $100,000 or 50% of the balance in the account at the time of the nonfiling. [12] The nonfiling is deemed to occur if the IRS does not receive the FBAR by June 30 of the calendar year following the year for which reporting is required. [13]

A willful failure to file an FBAR can also result in criminal penalties. These can include a fine up to $250,000, imprisonment for up to five years, or both. [14]

Guidelines for IRS Personnel on Nonfiling of FBARs

In evaluating a taxpayer's exposure to penalties for any failure to file an FBAR, it is also important to consider the IRS's administrative guidance. In several places, the Internal Revenue Manual provides important insights.

Pursuant to the Manual, regarding an FBAR violation, an IRS examining agent is not required to impose a penalty. Rather, if “the facts and circumstances of a particular case do not justify asserting a penalty,” the agent may instead issue an FBAR warning letter (Letter 3800). [15] Even if an IRS examining agent determines that imposition of a penalty is appropriate, he is not required to impose the maximum statutory penalties described above. Rather, the “actual amount of the penalty is left to the discretion of the examiner.” [16] The IRS has established mitigation guidelines for FBAR penalties pertaining to both non-willful and willful failures to file FBARs, which authorize the imposition of a penalty lower than the statutory maximum.

Where a failure to file is non-willful, the mitigation guidelines list three levels of violations/penalties:

> (1) If the aggregate balance of all accounts held during the year does not exceed $50,000, the penalty per FBAR violation is $500, not to exceed an aggregate penalty of $5,000 for all violations during the year.
>
> (2) If the aggregate balance in the account involved (not in all accounts) is over $50,000 but not over $250,000 at any time during the year, the penalty per violation is the lesser of $5,000 or 10% of the highest balance in the account during the year.
>
> (3) If the aggregate balance in the account involved exceeds $250,000, the penalty per account is $10,000, the statutory maximum.

Where a failure to file is willful, the mitigation guidelines provide four levels of violations/penalties:

> (1) If the maximum aggregate balance for the account does not exceed $50,000, the penalty per FBAR violation is the greater of $1,000 or 5% of the maximum account balance during the year of the account involved.
>
> (2) If (1) does not apply and the maximum balance in the account involved (not in all accounts) does not exceed $250,000 at any time during the year, the penalty per violation is the greater of $5,000 or 10% of the maximum account balance during the year.
>
> (3) If the maximum balance in the account involved exceeds $250,000 but does not exceed $1 million, the penalty per violation is the greater of 10% of the maximum account balance during the year or 50% of the closing balance in the account as of June 30 in the following calendar year.
>
> (4) If the maximum balance in the account involved exceeds $1 million, the penalty per account is the statutory maximum (greater of $100,000 or 50% of the balance in the account at the time of the nonfiling). [17]

Policies Underlying Imposition of Penalties for Nonfiling of FBARs

With regard to IRS examiners exercising their discretion in FBAR penalty cases, the Internal Revenue Manual says: "Whenever there is an FBAR violation, the examiner will either issue the FBAR warning letter, Letter 3800, or determine a penalty." [18] The Manual describes the reasons for imposition of an FBAR penalty as follows:

> Penalties should be asserted only to promote compliance with the FBAR reporting and recordkeeping requirements. In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future. [19]

To paraphrase, penalties are not designed to be punitive but rather to promote compliance with FBAR requirements (i.e., if a warning letter is sufficient to achieving "the desired result" of improving future compliance, penalties are not called for). The Manual also stresses that an examiner should take into account the facts and circumstances of a particular case in determining whether penalties are to be asserted and the amount of such penalties. [20]

Procedure for Filing a Delinquent FBAR

The instructions to the current FBAR say that if a delinquent report is filed, a statement explaining the reason for the late filing must be attached. With respect to this explanatory statement, one commentator has noted that "it makes good sense to draft the statements carefully ... in order to avoid sizable civil penalties for failure to file..." [21]

Strategies for Addressing Failures to File FBARs

If a U.S. person is delinquent in filing FBARs, the surrounding facts should be examined before concluding that the most severe penalties will result. This is what the Internal Revenue Manual directs IRS examiners to do.

It may be that one or more FBAR violations by an entity such as a corporation or a partnership were caused by an uninformed advisor. If the entity has changed advisors and, based on new counsel, intends to comply with reporting requirements in the future, the entity should first promptly file the delinquent FBARs. In the accompanying explanatory statements, it would be advisable to stress the role of the deficient prior advisor in the past nonfilings and to make it clear that, with the retention of the new advisor, the entity intends to comply with all FBAR filing requirements going forward. Since, according to the Manual, the reason for the IRS to assert FBAR penalties is to improve future compliance, the delinquent entity in this case may be able to persuade the IRS that a minor penalty, or simply the issuance of a warning Letter 3800, is the appropriate sanction.

A similar result may be possible if past nonfilings were due to incompetent management. Assuming a change in executives, once past delinquencies have come to light, the entity should promptly file the late FBARs and attach explanatory statements attributing the delinquencies to past management. As with the deficient advisor, these statements should say unequivocally that the entity will be compliant in the future. It would also be helpful if any executives remaining with the entity declare (perhaps in an affidavit appended to an explanatory statement) that those no longer with the company were responsible for FBAR compliance and that delinquencies were not known outside this group. If the delinquent entity is part of a corporate group, and affiliates of the entity have been FBAR compliant, it may be helpful to contrast their behavior with that of the noncompliant company, to indicate that the FBAR violations were not a result of a general policy to disregard FBAR requirements.

