

# EVOLUTION OF THE FBAR: WHERE WE WERE, WHERE WE ARE, AND WHY IT MATTERS

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## I. INTRODUCTION

Many people have financial accounts in foreign countries, but few of them are admitting it. This indisputable fact has miffed the U.S. government in general, and the Internal Revenue Service (“IRS”) in particular, for more than three decades. In an attempt to resolve the problem, Congress passed legislation decades ago requiring certain U.S. taxpayers to report their foreign accounts by filing a Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) each year. In tax circles, this form is commonly known as the Foreign Bank Account Report or “FBAR.” In addition to mandating the filing of annual FBARs, the legislation forced taxpayers to retain detailed records about their foreign accounts. Failure to comply with either of these requirements could lead to civil and criminal penalties. Despite these potential sanctions, FBAR compliance has remained relatively low for years.

Things are likely to change in the near future, though, for a variety of reasons. Importantly, Congress amended the law in late 2004, introducing new penalties for *non-willful* FBAR violations and more stringent penalties for *willful* violations. To implement this strengthened law, the U.S. Treasury Department delegated full investigatory and enforcement authority to the IRS. Now, this agency has in its arsenal several formidable weapons, including the power to take “any action reasonably necessary” to enforce FBAR compliance. Enforcement activities are also certain to rise because of the Patriot Act.<sup>1</sup> This controversial legislation modified the relevant provisions to expressly state that the FBAR is vital to the U.S. government not only in carrying out criminal and tax investigations, but also in conducting intelligence activities to protect against international

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1. Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001) [hereinafter USA PATRIOT ACT].

terrorism. Nowadays, once something has been labeled as crucial to the ubiquitous “war on terror,” there seem to be few (if any) limits on governmental efforts.

Thus it is clear that FBAR enforcement is on the rise. What is not clear, however, is how the IRS will accomplish its mission when unresolved issues abound. This article highlights the existing ambiguities to provide a better understanding of where we were, where we are, and why it matters.

## II. OVERVIEW OF THE FBAR

### A. *Description of the Relevant Law*

To fully appreciate the recent changes regarding the FBAR, it is first necessary to understand the applicable law. In 1970, Congress enacted the Bank Secrecy Act, which is codified in Title 31 (Money and Finance) of the U.S. Code.<sup>2</sup> The purpose of the Bank Secrecy Act was to require the filing of reports and the retention of records where doing so would be helpful to the U.S. government in carrying out criminal, tax and regulatory investigations.<sup>3</sup> One of the most important provisions of the Bank Secrecy Act was Section 5314(a), which provides that:

[T]he Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.<sup>4</sup>

Several articles have been written about Section 5314, but these tend to focus solely on one element, the FBAR filing requirement.<sup>5</sup> A careful reading of the statute, along with a

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2. Currency and Foreign Transactions Reporting Act, Pub. L. No. 91-508, tits. I-II (1970).

3. *Id.* § 202.

4. 31 U.S.C. § 5314(a) (1994). Unless otherwise expressly stated, all uses in this article of the terms “Section” or “Sections” refer to Title 31 (Money and Finance) of the U.S. Code.

5. See, e.g., Karen Canavan Brodsky et al., *Reporting Interests in Foreign Bank and Financial Accounts*, 35(3) TAX ADVISER 136-139 (Am. Inst. of Certified Pub. Accountants, Inc., Jersey City, N.J.), Mar. 2004; Steven M. Harris, *IRS-Revived Scrutiny of Foreign Accounts: Amnesty Offered But Uncertainty and Perils Remain*, 77 FLA. BAR J. 57 (2003), available at <http://www.floridabar.org> (follow “Publications” hyperlink; then follow “Florida Bar Journal” hyperlink); Eileen Sherr, *Reporting Foreign Bank Account Information*, 34(4) TAX ADVISER 185 (Am Inst. of Certified Pub. Accountants, Inc., Jersey

review of the applicable regulations, reveals that Section 5314 actually has two distinct requirements: filing FBARs and retaining certain records related to foreign accounts. With regard to the former, the relevant regulation (*i.e.*, 31 C.F.R. § 103.24) mandates the following:

Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the [IRS] for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form prescribed by the Secretary to be filed by such persons.<sup>6</sup>

With regard to the latter, the regulations contain considerable detail concerning exactly who must retain records, what these records must contain, when these records may be discarded, and where the records must be kept. In particular, the pertinent regulation states that:

Records of accounts required by § 103.24 to be reported to the [IRS] shall be retained by each person having a financial interest in or signature or other authority over any such account. Such records shall contain the name in which each such account is maintained, the number or other designation of such account, the name and address of the foreign bank or other person with whom such account is maintained, the type of such account, and the maximum value of each such account during the reporting period. Such records shall be retained for a period of 5 years and shall be kept at all times available for the inspection as authorized by law.<sup>7</sup>

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City, N.J.), Apr. 2003; Charles M. Bruce & Lewis J. Saret, *Always-Tricky Reporting of Foreign Bank Accounts Turning Dangerous with Patriot Act, Increased Enforcement Efforts*, No. 110 DAILY TAX REPORT (June 9, 2003); Mark F. Sommer, *Disclosure of Currency Transaction Violations: When, How and What If You Don't?*, 47 TAX LAW. 139 (1993); Vernon K. Jacobs, *Reporting Common Foreign Transactions of U.S. Clients*, 34(12) THE TAX ADVISER 732-736 (Am. Inst. of Certified Pub. Accountants, Inc. Jersey City, N.J.), Dec. 2003.

6. 31 C.F.R. § 103.24 (2005).

7. 31 C.F.R. § 103.32 (2005).

## B. *Description of the FBAR Form and the Instructions Thereeto*

Most people can imagine few things more tedious than studying IRS forms and instructions. In this case, however, the exercise is absolutely vital because these are the *only* places that many of relevant requirements and definitions are found. Apparently, the IRS made a conscious decision to place this critical information where few tax practitioners, and even fewer taxpayers, dare tread. The IRS recently explained that Section 5314(b)(1) granted it discretion to exempt certain groups from the FBAR filing requirement and “[i]ssuing instructions for the FBAR form is one way the Secretary may exercise this discretion.”<sup>8</sup> Many commentators have noted that the current FBAR form and instructions suffer many maladies, such as complicated instructions, ambiguous definitions, outdated terminology, and unnecessary duplication.<sup>9</sup> Mindful of this, the following analysis is an attempt to coherently organize and synthesize the available IRS information.

### 1. Who Must File an FBAR?

According to the FBAR instructions, a person must file an FBAR if *all* of the following elements are met: (i) a “U.S. person,” (ii) had a “financial interest” in, or “signature authority” over, or “other authority” over (iii) one or more “financial accounts” (iv) located in a “foreign country,” (v) and the aggregate value of such account(s) exceeded \$10,000, (vi) at any time during the calendar year.<sup>10</sup> As one might surmise from the repeated use of quotation marks, many of these elements contain terms-of-art. This specific terminology, discussed below, is derived almost exclusively from the FBAR instructions.<sup>11</sup>

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8. Internal Revenue Service, “FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR),” Question 25, <http://www.irs.gov/businesses/small/article/0,,id=148845,00.html> [hereinafter FBAR FAQs] (last visited Jan 24, 2007).

9. U.S. DEP’T OF THE TREASURY, A REPORT TO CONGRESS IN ACCORDANCE WITH § 361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 (USA PATRIOT ACT) 12 (April 26, 2002) [hereinafter TREASURY REPORT 2002].

10. DEP’T OF THE TREASURY, TD F 90-22.1, REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (OMB No. 1506-0009) (Jul. 2000) [hereinafter Form TD F 90-22.1] (General Instructions).

11. *Id.* (General Definitions).

## 2. What Do the Terms-of-Art Mean?

The FBAR instructions indicate that a “U.S. person” means a U.S. citizen, U.S. resident, domestic partnership, domestic corporation, domestic estate, or domestic trust.<sup>12</sup> Determining whether a U.S. person has the requisite relationship with a foreign financial account is less straightforward. In fact, ascertaining whether one has a “financial interest” in, “signature authority” over, or “other authority” over an account necessitates a close review of the instructions.

