A Closer Look at the Non-Willful FBAR Penalty

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I. *DEFINING THE IMPORTANT TERMS EVERY U.S. INDIVIDUAL WITH AN INTEREST IN FOREIGN FINANCIAL ACCOUNT(S) NEEDS TO UNDERSTAND*

A. Introduction

This article is designed to provide a background and overview of the laws governing the disclosure of foreign accounts on a Foreign Bank Account Report, Form TD F 90-22.1 ("FBAR"). This article also discusses the penalties that can be assessed against individuals for not timely disclosing foreign accounts on an FBAR. Although FBAR violations can result in both criminal and civil penalties, this article focuses on civil penalties that can be assessed by the Internal Revenue Service ("IRS") for an FBAR violation. In particular, this article analyzes the highly controversial non-willful penalty that can be assessed by the IRS against individuals who did not timely disclose foreign accounts on FBAR informational returns.

Despite the threat of civil and criminal penalties, for decades, many U.S. taxpayers have held interests in financial accounts located in foreign countries. However, few taxpayers were disclosing these accounts or the income received from these foreign accounts on their U.S. Tax Returns. In order to force U.S. taxpayers to properly disclose their foreign bank accounts to the IRS, Congress enacted laws providing for stiff penalties for not timely disclosing foreign accounts to the IRS. In particular, in 2004, as part of the Jobs Creation Act, Congress introduced a new set of penalties aimed at U.S. individuals who failed to properly disclose their interest in foreign accounts. The law promulgated by Congress in 2004 distinguished between *non-willful* and *willful* failure to timely disclose an interest in a foreign financial account on an FBAR by enacting two separate corresponding penalty structures. In addition, the U.S. Department of the Treasury delegated to the IRS full administrative, investigative, and enforcement authority in regards to the non-willful and willful penalties.

Recently, the IRS has made the enforcement of FBAR violations a top priority. What is unclear is how the IRS intends to assess the non-willful penalty against individuals who failed to comply with their FBAR filing obligations and whether the current statutory scheme available to assess the existing non-willful penalty is even valid. This article highlights the existing ambiguities of current law governing FBAR violations to provide a better understanding of where we were prior to the enactment of Jobs Creation Act, where we are in regards to the non-willful penalty, and potential defects in legislation governing the non-willful penalty.

B. An Overview of the Relevant Procedural Law Governing FBAR Filing

In 1970, Congress enacted what has commonly become known as the Bank Secrecy Act ("BSA"), as part of the Currency and Foreign Transactions Reporting Act. This was codified in Title 31 (Money and Finance) of the U.S. Code. The purpose of the BSA was to prevent money laundering by requiring the filing of reports and the retention of records where doing so would be helpful to the U.S. government in carrying out criminal, civil, tax, and regulatory investigations. One of the most important provisions of the BSA was Title 31 of United States Code Section 5314(a) ("Section 5314"), which provides in relevant part that:

> The Secretary of the Treasury ("Secretary") 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.

A careful reading of the statute indicates that it has two distinct requirements: 1) the filing of FBAR informational returns and 2) the keeping and retaining of specific records related to the accounts listed on the FBAR informational return.

First, the statute 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.

Second, the regulations of Section 5314 contain considerable detailed information regarding which financial records should be retained.[2]

In particular, the applicable sections of the regulation state that:

> Records of accounts required by §1030.24 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 five years and shall be kept at all times available for the inspection as authorized by law.

The above clearly demonstrates that not only must a holder of a foreign account report the account on his or her U.S. income tax return, the holder of a foreign account must also keep detailed records for five years after the account was disclosed on a U.S. tax return. Unfortunately, many taxpayers do not realize that they have a duty to disclose their interest in foreign accounts on an FBAR. Even fewer taxpayers realize that they have a record keeping duty if they held an interest in a foreign bank account. Although failing to properly maintain records can trigger civil penalties, recent IRS enforcement initiatives have focused mainly on failing to timely disclose foreign financial accounts; therefore, this article focuses strictly on this aspect.

C. Who Has a Legal Obligation to File an FBAR

To fully understand a taxpayer's legal duty in regards to disclosing a foreign account on an FBAR, it is first necessary to understand the applicable instructions promulgated by the IRS to prepare an FBAR. According to the instructions, a person must file an FBAR informational return if *all* of the following conditions are met: (1) a "U.S. person," (2) had a "financial interest" in, or "signature authority" over, or "other authority" over (3) one or more "financial accounts" (4) located in a "foreign country," (5) and the aggregate value of such account(s) exceeded $10,000, (6) at any time during the calendar year.[3] According to the instructions issued by the IRS, a "U.S. person" means a U.S. citizen, U.S. resident (green card holder or an alien residing in the United States), corporations, partnerships, or limited liability companies created or organized in the United States or under the laws of the United States; and trusts or estates formed under the laws of the United States.[4] In ascertaining whether one has a "financial interest" in or, "signature authority" over, or "other authority" over one or more foreign financial accounts, and if the aggregate value of such accounts exceed $10,000 requires a close review of the instructions of the FBAR instructions promulgated by the IRS.