For any delinquency, it is important to explain the business reason for establishment of the foreign account or accounts in question. As noted above, FBAR requirements were introduced in the Bank Secrecy Act of 1970 (“BSA”). One purpose for the enactment of the BSA was to combat money laundering and other illegal activities carried on through overseas accounts. In considering whether an FBAR violation was willful (and thus subject to the highest level of civil penalties), the Internal Revenue Manual Fraud Handbook directs an IRS examiner to consider, among other things, “evidence that the violation has, or may have, facilitated or concealed illegal activity by the institution, its employees, its customers, or others.” [22] Assuming that foreign accounts facilitate the normal business of the delinquent taxpayer, the reason or reasons for those accounts should be clearly and fully described in any explanatory statement that accompanies a late FBAR.

The frequency of any nonfiling is another important factor. When an IRS examiner is determining whether an FBAR violation was willful, recurrent violations are evidence of this state of mind. [23] Accordingly, if the nonfiling of an FBAR was a one-time event, perhaps something that fell through the cracks, for example, in the year when the delinquent entity combined with or was taken over by another company, the occurrence of the unusual transaction should be highlighted in the explanatory statement for the late FBAR.

If a taxpayer has argued that, under the facts and circumstances of its case, lower penalties or only a warning letter are the appropriate remedy, but the examiner disagrees, an administrative appeal of the examiner's decision is available. The Manual lists the procedures to be followed. [24]

Conclusion

The statutory penalty regime that applies to delinquent FBAR filings is daunting. Before concluding that the worst penalty results are a given, all facts related to the delinquency should be examined in the hope that these facts will lead an examiner to conclude that a lesser sanction is appropriate.

1

See Baker & McKenzie Voluntary Disclosure Steering Committee, "IRS Preliminary Guidance for Post-September 9, 2011, Voluntary Disclosures: OVDI 2011+?," **23 JOIT 59 (March 2012)**; Baker & McKenzie Voluntary Disclosure Steering Committee, "New 2011 Offshore Voluntary Disclosure Initiative," **22 JOIT 20 (May 2011)**; "IRS Announces Voluntary Compliance Initiative for Taxpayers With Unreported Offshore Income," JOIT Vol. 20 (June 2009) (Checkpoint only).

2

Treasury issued Temporary Regulations (**TD 9567**, December 14, 2011) with respect to new Form 8938 (Statement of Specified Foreign Financial Assets), otherwise known as the "Shadow FBAR." The requirement to file Form 8938 applies for tax years beginning after March 18, 2010. The Preamble to the Temporary Regulations specifically states that "reporting on Form 8938 and the FBAR is not duplicative and both forms must be filed, if required." U.S. citizens, U.S. income tax residents, and U.S. resident alien individuals taking a treaty-based return position under a relevant income tax treaty that they are not U.S. income tax residents must file Form 8938. Failure to comply can be subject to a penalty of U.S.$10,000 per failure but no more than U.S.$50,000 total with respect to the failure. See Michaels, "New 'Shadow FBAR' Regs.," **23 JOIT 60 (March 2012)**.

3

Bank Secrecy Act of 1970, P.L. 91-508, October 26, 1970 (“BSA”); 31 U.S.C. sections 5311-5330.

4

31 C.F.R. section 1010.350(b).

5

A “bank account” is essentially “an account maintained with a person engaged in the business of banking.” *Id.* section 1010.350(c)(1).

6

A “securities account” is “an account with a person engaged in the business of buying, selling, holding or trading stocks or other securities.” *Id.* section 1010.350 (c)(2).

7

Id. section 1010.350(c)(3). Certain accounts, such as those maintained by a U.S., state, or Indian tribe governmental entity, or international financial institution of which the U.S. government is a member, are not subject to FBAR reporting.

8

The Internal Revenue Manual (IRM) states that negligence penalties should be asserted only when the FBAR penalties under 31 U.S.C. section 5321(a)(5) and the FBAR warning letter (Letter 3800), discussed in the text below, are deemed inadequate. IRM section 4.26.16.4.3(2). This will not be a common occurrence; in those rare circumstances when it does occur, the revenue agent is directed to contact a BSA Program Analyst for guidance. *Id*.

9

31 U.S.C. section 5321(a)(5)(B)(i).

10

Id. section 5321(a)(5)(B)(ii).

11

IRM section 4.26.16.4.5.3(1). The IRM states further that willfulness is demonstrated by a person's “knowledge of the [FBAR] reporting requirements and the person's conscious choice not to file the FBAR.” *Id*. section 4.26.16.4.5.3(5). Willfulness may be attributed to a person, under the doctrine of “willful blindness,” where the person has made a “conscious effort to avoid learning about the FBAR reporting ... requirements.” *Id*. section 4.26.16.4.5.3(6). The burden of establishing willfulness is on the IRS. *Id*. section 4.26.16.4.5.3(3).

12

31 U.S.C. section 5321(a)(5)(C).

13

IRM section 4.26.16.4.4(4).

14

31 U.S.C. section 5322(a).

15

IRM section 4.26.17.4.2. A sample copy of Letter 3800 can be obtained by calling the IRS's FBAR office in Detroit at 313-234-1246.

16

Id. section 4.26.16.4.6(1).

17

Id. sections 4.26.16.4.6.2 and .3.

18

Id. section 4.26.16.4(3).

19

Id.

20

Id. section 4.26.16.4(6).

21

See Marsan, "Foreign Bank Accounts—FBARing Obligations, Enforcement Exposures and Managing the Risk: What Every Tax and Compliance Advisor Needs to Know Now!." 87 TAXES 35 (2009).

22

IRM, Part 25 (Special Topics), ch. 1 (Fraud Handbook), section 12 (BSA Willfulness Referral Procedures), Exhibit 25.1.12-1 (IRS Standards for Title 31 Referrals to FinCEN).

23

Id.

24

IRM section 4.26.17.4.7.