Legislative Recommendation #35

Modify the Definition of "Willful" for Purposes of Determining Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts

SUMMARY

- *Problem:* Penalties for failure to file international information returns or to disclose foreign assets are steep and grow even steeper when the IRS determines a taxpayer's failure was "willful." The IRS has become increasingly aggressive in asserting that taxpayers' failures to file are willful, which can lead to draconian penalties for good-faith errors.
- *Solution:* Increase the burden of proof on the IRS for declaring a failure "willful" and reduce the maximum penalty for willful violations.

PRESENT LAW

U.S. citizens, residents, or entities (collectively, U.S. taxpayers) with specified interests in foreign accounts exceeding $10,000 in total 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 (FBAR). 31 U.S.C. § 5321(a)(5) imposes civil penalties for failing to report accounts.

The amount of the civil penalty 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] Under 31 U.S.C. § 5321(a)(5)(C)(i)(I) and (II), the maximum civil penalty for a willful violation is the greater of $100,000 (adjusted for inflation) or 50 percent of "the balance in the account at the time of the violation."[2] As currently interpreted by the IRS in non-binding policy guidance, 31 U.S.C. § 5321(a)(5)(B)(ii) will not allow for a penalty to be imposed for a non-willful violation if the account holder filed accurate or amended FBAR(s) rectifying prior violations and had reasonable cause for failing to file the FBAR(s).[3]

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 his or her 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.[4] 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.

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

2 "The time of the violation" is the FBAR due date. Internal Revenue Manual (IRM) 4.26.16.5.2(2), FBAR Penalty Structure (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016; IRM 4.26.16.5.5(3) Penalty for Willful FBAR Violations (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016. *See also United States v. Schwarzbaum*, 24 F.4th 1355, 1365 (11th Cir. 2022).

3 The IRM provides that a penalty should not be imposed for a nonwillful violation if (1) the violation was due to reasonable cause; and (2) "[a]ccurate delinquent or amended FBAR(s) are filed, rectifying prior violation(s)." IRM 4.26.16.5.4(3), Penalty for Non-willful FBAR Violations (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016.

4 Specifically, the Streamlined Filing Compliance Procedures require a combination of income tax, FBAR, and potentially international information return delinquent submissions in addition to a Title 26 miscellaneous offshore penalty. Delinquent FBAR Submission Procedures solely concern instances where a taxpayer/account holder did report income from their foreign accounts on their income tax returns but did not file FBARs for those accounts. *See* IRS, Delinquent FBAR Submission Procedures, https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures (last visited Sept. 27, 2023) (no penalty if no underreporting and fixed before contact). *See also* IRS, Streamlined Filing Compliance Procedures, https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures (last visited Sept. 27, 2023).

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.[5] Some commentators have suggested the penalty is so severe that it may violate the U.S. Constitution's prohibition against excessive fines.[6] Individuals who have lived in foreign countries or have immigrated to the United States often maintain foreign bank accounts and may overlook this requirement for benign reasons.

Although the Internal Revenue Manual (IRM) limits the total amount of the penalties for non-willful violations to 50 percent of the highest aggregate balance (HAB) of all unreported foreign financial accounts for all years under examination, examiners are still free to propose a penalty of up to 100 percent of the HAB for willful violations 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 reasonably 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 makes sense in concept, its application can lead to unduly harsh results. If the IRS chooses to assert a violation was willful, it is very difficult for a taxpayer to prevail. 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 return when they sign it under penalties of perjury; the jurat they must sign states: "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 a taxpayer not to learn about the FBAR filing requirement after having been directed to the FBAR form by Schedule B and having signed the jurat.[8] 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.[9] Courts have arrived at different determinations when presented with this argument.[10] In practice, tax forms and

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5 Under current guidance, the IRS should not impose such a severe penalty. *See* IRM 4.26.16.5.5, Penalty for Willful FBAR Violations (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016 (discussed in the text below). *See also* IRM 4.26.16.5.5.3(7), Penalty for Willful FBAR Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016 ("In no event will the total penalty amount (among all open years) exceed 100 percent of the highest aggregate balance of all foreign financial accounts to which the violations relate during the years under examination."). Note that the IRM is not binding on the IRS.