For purposes of the FBAR, a direct interest and certain indirect interests qualify as “financial interests” in an account. A person has a *direct* “financial interest” in an account if such person is owner of record of, or holds legal title to, the account, regardless of whether the person maintains the account for personal benefit or for the benefit of others.<sup>13</sup> Multiple people can have a direct interest in the same account. On this score, the instructions indicate that if several people have a partial interest in an account or if the account is jointly held by two people, then each of the people has a direct financial interest in the account.<sup>14</sup> The rules regarding an *indirect* “financial interest” are slightly more complex. The FBAR instructions state that a U.S. person has an indirect “financial interest” in each account where the titleholder or owner of the account falls into one of the following four categories: (i) the person’s agent, nominee, or attorney, (ii) a corporation whose shares are owned, directly or indirectly, more than fifty percent by the person, (iii) a partnership in which the person owns greater than a fifty percent profits interest, or (iv) a trust from which the person derives in excess of fifty percent of the current income or in which the person has a present beneficial interest in more than fifty percent of the assets.<sup>15</sup>

A person has “signature authority” over an account if the person can control the disposition of the property in the account by delivering a document with the requisite signature or signatures to the bank or other person with whom the account is maintained.<sup>16</sup>

A person has “other authority” over an account if the person can control the disposition of the property in the account by communicating directly with the person with whom the account

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12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

is maintained, be it orally or otherwise.<sup>17</sup> A person who has the power to direct how an account is invested, but who cannot make disbursements from the account, does not have “other authority” over the account because he cannot control the disposition of the property therein.<sup>18</sup>

The definition of “financial account” is also tricky. It includes bank accounts, securities accounts, securities derivatives accounts, other financial instruments accounts, savings accounts, demand accounts, deposit accounts, time deposit accounts, mutual funds, and any other accounts maintained with either a financial institution or a person engaged in the business of a financial institution.<sup>19</sup> In addition, a recent IRS legal memorandum indicates that a foreign credit card account may constitute a “financial account” in certain circumstances.<sup>20</sup> For instance, if a credit card agreement requires the cardholder to make advance payments to cover anticipated charges, then the card would be considered a debit card and thus a “financial account.”<sup>21</sup>

In the FBAR context, the term “foreign country” includes all geographical areas, except the United States, Guam, Puerto Rico, and the Virgin Islands.<sup>22</sup>

The FBAR instructions refer to the “aggregate value” of the accounts “at any time during the calendar year.”<sup>23</sup> The amount for which the IRS is searching is clarified on the FBAR itself, which requires the person to indicate the “maximum value” of each account. Generally, the “maximum value” of an account is the largest amount of cash and non-monetary assets (*e.g.*, securities) that appear on any periodic account statement.<sup>24</sup> If periodic statements are not issued for the account, then the “maximum value” is the largest amount of cash and non-monetary assets in the account at any time during the year.<sup>25</sup> With respect to cash, the FBAR instructions direct a person to convert any foreign currency into U.S. dollars by using the official foreign exchange rate at the end of the year in question.<sup>26</sup>

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17. *Id.*

18. *See* FBAR FAQs, *supra* note 8, Question 20.

19. Form TD F 90-22.1, *supra* note 10 (General Definitions).

20. Tax Analysts, *Service Discusses Foreign Bank and Financial Accounts Report Penalty*, TAX NOTES TODAY, 14-14, Jan. 23, 2006 [hereinafter *Service Discusses Penalty*].

21. *Id.*

22. Form TD F 90-22.1, *supra* note 10 (General Definitions).

23. *Id.* (General Instructions).

24. *Id.* (Instructions, Item 22).

25. *Id.*

26. *Id.*

Regarding non-monetary assets (*e.g.*, securities), the instructions indicate that their value should be determined based on the fair market value of such assets at the end of the calendar year.<sup>27</sup> If the assets were withdrawn from the account during the year, then their value is based on the fair market value at the time of the withdrawal.<sup>28</sup> If the person is required to file an FBAR with regard to more than one account, then the person must ascertain the "maximum value" for *each* account separately using the preceding rules.<sup>29</sup> Finally, as a default rule, the instructions state that if a person had a financial interest in less than twenty-five accounts and cannot determine whether the "maximum value" of these accounts surpasses the \$10,000 threshold, then the person must provide all the information for *each* of the accounts.<sup>30</sup> In other words, the person is forced to error on the side of over-inclusion.

### 3. Are There Any Exceptions to the FBAR Filing Requirement?

Notwithstanding the broad definitions set forth above, there are six major exceptions to the FBAR filing requirement: the Commercial Bank Exception, the Publicly-Traded Domestic Corporation Exception, the Military Banking Facility Exception, the U.S. Branch of Foreign Bank Exception, the Consolidated Reporting Exception, and the Limited Control Exception.<sup>31</sup> Like the crucial terms-of-art, these exceptions do not originate in the relevant law or regulations. Instead, they are found exclusively in the FBAR instructions.

#### (a) Commercial Bank Exception

Under the FBAR instructions, an officer or employee of a bank that is subject to the supervision of the Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, or the Federal Deposit Insurance Corporation is not required to file an FBAR with respect to the foreign financial accounts maintained by the bank, provided that the officer or employee has no personal "financial interest" (as that term is defined above) in the account.<sup>32</sup>

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27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.* (Exceptions).

32. *Id.*



(b) Publicly-Traded Domestic Corporation  
Exception

The instructions provide that an officer or employee of certain corporations is not required to file an FBAR concerning his or her authority over a foreign financial account maintained by the corporation if the following conditions are met: the corporation is a domestic corporation, as opposed to a foreign corporation; the corporation's equity securities are listed on a national security exchange, *or* the corporation has more than \$10 million in assets or at least 500 shareholders; the officer or employee does not have a personal "financial interest" (as that term is defined above) in the account; and the chief financial officer of the corporation advised the officer or employee in writing that the corporation filed an appropriate FBAR regarding the account.<sup>33</sup> The IRS recently confirmed that this exception extends to officers and employees of domestic subsidiaries of publicly-traded domestic corporations.<sup>34</sup>

(c) Military Banking Facility Exception

According to the FBAR instructions, an account maintained at an institution that is properly operating as a "U.S. military banking facility" or as a "U.S. military finance facility" will not be considered an account in a "foreign country," even if the institution is located in a geographical area that would otherwise be deemed a "foreign country."<sup>35</sup>

(d) U.S. Branch of Foreign Bank Exception

The FBAR instructions indicate that an FBAR need not be filed with respect to any financial account maintained with a branch, agency or other office of a *foreign* bank or other financial institution that is located in the United States, Guam, Puerto Rico, of the Virgin Islands.<sup>36</sup> Conversely, the instructions clarify that a U.S. person must file a FBAR for "any financial account that is located in a foreign country, even if [such account] is held at an affiliate of a United States bank or other financial institution."<sup>37</sup>

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33. *Id.*

34. David A. Heywood, Attorney Suggests Revising Foreign Account Disclosure Instructions, *Tax Notes Today*, 39-16, Feb. 27, 2004.

35. Form TD F 90-22.1, *supra* note 10 (Military Banking Facility).

36. *Id.* (Exceptions).

37. *Id.*

## (e) Consolidated Reporting Exception

The Consolidated Reporting Exception is derived from the statement in the FBAR instructions that a corporation that owns (directly or indirectly) more than a fifty percent interest in one or more other entities may file a “consolidated FBAR” on behalf of itself and the other entities, provided that the consolidated FBAR lists all of the pertinent entities.<sup>38</sup> To be effective, the consolidated FBAR should be signed by an authorized official of the parent corporation.<sup>39</sup> It is important to note that, if the consolidated group has a financial interest in twenty-five or more foreign financial accounts, then the parent corporation simply notes that fact on the FBAR, without having to provide additional detail regarding each particular account until the IRS specifically requests it.<sup>40</sup>

## (f) Limited Control Exception

The FBAR instructions contain special rules for U.S. persons with “signature authority” or “other authority” over, but no “financial interest” in, foreign financial accounts.<sup>41</sup> If a person must complete an FBAR for an account in which no U.S. person had a “financial interest,” then, instead of being required to provide certain information on the FBAR regarding the owner of the account, the person may simply include the following statement: “No U.S. person had any financial interest in the foreign account.”<sup>42</sup> The FBAR instructions admonish, though, that this statement must be based on the person’s “actual belief” after the person has taken “reasonable measures” to ensure that the statement is accurate.<sup>43</sup>

## III. WHERE WE WERE

As mentioned above, FBAR violations can trigger both criminal and civil penalties.<sup>44</sup> Recent legislative changes only affect the *civil* penalties; therefore, this article focuses strictly on this aspect.

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38. *Id.* (Consolidated Reporting).

39. *Id.*

40. *Id.* This instruction is consistent with 31 C.F.R. § 103.24 (2005), which provides that “[p]ersons having a financial interest in 25 or more foreign financial accounts need only note that fact on the [FBAR]. Such persons will be required to provide detailed information concerning each account when so requested by the Secretary or his delegate.”

41. *Id.* (General Instructions).

42. *Id.* (Instructions, Item 26).

43. *Id.*

44. *See supra* Part I.

### A. Civil Penalties Under the Old Law

Under the law in effect until October 22, 2004, the Secretary of the Treasury could impose a civil penalty on any person who “willfully” violated Section 5314.<sup>45</sup> As discussed earlier, this type of violation included not only failures to file an FBAR, but also failures to retain the necessary records concerning the foreign account.<sup>46</sup> To impose penalties under the old law, the Secretary had the burden of proving that the taxpayer acted “willfully.”<sup>47</sup> Meeting this burden required the Secretary to demonstrate that the taxpayer knew about the two FBAR-related duties, yet intentionally ignored them.<sup>48</sup> As the U.S. Supreme Court noted, the government must leap a significant legal hurdle to prove willfulness:

Willfulness . . . requires the Government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty . . . [C]arrying this burden requires negating a defendant’s claim of ignorance of the law or a claim that because of a misunderstanding of the law, he had a good-faith belief that he was not violating any of the provisions of the tax laws.<sup>49</sup>

If the Secretary managed to meet this high evidentiary standard, he was authorized to impose certain civil penalties. In the case of violations involving a “transaction,” the maximum penalty was \$25,000 or the amount of the transaction (not to exceed \$100,000), whichever was greater.<sup>50</sup> Similarly, in situations involving a “failure to report the existence of an account or any identifying information required to be provided with respect to such account,” the maximum penalty was the larger of \$25,000 or the amount of the balance in the account at the time of the

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45. 31 U.S.C.S. § 5321(a)(5)(A) (LexisNexis 2004).

