Legislative Recommendation #35

Modify the Definition of 'Willful' for Purposes of Finding FBAR Violations and Reduce the Maximum Penalty Amounts

PRESENT LAW

U.S. citizens or residents with foreign account balances exceeding $10,000 in the aggregate during the year generally are required by 31 U.S.C. § 5314 and 31 C.F.R. § 1010.350 to report the accounts to the Financial Criminal Enforcement Network (FinCEN) in the Treasury Department. They must do so on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (or FBAR). 31 U.S.C. § 5321(a)(5) imposes civil penalties for failing to report accounts. The amount depends on whether the failure was "willful" or "non-willful." The maximum penalty for a non-willful violation is $10,000 (adjusted for inflation).[1] The maximum civil penalty for a willful violation is 50 percent of the maximum account balance during the year (or, if greater, $100,000 [adjusted for inflation] per violation).[2] Under 31 U.S.C. § 5321(a)(5)(B), no penalty may be imposed for a non-willful violation if the account holder reported all income from the account and had reasonable cause for failing to file the FBAR.

The IRS has created procedures that allow some account holders to correct non-willful noncompliance if they learn about the problem early. Under its Delinquent FBAR Submission Procedures and Streamlined Filing Compliance Procedures, the IRS will not impose a penalty (or will impose a penalty of five percent) for non-willful violations if an account holder reports the accounts on an FBAR and reports and pays tax on the income from the foreign financial accounts before being contacted by the IRS about an examination or FBAR violation.[3] However, account holders who first learn of their FBAR violations when the IRS initiates an exam or contacts them about a violation are ineligible for these procedures.

REASONS FOR CHANGE

The maximum FBAR penalty is among the harshest civil penalties the government may impose. For example, if an account holder maintains a balance of $25,000 in a foreign account that he willfully fails to report, the IRS may impose a penalty of over $100,000 per year and may go back six years, producing an aggregate statutory maximum penalty of over $600,000.[4] Some commentators have suggested the penalty is so severe that it might violate the U.S. Constitution's prohibition against excessive fines.[5] Individuals who have lived in foreign countries or have immigrated to the United States often maintain foreign bank accounts and may

1 31 U.S.C. § 5321(a)(5)(B)(i); 31 C.F.R. § 1010.821.

2 31 U.S.C. §§ 5321(a)(5)(C), (D)(ii).

3 *See* IRS, Delinquent FBAR Submission Procedures, https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures (last visited Nov. 18, 2020) (no penalty if no underreporting and fixed before contact); IRS, Streamlined Filing Compliance Procedures, https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures (last visited Nov. 18, 2020) (five percent penalty for U.S. residents if noncompliance fixed before contact and violation was non-willful).

4 Under current guidance, the IRS is unlikely to impose such a severe penalty. *See* Internal Revenue Manual (IRM) 4.26.16.6.5.3(3), Penalty for Willful FBAR Violations (Nov. 6, 2015) (discussed in the text below).

5 *See* Alison Bennett, *New FBAR Penalty Limits Seen Reflecting IRS Concern on Eighth Amendment Litigation*, BNA Tax Mgmt Weekly Rept (June 15, 2015).

overlook this requirement or avoid reporting the account for benign reasons (*e.g.,* a Holocaust survivor who lives in fear that a disclosed account may be confiscated by the government).[6]

Although Internal Revenue Manual (IRM) 4.26.16.6.5.3 says that "in most cases" examiners will not recommend a penalty greater than 50 percent of the highest aggregate balance (HAB) of all unreported foreign financial accounts for all years under examination, they are still free to recommend a penalty of up to 100 percent of the HAB if a manager approves.[7] Even half the HAB can be more than the current balance if the account value has declined. Account holders have argued in many cases that the harshness of the maximum penalty, particularly the "willful" penalty, is disproportionate to the reporting failure.

