Tax Insider™

IRS Provides Guidance on FBAR Penalties

Updated procedures on penalties imposed for failing to file the Report of Foreign Bank and Financial Accounts provide consistency and help taxpayers know what to expect.

By Steven L. Walker, J.D.
November 5, 2015

Tax professionals who advise clients on issues with FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR), should become familiar with IRS Memorandum SBSE-04-0515-0025, "Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties" (5/13/15). The guidance is significant because it provides procedures to ensure consistency and efficiency in the IRS's administration of the FBAR compliance program. The procedures include:

- A requirement that IRS examiners fully develop and adequately document their analysis of the civil FBAR willfulness penalty;
- Detailed instructions on how to calculate the penalty amount for willful violations and nonwillful violations of the FBAR rules, and limitations or caps on the penalty amounts in certain cases;
- Coordination of cases with technical specialists who have been designated to assist examiners with their FBAR cases, and coordination of cases with the IRS Chief Counsel's Office in willfulness cases; and
- A civil FBAR penalty case file checklist, detailing what documents must be in the administrative case file.

The new interim guidance is to be incorporated into Part 4, Chapter 26, of the Internal Revenue Manual (IRM).

FBAR penalty background

If an individual has a financial interest in or signature authority over a foreign financial account (including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account) exceeding certain thresholds, the Bank Secrecy Act may require the individual to report the account annually to the Treasury Department by electronically filing Form 114.

FBAR civil penalties

If an individual fails to file the FBAR, the IRS can impose one of two civil penalties:

- A nonwillfulness penalty, not to exceed $10,000, may be imposed on any person who violates or causes any violation of the FBAR filing and recordkeeping requirements (IRM §4.26.16.4.4); or

- A willfulness penalty may be imposed on any person who willfully fails to file the FBAR, with the ceiling on the penalty being the greater of $100,000 or 50% of the balance in the account at the time of the violation (IRM §4.26.16.4.5.1).

Significantly, the nonwillfulness penalty should not be imposed if an individual's violation was due to reasonable cause and the balance in the account was properly reported on an FBAR (IRM §4.26.16.4.4).

A few highlights of the new FBAR guidance are discussed below.

Cases must be fully developed and adequately documented

A key issue in FBAR penalty cases is whether the IRS has carried its burden of proof when it imposes the civil FBAR willfulness penalty for failing to file the form, which it must prove by a preponderance of the evidence (*McBride*, No. 2:09-cv-378 DN (D. Utah 11/8/12)).

A central aspect of an FBAR case is that examiners are expected to exercise their discretion, taking into account the facts and circumstances of each case, in determining whether penalties should be asserted and their amount (IRM §4.26.16.4.7). IRS revenue agents must use their "best judgment" and must "take into account all the available facts and circumstances of a case" when proposing FBAR penalties (SBSE-04-0515-002). Consequently, it can be difficult to predict with certainty what facts and circumstances will transform a case from one calling for a nonwillful penalty to one calling for a willful penalty, and, more importantly, when the IRS will seek to impose the FBAR willfulness penalty.

Under the guidance, IRS examiners are required to fully develop and adequately document in the examination workpapers their analysis of willfulness. The examiner's workpapers must support all willful penalty determinations and document the group manager's approval of this determination. The case file must include the examiner's FBAR workpapers, penalty calculations, and, for willful cases, the Chief Counsel's written advice memorandum and a summary memorandum explaining the FBAR penalties. The summary memorandum is sent to the taxpayer with a Letter 3709, *FBAR 30 Day Letter*.

There also is a new civil FBAR penalty case file checklist that the IRS agents must follow. The checklist details what information must be included in each FBAR examination case file, including the FBAR workpapers and penalty calculations.

The guidance is helpful in ensuring that there is an adequate administrative record and sufficient documentary evidence to support a finding of willfulness. Tax practitioners should attempt to obtain a copy of the administrative file and carefully review the examiner's evidence supporting a willfulness determination.

Limitations on penalty for willful violations

Another practical issue in FBAR penalties is determining the monetary amount of the civil penalty (i.e., how much an individual must pay for failing to file the form). One problem is that the FBAR statute imposing the penalty has a *ceiling* for the penalty—a maximum amount that can be imposed—but no floor (31 U.S.C. §5321 (a)(5)(C) ("the *maximum* penalty under subparagraph (B)(i) shall be increased to the greater of—(I) $100,000, or (II) 50 percent of the amount determined under subparagraph (D)").

Another problem is that "the total amount of penalties that can be applied under the FBAR statute can greatly exceed an amount that would be appropriate in view of the violation" (IRM §4.26.16.4). "FBAR penalties are determined per account, not per unfiled FBAR," but examiners are expected to exercise discretion, according to the IRS (id.). This has created uncertainty and controversy as to exactly how much an individual reasonably would be required to pay for willfully failing to file the form.

Under the new guidance, a dollar limit now exists for most cases where the IRS seeks to impose the willfulness FBAR penalty. The total penalty amount for all years under examination will be "limited to 50 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination" (SBSE-04-0515-0025). The IRS will then use a formula to allocate the total penalty amount to each year for which there is an FBAR violation.

The guidance is taxpayer-friendly.

> ***Example 1:*** An individual has accounts with highest aggregate balances of $50,000, $100,000, and $200,000 for 2010, 2011, and 2012, respectively. Under the new guidance, the total penalty amount would be $100,000 (50% of $200,000, since this is the highest aggregate balance during the years under examination). However, in the past, the penalty could have been $175,000 (50% of $50,000 plus 50% of $100,000 plus 50% of $200,000). In short, the new rules provide more certainty and clarity as to the amount of the willfulness penalty.