46. *See id.* (providing that the Secretary of the Treasury is empowered to impose a civil money penalty for any willful violation of section 5314); 31 U.S.C. § 5314 (2000) (requiring the retention of records and the filing of reports pertaining to transactions with foreign financial agencies); 31 C.F.R. §§ 103.24, .32 (2005) (specifying that reports and records pertaining to foreign financial accounts and interests held therein must be made and retained).

47. 31 U.S.C. § 5321(a)(5)(A) (2000).

48. The courts have consistently held that the term “willfulness” means a “voluntary, intentional violation of a known legal duty.” *Cheek v. United States*, 498 U.S. 192, 201 (1991); *United States v. Bishop*, 412 U.S. 346, 360 (1973); *United States v. Sturman*, 951 F.2d 1466, 1476 (6th Cir. 1991).

49. *Cheek*, 498 U.S. at 201-02.

50. 31 U.S.C. § 5321(a)(5)(B)(i); 31 C.F.R. § 103.57(g)(1).

violation (not to exceed \$100,000).<sup>51</sup> In summary, provided that the Secretary managed to establish that a taxpayer had acted “willfully” in not complying with Section 5314, he could assert a penalty ranging from \$25,000 to \$100,000, depending on the amount of the transaction or the balance of the account.

### B. *How Effective Was the Old Law?*

As explained above, the original purpose of the Bank Secrecy Act, which included Section 5314, was to require certain reports and records where they have a high degree of usefulness to the U.S. government in carrying out criminal, tax or regulatory investigations.<sup>52</sup> The purpose of the Bank Secrecy Act was subsequently broadened in 2001 with the passage of the Patriot Act.<sup>53</sup> This contentious legislation inserted language clarifying that the FBAR was also useful in conducting activities to protect against international terrorism.<sup>54</sup> Along with expanding the scope of the law, the Patriot Act required the Secretary to study methods for improving compliance with Section 5314 and submit annual reports to Congress regarding his progress.<sup>55</sup> Three reports have been released to the public thus far.

#### 1. First Report to Congress

The Secretary presented his initial FBAR report to congress in April 2002 (“First Report”).<sup>56</sup> According to the First Report, FBAR compliance was quite low:

[T]he IRS estimates that there may be as many as 1 million U.S. taxpayers who have signature authority or control over a foreign bank account and may be required to file FBARS. *Thus, the approximate rate of compliance with the FBAR filing requirements based on this information could be less than 20 percent.*<sup>57</sup>

The First Report attributed these low compliance rates largely to meager enforcement efforts.<sup>58</sup> With respect to *civil*

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51. 31 U.S.C. § 5321(a)(5)(B)(ii); 31 C.F.R. § 103.57(g)(2).

52. Currency and Foreign Transactions Reporting Act, *supra* note 2, § 202.

53. USA PATRIOT ACT, *supra* note 1, § 272.

54. *Id.* § 358(a).

55. *Id.* § 361(b). The law required an initial report within six months of the enactment of the Patriot Act, followed by annual reports thereafter. *Id.*

56. TREASURY REPORT 2002, *supra* note 9, at 1.

57. *Id.* at 6 (emphasis added).

58. *Id.* at 11.

penalties, the First Report explained that from 1993 to 2002 the U.S. government only considered imposing monetary penalties in twelve cases.<sup>59</sup> 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>60</sup> The results were similar in the case of *criminal* penalties. Between 1996 and 1998, the U.S. Department of Justice filed just nine indictments related to FBAR violations, while during 1999 and 2000 it filed none.<sup>61</sup> Certain tax practitioners vexed by these statistics labeled the low enforcement rate “a national scandal.”<sup>62</sup>

Why was there so little enforcement? According to the First Report, the reasons abounded. First, the government found it difficult to gather sufficient admissible evidence of undisclosed foreign financial accounts.<sup>63</sup> Taxpayers trying to hide funds tended to maintain accounts with institutions located in countries with strong financial secrecy laws and no tax treaty with the United States. Even if the countries did have a mutual legal assistance arrangement in place with the United States, obtaining information about foreign accounts was a “cumbersome, time-consuming process.”<sup>64</sup> Second, the U.S. Department of Justice often chose to charge the taxpayer with other violations.<sup>65</sup> Taxpayers failing to file FBARs are usually engaged in other illegal conduct, such as tax evasion, fraud or money laundering.<sup>66</sup> Prosecutors preferred to bring charges that are easier to understand and have “greater jury appeal,” instead of battling over FBAR violations that juries often consider “hyper-technical.”<sup>67</sup> A review of applicable case law reveals that the theory raised in the First Report regarding charging decisions is accurate. In many cases involving potential FBAR violations, the government opted to charge fraud, using the FBAR violation as one indicator of fraudulent activity.<sup>68</sup> Third, prosecutors had trouble meeting the relevant evidentiary standard; that is, they faced problems demonstrating that a

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59. *Id.* at 9.

60. *Id.* at 9-10.

61. *Id.* at 8.

62. Amy Hamilton, *A Glimpse Inside Offshore Greed*, 98 TAX NOTES 297, 299 (2003); Jack A. Blum, *D.C. Attorney's Testimony at Finance Hearing on Fraudulent Tax Schemes*, TAX NOTES TODAY, 71-34, Apr. 12, 2002.

63. TREASURY REPORT 2002, *supra* note 9, at 8.

64. *Id.*

65. *Id.* at 9.

66. *Id.*

67. *Id.*

68. *See, e.g.*, *Polidori v. Comm'r*, 72 T.C.M. (CCH) 1297 (1996); *Lerch v. Comm'r*, 53 T.C.M. (CCH) 1101 (1987); *Zand v. Comm'r*, 71 T.C.M. (CCH) 1758 (1996).

particular taxpayer acted “willfully” in not filing an FBAR.<sup>69</sup> On this note, the First Report explains that during an audit taxpayers usually claim that they were not aware of the filing requirement.<sup>70</sup> Litigation is risky for the government in these cases unless there is evidence to contradict the taxpayer’s claim, such as a letter from a tax advisor or financial planner discussing the FBAR.<sup>71</sup> The risk of litigation also increases when a taxpayer, once informed of the filing requirement, voluntarily filed any missing FBARs.<sup>72</sup> There were two rare cases where the government successfully met the “willfulness” standard.<sup>73</sup> In both of these cases, however, the violations were particularly egregious.

In light of the historically low compliance rates and enforcement snags, the government recognized that there was “room for improvement” and identified several goals for the following year.<sup>74</sup> Among these goals were revising the FBAR form and instructions by December 31, 2002, and delegating the authority for FBAR enforcement to the IRS.<sup>75</sup>

The government also announced that it planned to tailor efforts to distinct groups. The First Report recognized that many taxpayers failed to file FBARs “because of lack of knowledge or confusion about the filing requirements.”<sup>76</sup> For this group, the government prescribed enhanced outreach and educational programs such that accountants, tax practitioners, and tax-filing services would advise their clients to file FBARs when appropriate.<sup>77</sup> The First Report also recognized a second group comprised of taxpayers who intentionally fail to file FBARs in order to conceal income.<sup>78</sup> The prescription for these taxpayers: enforcement, and lots of it. Specifically, the Secretary stated that effective deterrence necessitated

a series of highly publicized criminal actions  
against intentional violators in order to raise the

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69. TREASURY REPORT 2002, *supra* note 9, at 10.

70. *Id.*

71. *See id.*

72. *Id.*

73. *See United States v. Clines*, 958 F.2d 578 (4th Cir. 1992); *United States v. Sturman*, 951 F.2d 1466, 1476-77 (6th Cir. 1991). Although the *Clines* opinion does not directly address the willfulness standard, the presumption arises that the government met its burden of proof, as the defendant’s conviction was affirmed by the appellate court.

74. TREASURY REPORT 2002, *supra* note 9, at 12-13.

75. *Id.*

76. *Id.* at 10-11.

77. *Id.* at 10-11, 13.

78. *Id.* at 11.

cost of being an FBAR scofflaw. Ideally, such cases would be brought not only as adjuncts to other types of criminal conduct such as tax evasion and . . . fraud, but also as stand-alone cases.<sup>79</sup>

## 2. Second Report to Congress

In accordance with the Patriot Act, the Secretary submitted another report to Congress in April 2003 (“Second Report”).<sup>80</sup> This Second Report is limited to describing the progress made toward the goals set by the Secretary in the First Report. Of note in the Second Report was the fact that the government had advanced on certain issues, including empowering the IRS to fully investigate *and* enforce FBAR violations.