While the distinction between willful and non-willful violations make sense, it generates controversy because it can be difficult for taxpayers to establish that a violation was not willful.[8] Schedule B of Form 1040, U.S. Individual Income Tax Return, asks if the taxpayer has a foreign account and references the FBAR filing requirement. Taxpayers are presumed to know the contents of their returns when they sign the return under penalty of perjury, swearing "Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct and complete." It may be considered reckless or "willful blindness" for them not to learn about the FBAR filing requirement after having been directed to the FBAR form by Schedule B.[9] For this reason, the government might reasonably argue (and a court might reasonably find) that *any* failure to file an FBAR form is willful where a taxpayer filed a federal tax return that included Schedule B, which directs taxpayers to the FBAR filing requirement.[10] This is particularly true if a taxpayer has taken steps to hide the account to protect his or her financial privacy.[11]

Account holders who do not file required FBAR forms due to negligence, inadvertence, or similar non-nefarious causes may be subject to penalties for non-willful violations (which have a reasonable cause exception). But they should not face uncertainty regarding the possible application of the extraordinarily harsh penalties for "willful" violations. The National Taxpayer Advocate recommends that Congress clarify that the IRS must prove a violation was "willful" without relying so heavily on the instructions to Schedule B or the failure to check the box on Schedule B before imposing a willful FBAR penalty. To address violations

---

6 For these and other examples, see, *e.g.*, Appeal of Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Oct. 6, 2011), https://www.irs.gov/pub/irs-utl/ntamemo_appealtad2011-1.pdf.

7 The IRS also has "mitigation" guidelines that could result in lower penalties. *See* IRM Exhibit 4.26.16-1, FBAR Penalty Mitigation Guidelines for Violations Occurring After October 22, 2004 (Nov. 6, 2015). Commentators have suggested the IRS limited the maximum FBAR its examiners would propose to address concerns that the statutory maximums could violate the Excessive Fines clause of the Eighth Amendment to the Constitution. *See, e.g.*, Alison Bennett, *New FBAR Penalty Limits Seen Reflecting IRS Concern on Eighth Amendment Litigation*, BNA Tax Mgmt Weekly Rept (June 15, 2015).

8 Following successful litigation about the conduct that triggers the willful FBAR penalty, the definition of willfulness appears to have expanded. *Compare* IRM 4.26.16.6.5.1(1), Willful FBAR Violations - Defining Willfulness (Nov. 6, 2015) (defining willfulness for purposes of the civil FBAR penalty as "a voluntary, intentional violation of a known legal duty") and *Ratzlaf v. U.S.*, 510 U.S. 135, 142 (1994) (citing *Cheek v. U.S.*, 498 U.S. 192, 201 (1991)) (same), *with* Program Manager Technical Advice 2018-13 (May 23, 2018) (concluding that willfulness now "includes not only knowing violations of the FBAR requirements, but willful blindness to the FBAR requirements as well as reckless violations…").

9 *See, e.g.*, *Norman v. United States*, 942 F.3d 1111, 1115 (Fed. Cir. 2019).

10 *See, e.g.*, *United States v. Bohanec*, 263 F. Supp. 3d 881, 890 (C.D. Cal. 2016) (finding willful blindness, in part, because "Schedule B of Defendants' 1998 tax return put them on notice that they needed to file an FBAR," even though it was checked "yes" to indicate foreign accounts).

11 *See, e.g.*, *Williams v. Comm'r*, 489 Fed. App'x. 655, 659 (4th Cir. 2012) (unpublished) ("Evidence of acts to conceal income and financial information, combined with the defendant's failure to pursue knowledge of further reporting requirements as suggested on Schedule B, provide a sufficient basis to establish willfulness on the part of the defendant," *quoting U.S. v. Sturman*, 951 F.2d 1466, 1476 (6th Cir. 1992)); *U.S. v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012). *See also* IRM 4.26.16.6.5.1(5)(note), Willful FBAR Violations - Defining Willfulness (Nov. 6, 2015).

that result from recklessness or willful blindness, Congress should establish a separate penalty that is greater than the penalty applied to non-willful violations but less than the penalty applied to willful violations.

RECOMMENDATIONS[12]

- Clarify that the government has the burden to establish actual willfulness (*i.e.*, specific intent to violate a known legal duty, rather than mere negligence, gross negligence, or recklessness) before asserting a willful FBAR penalty and cannot meet this burden by relying primarily on the Schedule B attached to a return.
- Reduce the statutory maximum civil penalty for a willful FBAR violation to the maximum penalty the IRM currently allows its examiners to assert without managerial approval (*i.e.*, no greater than 50 percent of the highest annual asset balance in the unreported account during the years of noncompliance).
- Establish a penalty for reckless FBAR violations and those due to willful blindness. The penalty should be greater than the penalty for non-willful violations, but less than the penalty for willful violations.

12 For more detail, see National Taxpayer Advocate 2014 Annual Report to Congress 331-345 (*Foreign Account Reporting: Legislative Recommendations to Reduce the Burden of Filing a Report of Foreign Bank and Financial Accounts (FBAR) and Improve the Civil Penalty Structure*).