The guidance, however, does state that an examiner may recommend a penalty that is higher or lower than 50% of the highest aggregate account balance of all unreported foreign financial accounts based on the facts and circumstances. Consequently, this provision provides tax practitioners with room to negotiate a penalty that is lower than 50%. That being said, there is a risk, however, that the examiner could seek a penalty amount higher than 50% in some cases.

Penalty amount for nonwillful violations

The memo also provides guidance on how to calculate the nonwillful penalty. In the past, there was controversy as to whether the IRS would seek to impose a nonwillful penalty for each unreported account—which would significantly drive up the penalty amount—and/or whether the case could be administratively resolved simply by imposing a single nonwillful penalty for all violations. Under the new rules, for cases involving multiple violations:

- Examiners will recommend one penalty for each open year, regardless of the number of unreported foreign financial accounts; and
- The penalty for each year will be determined based on the aggregate balance of all unreported foreign financial accounts, and the penalty for each year will be limited to $10,000.

The guidance also provides that if the facts and circumstances warrant it, the IRS may only impose a single penalty, not to exceed $10,000, for one year only. In making this determination, the IRS takes into account the conduct of the person who was required to file and the aggregate balance of the unreported foreign financial accounts.

> ***Example 2:*** An individual has accounts with highest aggregate balances of $50,000, $100,000, and $200,000 for 2010, 2011, and 2012, respectively. Under the new guidance, the nonwillful penalty could be a single penalty that would not exceed $10,000 for 2010, $10,000 for 2011, and $10,000 for 2012. Thus, the total dollar amount of the penalty would not exceed $30,000 ($10,000 + $10,000 + $10,000) under one scenario. Alternatively, the total penalty could simply be $10,000 (or some lesser amount), which would be a single penalty for one year only.

For other cases, however, the guidance states that the facts and circumstances may indicate that asserting a separate nonwillful penalty for each unreported foreign financial account, and for each year, is warranted. Practitioners should attempt to work with the examining agent and try to show why this result is not warranted based upon the facts of the case.

In short, the guidance on how to calculate the FBAR penalty amount is a significant improvement and tax professionals advising clients on potential FBAR violations should review it carefully.

New FBAR coordinator

An operating division FBAR coordinator must now review FBAR cases after the examiner preliminarily determines the penalties to be asserted. Operating division FBAR coordinators are revenue agents or technical specialists whom an operating division has designated to assist examiners with their FBAR cases. The existence of operating division FBAR coordinators should provide some level of consistency and, hopefully, predictability about the administration of FBAR penalty cases.

Chief Counsel's review of willfulness penalty

Chief Counsel is required to review cases for which willful penalties have been determined. The legal advice is limited to providing advice on whether:

- An FBAR violation occurred;
- The FBAR violation was willful; and
- The proposed penalty is within the statutory limits of 31 U.S.C. Section 5321(a)(5)(C).

Chief Counsel must provide a written memorandum setting forth the legal advice, which is part of the administrative file. This is an additional layer of review that hopefully will prevent the examining agent from seeking to impose a penalty where one is not justified.

Big picture

It is important to remember that an individual has only two administrative opportunities to challenge an FBAR penalty. The first is during the examination phase, and the second is at IRS Appeals. If an individual disagrees with the examiner, the IRS will issue a Letter 3709, which gives the individual the option to file a protest with Appeals. This is really the individual's last chance to cost-effectively resolve the case.

A trap for the unwary: The venue for challenging FBAR penalties is a U.S. district court or the Federal Court of Claims, not the U.S. Tax Court (IRM §8.11.6.1). Individuals seeking to challenge an FBAR penalty after it has been assessed may either (1) pay the penalty and file a refund suit or (2) wait until the government files a suit in district court to collect the penalty and challenge the assessment (id.). Consequently, the best course of action may be to attempt to settle the case at Appeals.

Lastly, the collection of FBAR penalties also raises issues.

Unknown to some practitioners is that the Internal Revenue Code does not apply to the collection of an FBAR penalty, and so the government lacks its normal collection remedies under Secs. 6301–6344. The collection remedies for FBAR penalties are in Title 31, but they are not as robust as the remedies in the Code. For example, the IRS cannot file a federal tax lien or seize property.

At the same time, an individual cannot request an installment agreement or file an offer in compromise with the IRS. However, the IRS has the option of reducing the FBAR assessment to a civil judgment through the Justice Department. Once done, this opens up a new range of collection remedies for the government. The statute of limitation on bringing suit to collect the assessment of civil penalties is two years from the date of assessment or the date any judgment becomes final in any criminal action under 31 U.S.C. Section 5321(b)(2) (IRM §4.26.17.5.5). In short, individuals who owe FBAR penalties face an added level of complexity in finding a workable solution to pay the debt owed to the government.

Conclusion

The recent guidance issued by the IRS is a very important document to become familiar with for tax professionals who advise taxpayer's on FBAR issues. It is worthwhile to take the time to carefully review the guidance.

Steven L. Walker (mailto:swalker@walk-law.com)*, J.D., LL.M., is a tax attorney with the Law Offices of Steven L. Walker, A Professional Law Corporation, in San José, Calif., who specializes in civil and criminal tax litigation. For more information, see www.walk-law.com* (http://www.walk-law.com) .