Under Treasury Directive 15-41 (1992), the Secretary delegated to the IRS the authority to *investigate* possible FBAR violations.<sup>81</sup> If the revenue agent or other member of the IRS examination staff detected an FBAR violation, the IRS Criminal Investigation Division (“CID”) would review the case.<sup>82</sup> At this point, there was a fork in the road. On one hand, CID would forward the cases that it recommended for criminal prosecution to the IRS Office of Chief Counsel, which would conduct its own independent review.<sup>83</sup> If the IRS Office of Chief Counsel believed that prosecution was warranted, it would refer the case to the U.S. Department of Justice, where a final decision regarding the advisability of criminal prosecution was made.<sup>84</sup> On the other hand, cases that the CID decided not to investigate criminally would be referred to the U.S. Treasury Department Financial Crimes Enforcement Network (“FinCEN”) for possible *civil* penalties.<sup>85</sup> In other words, while the IRS had been delegated the authority to *investigate* potential violations of the law, the U.S. Department of Justice and FinCEN retained the authority to *enforce* the law.

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79. *Id.*

80. See DEPT OF THE TREASURY, A REPORT TO CONGRESS IN ACCORDANCE WITH §361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 (USA PATRIOT ACT) (April 24, 2003) [hereinafter TREASURY REPORT 2003].

81. 31 C.F.R. § 103.56(c)(2) (2005) (“Authority for *investigating* criminal violations of this part is delegated as follows. . . To the Commissioner of Internal Revenue except with respect to § 103.23.”) (emphasis added); TREASURY REPORT 2003, *supra* note 80, at 4.

82. TREASURY REPORT 2003, *supra* note 80, at 4.

83. *Id.*

84. *Id.*

85. *Id.*

In April 2003, the IRS and FinCEN signed a Memorandum of Agreement whereby FinCEN delegated its *enforcement* authority to the IRS.<sup>86</sup> Why? The IRS was granted this enhanced authority because it has more resources than FinCEN that can be devoted to enforcement, the FBAR is more directed toward tax evasion, instead of money laundering or other financial crimes to which FinCEN is geared, and most FBARs are filed by individuals, not financial institutions.<sup>87</sup> Under the new regulations reflecting this delegation, the IRS is empowered to investigate potential civil and criminal violations, issue summonses as necessary, assess and collect civil penalties, issue administrative rulings, and take “any other action reasonably necessary” for the enforcement of the FBAR-related provisions.<sup>88</sup>

While the government progressed in certain areas since the issuance of the First Report, the Second Report confirms that it did not fare as well with others. For example, despite its original goal of revising the FBAR form and instructions by December 31, 2002, these items remained unchanged.<sup>89</sup> According to the Second Report, FinCEN originally undertook this task, but the IRS assumed responsibility for these revisions as part of the recent delegation of authority.<sup>90</sup> As to when this project will be completed, the Second Report merely says that the IRS “will determine a revised target date.”<sup>91</sup>

### 3. Third Report to Congress

Like its immediate predecessor, the next report submitted to Congress (“Third Report”) limits itself to describing the progress made toward reaching the Secretary’s objectives.<sup>92</sup> The Third Report contains considerable detail regarding the “new tools” that the IRS has developed to administer the FBAR program and the “comprehensive marketing strategy” that the IRS is using to

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86. See I.R.S. News Release IR 2003-48 (Apr. 10, 2003).

87. *Id.*; Internal Revenue Serv., *IRS Announces Expansion of Enforcement Authority for Overseas Accounts*, TAX NOTES TODAY, 70-13, Apr. 11, 2003; 68 Fed. Reg. 26489 (May 16, 2003); TREASURY REPORT 2003, *supra* note 80, at 4.

88. 31 C.F.R. § 103.56(g) (2005).

89. TREASURY REPORT 2003, *supra* note 80, at 5.

90. *Id.*

91. *Id.*

92. DEP’T OF THE TREASURY, A REPORT TO CONGRESS IN ACCORDANCE WITH § 361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 (USA PATRIOT ACT) 5 (2005) [hereinafter TREASURY REPORT 2005]. This report is not dated, but the introduction states that “the Secretary of the Treasury submits this third annual report.” *Id.* at 3.



disseminate the message about FBAR compliance.<sup>93</sup> The Third Report also contains two pieces of information that are not as optimistic. The first is that the IRS had yet to release a revised FBAR form and instructions.<sup>94</sup> According to the Third Report, the IRS reviewed materials that FinCEN previously compiled, as well as hundreds of questions and comments from tax practitioners, taxpayers and revenue agents.<sup>95</sup> After doing so, the IRS “adopted the same approach as FinCEN in concentrating on the instructions [to the FBAR] and leaving material revision of the form itself to another day.”<sup>96</sup> This concentration has yet to render any new instructions.

The second piece of interesting information relates to FBAR compliance rates. The Third Report highlights the fact that the number of FBARs filed in 2003 was seventeen percent higher than in 2000.<sup>97</sup> While this improvement is laudable, it needs to be put into perspective. As the Third Report acknowledges, the increased filing is partially due to one-time IRS settlement programs, such as the Offshore Voluntary Compliance Initiative and the Last Chance Compliance Initiative, under which taxpayers were required to file delinquent FBARs.<sup>98</sup> Moreover, the total number of FBARs filed, 204,689,<sup>99</sup> is somewhat measly when one remembers that the First Report estimated that one million U.S. taxpayers hold foreign financial accounts.<sup>100</sup>

#### IV. WHERE WE ARE

##### A. *Civil Penalties Under the New Law*

The First Report, the Second Report and Third Report show that recent FBAR compliance has been less than satisfactory to the government. In response to this widespread disobedience, members of Congress introduced various bills containing provisions designed to increase penalties for FBAR violations.<sup>101</sup>

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93. *Id.* at 5, 9.

94. *See id.* at 7-8, 11-12.

95. *Id.* at 7.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. TREASURY REPORT 2002, *supra* note 9, at 6.

101. *See* H.R. REP. NO. 108-126, at 53 (2003) (Conf. Rep.), *as reprinted in* 2003 U.S.C.C.A.N. 730, 774; Tax Haven and Abusive Tax Shelter Reform Act of 2002, S. 2339, 107th Cong. § 6717 (2002); Tax Administration Good Government Act of 2004, S. 882, 108th Cong. § 151 (2004); STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF THE CHAIRMAN’S MARK OF THE “TAX ADMINISTRATION GOOD

None were successful on this score. None, that is, until the passage of the American Jobs Creation Act of 2004 (“Jobs Act”) on October 22, 2004.<sup>102</sup>

Under the Jobs Act, the Secretary (and thus the IRS pursuant to the recent delegation of authority) “may” impose a civil penalty on any person who violates Section 5314.<sup>103</sup> As discussed, this type of violation encompasses both failures to file an FBAR and failures to retain the necessary records concerning foreign financial accounts.<sup>104</sup>

In the case of *non-willful* violations, the IRS may impose a maximum penalty of \$10,000.<sup>105</sup> However, the IRS cannot impose such a penalty if two conditions are met: (i) the violation was due to “reasonable cause,” and (ii) the amount of the transaction *or* the balance in the account at the time of the transaction was properly reported.<sup>106</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 fifty percent of the amount of the “transaction,” whichever is greater.<sup>107</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 fifty percent of the balance in the account at the time of the violation.<sup>108</sup>

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GOVERNMENT ACT OF 2004” 23-24 (Comm. Print 2004); Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2004, S. 1072, 108th Cong. § 5622 (2004); STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF THE “HIGHWAY REAUTHORIZATION AND EXCISE TAX SIMPLIFICATION ACT OF 2004” 103-04 (Comm. Print 2004); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 412 (2003); STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF THE CHAIRMAN’S MARK OF THE “JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT” 54-55 (Comm. Print 2003); CARE Act of 2003, S. 476, 108th Cong. § 712 (2003); STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF S. 476, THE “CARE ACT OF 2003,” AS PASSED BY THE SENATE 120-21 (Comm. Print 2003); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., DESCRIPTION OF THE “SMALL BUSINESS AND FARM ECONOMIC RECOVERY ACT” 82-83 (Comm. Print 2002); American Competitiveness Act of 2002, H.R. 5095, 107th Cong. § 115 (2002); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., TECHNICAL EXPLANATION OF H.R. 5095 (THE “AMERICAN COMPETITIVENESS ACT OF 2002”) 28-29 (Comm. Print 2002); Tax Shelter Transparency Act, S. 2498, 107th Cong. § 212 (2002); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., DESCRIPTION OF PROPOSALS IN S. 2498, THE “TAX SHELTER TRANSPARENCY ACT” 18-19 (Comm. Print 2002).

102. Pub. L. No. 108-357 § 821, 118 Stat. 1418, 1586 (2004).

103. 31 U.S.C.S. § 5321(a)(5)(A) (LexisNexis 2004).

104. *Id.*; 31 C.F.R. § 103.24(a) (2005); 31 C.F.R. § 103.32 (2005).

105. 31 U.S.C.S. § 5321(a)(5)(B)(i).

106. *Id.* § 5321(a)(5)(B)(ii).

107. *Id.* § 5321(a)(5)(C)(i), (D)(i).

108. *Id.* § 5321(a)(5)(C)(i), (D)(ii).