6 *See* Alison Bennett, *New FBAR Penalty Limits Seen Reflecting IRS Concern on Eighth Amendment Litigation*, BNA Tax Mgmt Weekly Rept (June 15, 2015), https://www.bloomberglaw.com/product/tax/document/X80RQG3C000000. However, courts have held either that the FBAR penalties were not excessive or that the Eighth Amendment does not apply to them. *See United States v. Toth*, 33 F.4th 1, 19 (1st Cir. 2022); *United States v. Bussell*, 699 F. App'x 695, 696 (9th Cir. 2017); *United States v. Kerr*, 2022 WL 912563, at *10 (D. Ariz. 2022); *United States v. Schwarzbaum*, 611 F. Supp. 3d 1356, 1374 (S.D. Fla. 2020), *vacated and remanded on other grounds*, 24 F.4th 1355 (11th Cir. 2022).

7 *See* IRM 4.26.16.5.4.1, Penalty for Non-willful Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016; IRM 4.26.16.5.5.3, Penalty for Willful FBAR Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016. The IRS also has "mitigation" guidelines that could result in lower penalties. *See* IRM Exhibit 4.26.16-2, FBAR Penalty Mitigation Guidelines for Violations Occurring After October 22, 2004 (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016. 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), https://www.bloomberglaw.com/product/tax/document/X80RQG3C000000.

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

9 *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).

10 Compare *United States v. Bohanec*, *id.*, with *United States v. Schwarzbaum*, 611 F. Supp. 3d (S.D. Fla. 2020) (finding that willfulness could not be shown under a theory of constructive knowledge based on the signing of tax returns that included Schedule B where reasonable reliance on a tax preparer was present), *vacated and remanded on other grounds*, 24 F.4th 1355 (11th Cir. 2022).

instructions contain a lot of verbiage, and few if any taxpayers have a complete understanding of all lines, questions, and instructions on a return.

Account holders who do not file required FBAR forms due to negligence, inadvertence, or similar causes may be subject to penalties for non-willful violations (which have a reasonable cause exception). But they should not face uncertainty regarding possible application of the harsh penalties for "willful" violations. The National Taxpayer Advocate recommends Congress clarify that the IRS must prove a violation was "willful" without relying on the instructions to Schedule B or the failure to check the box on Schedule B before imposing a willful FBAR penalty and must do so by clear and convincing evidence – the standard typically required in fraud cases.[11]

RECOMMENDATIONS

- Clarify that the government has the burden to establish willfulness by clear and convincing evidence before asserting a civil willful FBAR penalty and that the government cannot meet this burden by relying on the Schedule B attached to a return.
- Remove subsection (I) in 31 U.S.C. § 5321(a)(5)(C)(i), which would have the effect of narrowing the statutory maximum civil penalty for a willful FBAR violation to no greater than 50 percent of the balance in the account at the time of the violation so that a $100,000 penalty cannot be imposed with respect to low-balance accounts.[12]

11 In Tax Court, the IRS bears the burden of proving fraud by "clear and convincing" evidence. *See* Tax Ct. R. 142(b) ("In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the [IRS], and that burden of proof is to be carried by clear and convincing evidence."); IRM 25.1.6.2(3), Overview (June 10, 2021), https://www.irs.gov/irm/part25/irm_25-001-006 ("Civil fraud penalties will be asserted when there is clear and convincing evidence that some part of the understatement of tax was due to fraud" (underlining in original text)). However, U.S. district courts generally have not required the government to present "clear and convincing" evidence to prove willfulness in FBAR cases. *See, e.g.*, *United States v. Garrity*, 304 F. Supp. 3d 267 (D. Conn. 2018); *United States v. Bohanec*, 263 F. Supp. 3d 881 (C.D. Cal. 2016); *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012); *United States v. Williams*, 106 A.F.T.R.2d (RIA) 2010-6150 (E.D. Va. 2010), *rev'd on other grounds*, 489 Fed. Appx. 655 (4th Cir. 2012).

12 For more detail, *see* National Taxpayer Advocate 2014 Annual Report to Congress vol. 1, at 331 (Legislative Recommendation: *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*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/2014-ARC_VOL-1_S2_LR-6-508.pdf.