In summary, the Jobs Act makes three principal changes. First, it adds a new penalty for cases involving non-willful violations.<sup>109</sup> 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.<sup>110</sup> By contrast, the new law allows the IRS to assert the penalty any time an FBAR is not properly filed or the records are not properly maintained.<sup>111</sup> This shifts the burden to the taxpayer to meet the “reasonable cause” exception.<sup>112</sup> Third, the new law increases the maximum penalty that may be imposed for willful violations.<sup>113</sup> The previous penalty ranged from \$25,000 to \$100,000, depending on the amount of the transaction or the balance in the account.<sup>114</sup> Now, however, these penalties have increased substantially.<sup>115</sup> 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.<sup>116</sup> As a result, this new FBAR penalty could have serious consequences for taxpayers holding large sums of money in undisclosed foreign financial accounts. According to one commentator, the message from Congress is unmistakable: “taxpayers must disclose, disclose, disclose, or suffer the consequences.”<sup>117</sup>

### B. *Unresolved Issues Regarding the FBAR*

It is clear that potential penalties for FBAR violations have dramatically increased. It is equally clear that the IRS is determined to boost FBAR enforcement. This could be a volatile combination, particularly when unresolved issues about the FBAR are plentiful. Some of these issues are discussed in detail below.

#### 1. Who is Subject to the FBAR Filing Requirements?

An issue of tremendous importance is the scope of the FBAR

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109. *Id.* § 5321(a)(5)(A).

110. 31 U.S.C. § 5321(a)(5)(A) (2000).

111. 31 U.S.C.S. § 5321(a)(5)(B)-(D) (LexisNexis 2004).

112. *See Id.* § 5321(a)(5)(B)(ii).

113. *Compare* 31 U.S.C.S. § 5321(a)(5)(C) *with* 31 U.S.C. § 5321(a)(5)(B).

114. 31 U.S.C. § 5321(a)(5)(B).

115. *See* 31 U.S.C.S. § 5321(a)(5)(C), (D).

116. *Id.*

117. RIA, RIA'S COMPLETE ANALYSIS OF THE AMERICAN JOBS CREATION ACT OF 2004 361 (2004) (comment by Jasper L. Cummings, Jr. and Robert P. Hanson).

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, Section 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.<sup>118</sup> For purposes of Section 5314, the term “person” includes not only individuals, but also corporations, companies, associations, firms, partnerships, societies, joint stock companies, trustees, representatives of an estate, and, when the Secretary prescribes, a governmental entity.<sup>119</sup> In the end, Section 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, entities, and representatives) based on their business activities within the United States.

The critical regulation, 31 C.F.R. § 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).”<sup>120</sup> As with Section 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>121</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>122</sup> Thus, while Section 5314 limits itself to those persons located in and doing business in the United States, 31 C.F.R. § 103.24 imposes the FBAR filing requirement on any person (individual or entity)

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118. 31 U.S.C.S. § 5314(a).

119. *Id.* § 5312(a)(5).

120. 31 C.F.R. § 103.24(a) (2005).

121. *Id.* § 103.11(z) (2005).

122. *See, e.g., World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 291 (1980) (forum state may exercise personal jurisdiction over a nonresident defendant where sufficient minimum contacts exist between the defendant and that state); *In re Anschuetz & Co., GmbH*, 754 F.2d 602, 604 (5th Cir. 1985) (discovery rules under Federal Rules apply to foreign Hague Convention state nationals subject to personal jurisdiction in a United States court); *United States v. Field*, 532 F.2d 404, 409-410 (5th Cir. 1976) (alien subpoenaed to testify before grand jury must comply even if doing so subjects him to criminal prosecution in his home country); *United States v. Germann*, 370 F.2d 1019, 1020 (2nd Cir. 1967) (grand jury witnesses must return for later questioning if so directed or be held in contempt); *United States v. Toyota Motor Corp.*, 561 F. Supp. 354, 357-58 (C.D. Cal. 1983) (I.R.C. § 7602 grants expansive reach for in personam jurisdiction in tax cases).

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.<sup>123</sup> The instructions further state that the term "U.S. person" includes only U.S. citizens and residents, domestic partnerships, domestic corporations, domestic estates and trusts.<sup>124</sup> Unlike Section 5314 and 31 C.F.R. § 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.

The courts have often held that when there is an inconsistency between a statute and the regulations, the statute supersedes the regulations.<sup>125</sup> Moreover, courts have acknowledged that instructions to IRS forms are of dubious interpretive value.<sup>126</sup> It could be argued, therefore, that the scope of the FBAR filing requirement is determined by Section 5314(a). Other arguments are equally valid. For instance, one could claim that while the applicability of Section 5314(a) is potentially vast, it has been narrowed. Section 5314(b) states that the Secretary may prescribe several things, including "a reasonable classification of persons subject to or exempt from a requirement."<sup>127</sup> Following this logic, one could claim that the scope of the FBAR filing requirement is generally determined by 31 C.F.R. § 103.24, as modified by the instructions to the FBAR. This seems to be the approach that the IRS is taking, at least informally.<sup>128</sup> A lengthy analysis of statutory construction exceeds the parameters of this article; however, it is important to understand that even some of the most basic questions surrounding the FBAR, such as who must file the form in the

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123. Form TD F 90-22.1, *supra* note 10 (General Instructions).

124. *Id.*

125. *See, e.g.,* *Caldera v. J.S. Alberici Const. Co., Inc.*, 153 F.3d 1381, 1383 (Fed. Cir. 1998) ("Statutes trump conflicting regulations."); *Furlow v. United States*, 55 F. Supp. 2d 360, 364 (D. Md. 1999) ("It is a fundamental principle of American law that legislative statutes take precedence over conflicting administrative regulations.")

126. *See, e.g.,* *Gold-N-Travel, Inc. v. Commissioner*, 93 T.C. 618, 621 (1989) ("[The IRS] appears to be taking the position that [its] instructions [on the relevant form] are controlling . . . We reject that position in regard to his instructions.")

127. 31 U.S.C. § 5314(b) (2000).

128. *See* FBAR FAQs, *supra* note 8, Question 25. "Section 5314(b)(1) of Title 31 gives the Secretary of the Treasury the discretion to exempt groups of persons identified in Section 5314(a) from the FBAR filing requirements. Issuing instructions for the FBAR form is one way the Secretary may exercise this discretion." *Id.*

first place, are far from clear.

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

As explained above, FinCEN delegated its FBAR enforcement authority to the IRS in April 2003.<sup>129</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>130</sup>

This delegation raises a number of unresolved issues. For instance, Section 5321(b) provides that the Secretary may assess a civil penalty under Section 5321(a), which specifies that this authority is derived from sections in Title 31 of the U.S. Code, not Title 26 (*i.e.*, the Internal Revenue Code).<sup>131</sup> This authority is different from that of the IRS. Section 6201(a) of the Internal Revenue Code 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*.”<sup>132</sup> This raises several immediate questions. What procedures will (and must) the IRS follow in assessing the FBAR penalty?<sup>133</sup> Do taxpayers have a right to a review of any unresolved FBAR penalties by the IRS Appeals Office?<sup>134</sup> If the taxpayer is dissatisfied with the decision from the IRS Appeals Office, will he have the right to judicial review by petitioning the U.S. Tax Court?<sup>135</sup> A similar issue is raised by Section 5321(b)(2), which provides that the Secretary may commence a civil action to recover FBAR penalties assessed pursuant to Section 5321(b)(1).<sup>136</sup> 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*.”<sup>137</sup> 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>138</sup>

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129. *See supra* text accompanying note 86.

130. 31 C.F.R. § 103.56(g) (2005).

131. *See* 31 U.S.C. § 5321 (2000).

132. I.R.C. § 6201(a) (2000) (emphasis added).

133. Steven Toscher & Michael R. Stein, *FBAR Enforcement is Coming!*, JOURNAL OF TAX PRACTICE & PROCEDURE, Dec. 2003-Jan. 2004, at 31.

134. *Id.*

135. *Id.*

136. 31 U.S.C. § 5321.

137. I.R.C. § 6301 (emphasis added).

138. Toscher & Stein, *supra* note 133, at 31.

The IRS has yet to make a definitive statement on the issue, but it appears the 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 regarding the FBAR, IRS attorneys reached the following conclusion: "Please note that under [I.R.C. §] 7491(c), 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 [I.R.C. §] 7491(c) will have no bearing here."<sup>139</sup>

### 3. Will the IRS Exercise Discretion?

As mentioned above, 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, Section 5321(a)(5)(A) provides that the Secretary "may" impose a civil penalty.<sup>140</sup> The federal courts have consistently held that when Congress uses the word "may," it means "may" in the usual sense and does not mean "must" or "shall."<sup>141</sup> Moreover, in terms of the size of the penalty for non-willful violations, Section 5321(a)(5)(B)(i) states that the fine "shall not exceed" \$10,000 per violation; it does not mandate a \$10,000 penalty.<sup>142</sup> Similarly, in the case of willful violations, Section 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.<sup>143</sup>

There are indications that the IRS appreciates the discretionary nature of its authority. For example, internal IRS "Guidelines for Calculation of FBAR Civil Penalty for Willful Violations" ("FBAR Penalty Guidelines") list four conditions for penalty mitigation.<sup>144</sup> The FBAR penalty would be limited if: (1) the taxpayer has no history of FBAR violations, (2) the funds passing through the undisclosed foreign financial accounts were not from illegal sources and or used for criminal purposes, (3) the taxpayer cooperated during the examination, and (4) the IRS did not assert a civil fraud penalty against the taxpayer based on the

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139. *Service Discusses Penalty*, *supra* note 20 (emphasis removed).

140. 31 U.S.C. § 5321(a)(5)(A).

141. *In re Davenport*, 175 B.R. 355, 359 (E.D. Cal. 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 v. United States*, 50 Fed. Cl. 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.").

142. 31 U.S.C.S. § 5321(a)(5)(B)(i) (LexisNexis 2004).

143. *Id.* § 5321(a)(5)(C)(i).

144. *Toscher & Stein*, *supra* note 133, at 31.

failure to report income derived from the undisclosed foreign financial account.<sup>145</sup> Perhaps a clearer illustration of the IRS's awareness of its discretion comes from an internal legal memorandum issued by IRS Division Counsel providing guidance on the application of civil FBAR penalties ("Guidance Memo").<sup>146</sup> The Guidance Memo makes it absolutely clear that it is unnecessary to impose a civil FBAR penalty in the context of certain IRS settlement initiatives, the revenue agent handling the case has complete discretion not to impose such a penalty, and imposing a civil FBAR penalty in cases where it is inappropriate would lead to "absurd" results that undermine the congressional purpose of encouraging voluntary compliance.<sup>147</sup> The Guidance Memo provides considerable detail on this issue:

In other situations, in which taxpayers want to accept the LCCI [Last Chance Compliance Initiative] offer, but feel that they should not be liable for the FBAR penalty, *examiners have discretion not to impose the FBAR penalty . . .*

We disagree with the statement . . . that the taxpayer must agree to the FBAR penalty for one year in order to participate in the LCCI program. Under both the LCCI program and the mitigation guidelines for FBAR penalties, *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.*

[T]here appears to be a concern that the civil FBAR penalty must be asserted in every situation identified. The penalty statute, however, *provides for discretion* in asserting the penalty. The purpose for the penalty, and the reason for the flexibility Congress provided in asserting the penalty, is to encourage compliance. *There 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>148</sup>

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145. *Id.*

146. *Service Discusses Penalty, supra* note 20.

147. *Id.*

148. *Id.* (emphasis added).



Despite the clarity of the law, the FBAR Penalty Guidelines, and the Guidance Memo, certain IRS personnel insist on not exercising their discretion, opting instead to automatically assert the maximum penalties permitted under Section 5321. Such behavior is troubling for two main reasons. First, the assertion of full penalties, particularly where they are not warranted, forces the taxpayer to face two equally unattractive propositions: pay large IRS fines or pay large professional fees to defend against such fines. Second, mounting a successful penalty defense, in the case of both willful and non-willful penalties, normally requires the taxpayer to demonstrate his ignorance of the FBAR requirements. While it is true that many taxpayers are completely unaware of such requirements, proving this to the satisfaction of the IRS or the courts may become more difficult. This issue is discussed directly below.

#### 4. Many People Are Unaware of the FBAR Filing Requirement, but Can They Prove It?

Depending on the severity of the violation and the amount of evidence thereof, the IRS may claim either that a taxpayer acted non-willfully or willfully in not complying with the FBAR requirements. In the case of the former, the taxpayer can defend himself by showing that there was “reasonable cause” for the violation.<sup>149</sup> In the case of the latter, the taxpayer must prove that he was not willful. Many times, the key in both cases will be to demonstrate that the taxpayer was oblivious to the FBAR-related requirements, and therefore 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>150</sup> Likewise, at least one court has held that ignorance of the law negates a charge of willfulness.<sup>151</sup> In its recent Guidance Memo, the IRS conceded this point:

[I]n order for there to be a voluntary intentional violation of a known legal duty, the accountholder 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

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149. See 31 U.S.C.S. § 5321(a)(5)(B)(ii) (2004).

150. IRM § 20.1.1.3.1.2.1 (Aug. 20, 1998).

151. See *Ratzlaf v. United States*, 510 U.S. 135, 136-37 (1994).

principle is that there is no willfulness if the accountholder has no knowledge of the duty to file the FBAR.<sup>152</sup>

It is undeniable that many taxpayers, as well as many of their tax advisors, are ignorant of the FBAR filing requirement. Are these people simply clueless? Not by a long shot. As one commentator explains, the widespread unawareness of the FBAR is quite understandable:

[T]he FBAR, which is a short, two-page form, is deceptively simple. Its concise format hides several latent issues. More critically, the FBAR filing requirements' broad applicability combined with the association in the minds of most practitioners and lay people of the FBAR with so-called "tax cheats," who use unreported bank accounts to commit tax fraud, causes many people to fail to understand that they must file an FBAR.<sup>153</sup>

Examples abound of situations in which persons who should file an FBAR unintentionally fail to do so. Take the European businessman who gives his daughter, a U.S. resident, a credit card issued by a bank located in Europe.<sup>154</sup> If the credit card is secured by that account, the daughter must file an FBAR.<sup>155</sup> Another example is the U.S. citizen studying abroad who opens a local bank account to facilitate the payment of local expenses, such as tuition, rent, food, etc.<sup>156</sup> If the student deposits more than \$10,000 in the account, then he must file an FBAR.<sup>157</sup> An FBAR could also be required as a result of international romance. Say a U.S. citizen marries a South American and decides to reside abroad with his new spouse. If this newlywed maintains his American citizenship, opens a financial account abroad, and allows the balance in the account to surpass the \$10,000 threshold, he must file an FBAR.<sup>158</sup> On a less amorous note, U.S. expatriates often become subject to the FBAR rules. If, for instance, a U.S. citizen is sent to Mexico on a temporary work assignment and maintains an account with over \$10,000 at any

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152. *Service Discusses Penalty, supra* note 20.

153. *Bruce & Saret, supra* note 5.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

time during his stay, he must file an FBAR.<sup>159</sup>

Another situation, which is seen with increasing frequency by international tax practitioners, is the daddy-died-with-an-offshore-account scenario. In these cases, a parent opens a foreign account and, unbeknownst to the child, lists the child as the sole beneficiary of the account. If the parent dies with over \$10,000 in the foreign account, the child instantly inherits more than just money; he also takes on an FBAR filing requirement. Thus, in addition to dealing with the grief of losing a loved one and administering an estate, the child is faced with an obscure international tax compliance issue. The U.S. government has recognized the incidence of the daddy-died-with-an-offshore-account situation. Indeed, a recent study states that “[i]n an increasingly global and mobile world, taxpayers may hold foreign accounts and credit cards for a number of legitimate reasons. For example, taxpayers may have . . . inherited money from a foreign relative.”<sup>160</sup>

A final group of persons who may be subject to, yet unaware of, the FBAR filing requirement involves immigrants. According to recent congressional reports, the amount of money that is earned in the United States and then remitted to foreign accounts is enormous.<sup>161</sup> Currently, some \$10 billion are transferred to Latin America each year, and this number is expected to increase to \$25 billion within the next five years.<sup>162</sup> It is important to note that, contrary to popular belief, these remittances are not used solely for basic subsistence; they are also used for financing education and housing.<sup>163</sup> If any of the persons remitting funds becomes a U.S. resident or citizen, and the account to which they are sending these remittances ever exceeds \$10,000 during a year, they must file an FBAR or face sizable penalties—welcome to the USA!

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159. *Id.*

160. GENERAL ACCOUNTING OFFICE, DATA SHARING AND ANALYSIS MAY ENHANCE TAX COMPLIANCE AND IMPROVE IMMIGRATION ELIGIBILITY DECISIONS 47 (GAO Highlights Report on GAO-04-972T) (July 21, 2004), <http://www.gao.gov/new.items/d04972t.pdf> [hereinafter DATA SHARING].

161. *Remittances: Reducing Costs, Increasing Competition, and Broadening Access to the Market: Hearing on H.R. 2074 and H.R. 2637 Before the H. Comm. on Financial Servs.*, 108th Cong. 4 (2003) (statement of Jeb Hensarling, Member, House Comm. on Financial Services).

162. *Id.* at 1 (statement of Spencer Bachus, Acting Chairman, House Comm. on Financial Services).

163. Press Release, U.S. Treasury Dep't, Mark Sobel, Deputy Assistant Sec'y, Int'l Monetary Policy, Int'l Affairs, Dep't of Treasury, Remarks to Central America in the United States Conference held at the Department of State (Oct. 6, 2004), <http://www.treas.gov/press/releases/js1995.htm>.

There are several other 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 (Internal Revenue Code).<sup>164</sup> 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 would never find the FBAR filing requirement. Second, the common name for the relevant form, "FBAR," is a misnomer. As discussed, 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. Perhaps the IRS should revive the predecessor form to the FBAR, which provided more clarity. Until 1976, taxpayers were required to file Form 4683 (U.S. Information Return on Foreign Bank, Securities, and Other Financial Accounts).<sup>165</sup> Third, as explained above, 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 a Michigan address for the Treasury Department.<sup>166</sup> The forerunner to the FBAR was filed with the income tax return, but this changed in 1976 because of heightened restrictions regarding the disclosure of tax information by the IRS to other agencies within the Treasury Department.<sup>167</sup> 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.<sup>168</sup> To make it even more confusing, a taxpayer may request an automatic extension of six months to file his income tax return, but no extensions

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164. See 31 U.S.C.S. § 5314 (2004).

165. GENERAL ACCOUNTING OFFICE, BETTER USE OF CURRENCY AND FOREIGN ACCOUNT REPORTS BY TREASURY AND IRS NEEDED FOR LAW ENFORCEMENT PURPOSES 2 (GGD-79-224) (April 6, 1979), <http://archive.gao.gov/f0302/109024.pdf> [hereinafter BETTER USE NEEDED].

166. See Form TD F 90-22.1, *supra* note 10.

167. BETTER USE NEEDED, *supra* note 165, at 22.

168. See FBAR FAQs, *supra* note 8, Question 10.

whatsoever are available for filing the FBAR.<sup>169</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 page. 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.<sup>170</sup> There, at the bottom of the page, Part III inquires about foreign accounts and broaches the possibility of filing an FBAR.<sup>171</sup> Logic dictates that if FBAR filings were so important to tax administration and international terrorism, the appropriate questions would be very conspicuous. Congress has suggested this before, stating that the FBAR question “should be included on the first page of all tax returns if there is a serious intent and effort by the IRS, Department of Treasury and other Federal agencies to combat the foreign bank account problem.”<sup>172</sup> The Treasury rejected this idea, though, citing competing demands for space on the initial pages of tax returns and tax-simplification goals.<sup>173</sup> Finally, much of the generalized ignorance of the FBAR filing requirement may possibly be traced to the ignorance of many tax return preparers. To be sure, most tax return preparers are competent professionals; they stay abreast of the ever-changing tax law, ask the right questions of the taxpayer, review the relevant documentation, and adeptly complete the tax return. There are those, however, that may fail to raise the FBAR issue. Support for this theory is found in a recent governmental study regarding professional tax preparers, which explained that:

Anyone can be a paid tax preparer. No laws or regulations limit who can sell tax preparation services. The types and training of paid preparers vary widely. They range from attorneys and certified public accounts (CPA) to preparers who are not licensed and have no formal training. Commercial preparers may hire any of these and may also provide their own training.<sup>174</sup>

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169. *Id.*

170. IRS Form 1040, Schedule B – Interest and Ordinary Dividends (OMB No. 1545-0074) (2005), at <http://www.irs.gov/pub/irs-pdf/f1040sab.pdf> [hereinafter Form 1040].

171. *Id.*

172. BETTER USE NEEDED, *supra* note 165, at 23-24.

173. *Id.* at 23.

174. GENERAL ACCOUNTING OFFICE, MOST TAXPAYERS BELIEVE THEY BENEFIT, BUT SOME ARE POORLY SERVED 2 (GAO Highlights Report on GAO-03-610T) (April 1, 2003), <http://www.gao.gov/new.items/d03610t.pdf>.

Simply put, many tax return preparers, like taxpayers, are often unaware of the FBAR rules. As one practitioner explains, “often the accountants, attorneys, financial planners, and other professionals who advise such individuals do not think about the FBAR . . . .”<sup>175</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 non-willful 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.

Demonstrating that a taxpayer had *actual* knowledge of the FBAR filing requirement is difficult in the absence of some compelling evidence, such as a written document from a tax advisor informing the taxpayer of his filing obligations.<sup>176</sup> Therefore, the IRS will likely contend that the taxpayer had *constructive* knowledge and that the taxpayer should have known about the filing requirement. In doing so, the IRS will almost certainly point to three main sources: IRS forms, IRS publications, and the IRS website.

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?”<sup>177</sup> If so, the taxpayer must check the “yes” box and then disclose the name of the foreign country in which the account is located.<sup>178</sup> The taxpayer is also told to consult the Instructions to Schedule B for requirements related to foreign financial accounts.<sup>179</sup> There, a taxpayer to whom no exception applies is instructed to file an FBAR by June 30 with the Treasury Department.<sup>180</sup> Many other IRS forms contain similar questions and instructions regarding foreign accounts, including

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175. Bruce & Saret, *supra* note 5.

176. TREASURY REPORT 2002, *supra* note 9, at 10.

177. Form 1040, *supra* note 170.

178. *Id.*

179. *Id.*

180. *Id.*

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 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 website, such as the page entitled "FAQs regarding Report of Foreign Bank and Financial Accounts."<sup>181</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.

#### 5. Is It Possible to Meet the "Reasonable Cause" Exception?

As explained above, the law related to the FBAR dramatically changed with the enactment of the Jobs Act in October 2004.<sup>182</sup> The new law dictates that, in cases of *non-willful* violations, the IRS may impose a maximum penalty of \$10,000.<sup>183</sup> However, the IRS cannot impose such a penalty if two conditions are met: (i) the violation was due to "reasonable cause," *and* (ii) the amount of the "transaction" *or* the balance in the account at the time of the "transaction" was properly reported.<sup>184</sup> This exception appears relatively simple, but it is fraught with complexities and uncertainties.

##### (a) First Condition

The first prong of the exception seems straightforward enough for those who regularly deal with U.S. tax law; the

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181. See FBAR FAQs, *supra* note 8.

182. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of 23 U.S.C. and 26 U.S.C.).

183. 31 U.S.C.S. § 5321(a)(5)(B)(i) (LexisNexis 2004).

184. *Id.* § 5321(a)(5)(B)(ii).

taxpayer simply has to 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>185</sup> The Penalty Handbook contains numerous statements to this effect, including the following:

- i. “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>186</sup>
- ii. “For those penalties where reasonable cause can be considered, *any reason* which establishes that the taxpayer exercised ordinary business care and prudence, but was unable to comply with a prescribed duty with then prescribed time, will be considered.”<sup>187</sup>
- iii. “Taxpayers have reasonable cause when their conduct justifies the nonassertion or abatement of a penalty. Each case *must be judged individually* based on the facts and circumstances at hand.”<sup>188</sup>
- iv. “Reasonable cause determinations **MUST** be made on the individual facts and circumstances of each case.”<sup>189</sup>
- v. “Determinations as to whether or not reasonable cause exists must be based on a *careful consideration of the facts and circumstances of each case* prior to assertion of a penalty. Examiners should consider *any reason a taxpayer provides* in conjunction with the guidelines, principles and evaluating factors set forth in the [Penalty Handbook], as well as the applicable [Internal Revenue Code provision and regulations] relating to the specific penalty.”<sup>190</sup>

The Penalty Handbook also indicates that a taxpayer’s unawareness may give rise to reasonable cause. Indeed, it

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185. IRM 20.1.1.3.1 (Aug. 20, 1998).

186. *Id.* (emphasis added).

187. *Id.* (emphasis added).

188. *Id.* (emphasis added).

189. IRM 20.1.2.1.3 (July 31, 2001) (emphasis in original).

190. IRM 20.1.9.2 (Aug. 7, 1998) (emphasis added).



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>191</sup> The Penalty Handbook further recognizes that a taxpayer may have reasonable cause for non-compliance if he was unaware of a requirement and could not reasonably be expected to know the requirement.<sup>192</sup>

The preceding portions of 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, however, is the potential inapplicability of the Penalty Handbook. As explained above, the FBAR penalties are derived from Title 31 of the U.S. Code, not from Title 26 (*i.e.*, the Internal Revenue Code).<sup>193</sup> 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>194</sup> Logic dictates that because 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. Case law also supports this proposition. For example, in a recent case the court held that “when the identical word is used in two related statutes . . . courts will give the word the same meaning when interpreting both statutes” absent some compelling reason not to do so.<sup>195</sup> Nevertheless, this conclusion has not been publicly confirmed by the IRS yet.

#### (b) Second Condition

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

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191. IRM 20.1.1.3.1.2.1 (Aug. 20, 1998).

192. *Id.*

193. *See supra* text accompanying note 131.

194. IRM 20.1.1.1.2 (Aug. 20, 1998) (emphasis added).

195. *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42, 63 (1997) (citing *Comm'r v. Lundy*, 516 U.S. 235 (1996); *Sullivan v. Stroop*, 496 U.S. 478, 484 (1990)).

account at the time of the “transaction” was properly reported.<sup>196</sup>

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

i. Rationale for the Reasonable Cause Exception

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 initiative was the Offshore Voluntary Compliance Initiative, which the IRS launched in early 2003.<sup>197</sup> After this settlement initiative concluded, the U.S. Government Accountability Office conducted a study of the program (“GAO Report”).<sup>198</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>199</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. The GAO Report made an enlightened statement on this point:

In an increasingly global and mobile world, taxpayers may hold foreign accounts and credit cards for a number of legitimate reasons. For example, taxpayers may have worked or traveled overseas extensively or inherited money from a foreign relative. Some taxpayers in these situations told [the] IRS that they were unaware they had to pay U.S. taxes on this income and that their noncompliance was unintentional.<sup>200</sup>

Although not expressly stated in the congressional reports related to the Jobs Act of 2004, 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 report from the U.S. House of Representatives (“House Report”)

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196. 31 U.S.C.S. § 5321(a)(5)(B)(ii) (LexisNexis 2004).

197. Rev. Proc. 2003-11, 2003-1 C.B. 311.

198. See DATA SHARING, *supra* note 160.

199. *Id.* at 32.

200. *Id.* at 47.

states that the penalty for non-willful 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>201</sup>

Based on the GAO Report and House Report, the legislative 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.

## ii. Meanings of Particular Terms

To benefit from the penalty exception, the new law requires the taxpayer to demonstrate that either “the amount of the *transaction*” or “the *balance* in the account *at the time of the transaction*” was properly reported.<sup>202</sup> Meeting this second condition of the exception is troublesome for the following 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 Section 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.<sup>203</sup> The distinction is also clear from 31 C.F.R. § 103.24, which mandates the filing of an FBAR where a certain “relationship” exists with respect to a foreign financial account.<sup>204</sup> Lest there be any doubt in this regard, the instructions to the FBAR require certain persons to report their “relationship” with certain accounts.<sup>205</sup> The relevant regulations generally define the term “transaction” as a “purchase, sale, loan, pledge, gift, transfer, delivery or other disposition.”<sup>206</sup> In other words, to be a “transaction” for FBAR purposes, something beyond merely holding a foreign financial account must occur. Accordingly, for taxpayers who engage in no

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201. H.R. REP. NO. 108-548, pt. 1, at 276 (2004).

202. 31 U.S.C.S. § 5321(a)(5)(B)(ii) (LexisNexis 2004) (emphasis added).

203. *Id.* § 5214(a).

204. 31 C.F.R. § 103.24 (2005).

205. Form TD F 90-22.1, *supra* note 10 (General Instructions).

206. 31 C.F.R. § 103.11(ii) (2005). This regulation expands the definition of “transaction” with respect to “financial institutions.” Under 31 C.F.R. § 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.

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. In fact, the language in new Section 5321(a)(5)(B)(ii)(II) is erroneous and incompatible with legislative history. This conclusion finds support in two places. New Section 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.”<sup>207</sup> Former Section 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.”<sup>208</sup>

Third, even if the language in new Section 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*,”<sup>209</sup> this would still not be enough to allow taxpayers to satisfy the second condition. Indeed, 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.<sup>210</sup> 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, which asks for the maximum value of the account. As discussed above, both the GAO Report and the House Report 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 these two reports, it is evident that new Section 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 Section 5321(a)(5)(D)(ii), which determines the *amount* of

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207. 31 U.S.C.S § 5321(a)(5)(D)(ii).

208. 31 U.S.C. § 5321(a)(5)(B)(ii)(I) (2000).

209. 31 U.S.C.S. § 5321(a)(5)(B)(ii)(II).

210. Form 1040, *supra* note 170.

the penalty.<sup>211</sup> However, having such a focus in new Section 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 Section 5321(a)(5)(B)(ii)(II) should 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 annual income tax return (not “at the time of the transaction”). Congress recently passed the Tax Technical Corrections Act of 2005.<sup>212</sup> This curative legislation contained many modifications to the Jobs Act; however, changes related to the FBAR provisions were not among them.<sup>213</sup> Accordingly, taxpayers must await further congressional action.

Meanwhile, taxpayers accused of FBAR violations may still be able to avail themselves of the “reasonable cause” exception based on statutory construction principles. Where a statute and a legislative committee report are inconsistent, the statute generally governs.<sup>214</sup> There are, of course, exceptions to the general rule. For instance, statutory language does not govern where the legislative history contains unequivocal evidence of Congress’s purpose for enacting a particular provision.<sup>215</sup> Additionally, portions of a statute may be disregarded when paying them an amount of inordinate attention would lead to “absurd” results.<sup>216</sup> Finally, statutory verbiage may be devalued when it is the result of an error in the drafting process.<sup>217</sup> This article is not the place for a lengthy analysis of statutory interpretation, but it appears that, when put to the judicial test, taxpayers may qualify for the reasonable cause exception despite the erroneous statutory language.

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211. 31 U.S.C.S. § 5321(a)(5)(D)(ii).

212. The Tax Technical Corrections Act of 2005 was passed as part of the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, 119 Stat. 2577 (2005).

213. See STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., 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 93 (Comm. Print 2005).

214. *Strom v. Goldman, Sachs & Co.*, 202 F.3d 138, 145 (2d Cir. 1999); *Abourezk v. Reagan*, 785 F.2d 1043, 1055 (D.C. Cir. 1986), *aff’d*, 484 U.S. 1 (1987); *Sharp v. United States*, 27 Fed. Cl. 52, 61 (1992), *aff’d*, 14 F.3d 583 (1993).

215. *Burlington N. R.R. Co. v. Okla. Tax Comm’n*, 481 U.S. 454, 461 (1987); *Anaheim Gardens v. United States*, 33 Fed. Cl. 24, 34 (1995).

216. *Sigmon Coal Co. v. Apfel*, 226 F.3d 291, 304 (4th Cir. 2000), *aff’d*, 534 U.S. 438 (2002).

217. *Chateaugay Corp. v. Aetna*, 89 F.3d 942, 953-54 (2d Cir. 1996).

## 6. When Does the Violation Occur?

The applicable regulations explain that FBARs must be filed “with respect to foreign financial accounts exceeding \$10,000 maintained during the previous calendar year.”<sup>218</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.”<sup>219</sup> 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 succeeding calendar year is June 30.<sup>220</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 report the existence of an account or any identifying information required to be provided with respect to an account.”<sup>221</sup> Stated differently, the IRS may impose penalties if a person willfully fails to file an FBAR or fails to retain the records related to the foreign financial accounts. 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>222</sup> In particular, the new law states that the maximum penalty that the IRS may impose is \$100,000, or fifty percent of the balance in the account “at the time of the violation,” whichever amount is larger.<sup>223</sup> The regulations calculate the penalty amount based on the balance in the account “at the time of the violation,” too.<sup>224</sup>

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218. 31 C.F.R. § 103.27(c) (2005).

219. Form TD F 90-22.1, *supra* note 10 (General Instructions).

220. 31 C.F.R. § 103.27(c).

221. 31 U.S.C.S. § 5321(a)(5)(C), (D)(ii) (LexisNexis 2004).

222. *Id.* § 5321(a)(5)(D)(ii).

223. *Id.* § 5321(a)(5)(C), (D)(ii). 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 U.S.C. § 5321(a)(5)(B)(ii) (2000).

224. 31 C.F.R. § 103.57(g)(2) (2005).

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:

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>225</sup>

The government's position on when a violation occurs is also evident from the FBAR Penalty Guidelines.<sup>226</sup> In determining the proper penalty amount for failing to file an FBAR, this document directs IRS personnel to the balance in the account "as of the due date for filing the FBAR."<sup>227</sup> In calculating the penalty for failing to retain the records related to a foreign financial account, this document directs IRS personnel to the balance in the account "as of the date the [IRS] first requests the records."<sup>228</sup>

The impact of the preceding rules could be significant. Expanding on the example presented earlier, 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 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 Section 5321(a)(5)(D)(ii), the maximum penalty is \$100,000, or fifty percent of the balance in the account "at the time of the

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225. *Service Discusses Penalty, supra* note 20 (emphasis added).

226. See INTERNAL REVENUE SERVICE, GUIDELINES FOR CALCULATION OF THE FBAR CIVIL PENALTY FOR WILLFUL VIOLATIONS [hereinafter PENALTY GUIDELINES] (on file with author).

227. *Id.*; see generally Toscher & Stein, *supra* note 133, at 31.

228. PENALTY GUIDELINES, *supra* note 226; see generally Toscher & Stein, *supra* note 133, at 31.

violation,” whichever amount is larger.<sup>229</sup> The government’s position, as set forth in the Guidance Memo and the FBAR Penalty Guidelines, 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 appears that although the person violated the law since he did not file 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* fifty percent of the highest balance in the account (*i.e.*, \$2.5 million). In addition, if the IRS initiated an examination of the person in, say, 2007, similar results would occur. The IRS would presumably request that the person disclose all of the records related to the foreign account. If the person failed to do so, then, pursuant to the FBAR Penalty Guidelines, a records-retention violation would have occurred at that moment. To the IRS’s chagrin, the balance in the (closed) account in 2007 would be \$0. The maximum penalty for not retaining records, therefore, would be significantly limited.

## V. WHY IT MATTERS

This article demonstrates that at least a few things in the FBAR realm are relatively clear: potential penalties for FBAR violations have radically increased, the IRS is adopting new measures designed to improve FBAR compliance, and foreign financial accounts are now expressly linked to international terrorism. Notwithstanding the clarity on these issues, ambiguities surrounding the FBAR remain. Who exactly must file an FBAR? Can taxpayers take advantage of normal procedural protections in defending against FBAR penalties? Will the IRS exercise its statutory discretion? Can taxpayers with no actual knowledge of the FBAR requirements take refuge in their ignorance? Is it feasible to meet the “reasonable cause” exception? When precisely does an FBAR violation occur?

This combination of clarity and ambiguity will surely prove explosive for affected taxpayers. Much of this volatility could be eliminated by congressional amendments and unequivocal pronouncements from the IRS, but holding one’s breath may not be advisable. Congress recently passed the Tax Technical Corrections Act of 2005; this remedial legislation contained no changes to the FBAR provisions. The IRS is in the process of drafting a revised FBAR form and instructions, yet these improvements are not scheduled for release until 2007. Until the

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229. 31 U.S.C.S. § 5321(a)(5)(D)(ii) (LexisNexis 2004).



major issues are resolved, those persons with any connection whatsoever to a foreign financial account would be wise to consult a knowledgeable tax advisor in order to discuss where we were and where we are—why it matters is painfully obvious.