1. Defining Financial Interest in Financial Accounts Located Outside the United States

A U.S. person has a financial interest in a foreign financial account for which he is the owner of record or holder of legal title, regardless of whether the account is maintained for the benefit of the U.S. person or for the benefit of another person.[5] The instructions also state that a U.S. person has a "financial interest" in each account where the titleholder or owner of the account falls into one of the following six categories: (i) the U.S. person's agent, nominee, or attorney, (ii) a corporation whose shares are owned, directly or indirectly, more than 50 percent by the person, (iii) a partnership in which the person owns greater than a 50 percent profits interest, (iv) a trust of which a U.S. person is the trust grantor and has an ownership interest in the trust for United States tax purposes, (v) a trust from which the person derives in excess of 50 percent of the current income or in which the person has a present beneficial interest in more than 50 percent of the assets, or (vi) any other entity in which the U.S. person owns directly or indirectly more than 50 percent of the voting power.[6]

2. Defining Signature Authority

A person has "signature authority" over an account if the person can control the disposition of assets held in a foreign financial account by direct communication (whether in writing or otherwise) to the bank or other financial institution that maintains the financial account.[7] Certain important exceptions exist for members of the military stationed in a military installation outside of the United States and beneficiaries of a foreign trust if the trust or trustee or agent of the trust files an FBAR disclosing the trust's foreign financial accounts.[8]

3. Defining Financial Account

The definition of "financial account" located in a "foreign country" can be difficult to understand. According to the FBAR instructions, a financial account includes

securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution. A financial account also includes a commodity future or option account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund.[9] For reporting purposes, the term "foreign country" includes all geographical areas except the United States, Guam, Puerto Rico, American Virgin Islands, District of Columbia, Northern Mariana Islands, and Indian lands.[10]

4. Defining Aggregate Value

The FBAR instructions refer to the "aggregate value" of the accounts "at any time during the calendar year."[11] 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.[12] Generally, the "maximum value" of an account is the largest amount of cash and nonmonetary assets that appear on any periodic account statement.[13] If periodic statements are not issued for the account, then the "maximum value" is the largest amount of cash and nonmonetary assets in the account at any time during the year.[14] With respect to cash, the FBAR instructions direct a person to convert any foreign currency into U.S. dollars by using the treasury's financial service rate at the end of the year in question.[15]

5. Defining Non-Monetary Assets

Regarding non-monetary assets, such as 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.[16] 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.[17] 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.[18] Finally, as a default rule, the instructions state that if a person had a financial interest in less than 25 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.[19]

The instructions above demonstrate that taxpayers must carefully review the FBAR instructions in order to properly complete the FBAR form. The failure to carefully review the instructions to prepare an FBAR informational return or confusion regarding the definition of the words utilized in the FBAR instructions will result in the improper completion of an FBAR.

II. CIVIL TAX PENALTIES RELATED TO FBAR

A. The History of Civil Penalties for Failing to Timely File FBAR Information Returns Prior to 2004

On October 22, 2004, with the signing into law of the Jobs Creation Act ("Jobs Act"), the penalties for not timely disclosing a foreign financial account greatly increased. Prior to the Jobs Act, federal law provided that the IRS could only impose a civil penalty on any person who "willfully" violated 31 United States Code section 5314. This type of violation included not only failures to file an FBAR, but also failures to retain the necessary records concerning the foreign account. To impose penalties prior to the Jobs Act, the Secretary had the burden of proving that the taxpayer acted "willfully." Meeting this burden required the Secretary to demonstrate that the taxpayer knew about the two aforementioned duties, yet intentionally ignored these duties. This standard was defined in *Cheek v. United States*, 498 U.S. 192 (1991). In *Cheek*, the U.S. Supreme Court stated that the government must overcome 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. . . . Carrying 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. [20]

Before the application of the Jobs Act of 2004, FBAR related penalties could be imposed only if the Secretary could meet the high standard enunciated by the Supreme Court. The maximum penalty was $25,000 or the amount of the transaction (not to exceed $100,000), whichever was greater. In cases 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 violation.[21]

B. Civil Penalties for Failing to Timely Disclose an FBAR Subsequent to the Enactment of the Jobs Act

The Jobs Act of 2004 provides that the Secretary (and by extension the IRS pursuant to delegation of authority) "may" impose a civil penalty on any person who violates Section 5314. Under the Jobs Act, a penalty may be imposed under 31 United States Code section 5321(5)(A) and (C) for *non willful* and *willful* violations of the law.

In cases of *non-willful* violations, the IRS may assess a penalty up to $10,000 per violation. The *non-willful* penalty may only be assessed if the (1) violation was due to "reasonable cause," and (2) the amount of the transaction *or* the balance in the account at the time of the transaction was properly reported. The Jobs Act also enacted a new penalty scheme in cases where *willfulness* is demonstrated with the failure to timely file an FBAR. In the case of willful violations involving a financial "transaction" the IRS can impose a penalty of $100,000 or 50 percent of the amount of the financial "transaction," whichever is greater.[22] In situations in which the "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 50 percent of the balance in the account at the time of the violation.

The Jobs Act made three significant changes to the penalty structure for FBAR violations. First, the Jobs Act added a new penalty for cases involving non-willful violations. Second, the Jobs Act changed the burden of proof in regards to the assessment of certain FBAR penalties. Prior to the enactment of the Jobs Act, all FBAR associated penalties required the IRS to demonstrate willfulness. In order to assess any FBAR penalties the IRS had to show by clear and convincing evidence that the taxpayer knew about the FBAR filing and intentionally failed to comply with the law.[23] The Jobs Act changed the applicable law to allow the IRS to assert a penalty any time an FBAR is not timely or properly filed with the Government. Third, the Jobs Act increased the maximum penalty that may be imposed for willful FBAR violations. Prior to the Jobs Act, the penalty for not complying with the FBAR filing requirements ranged from $25,000 to $100,000. The Jobs Act increased these penalties significantly. Under the Jobs Act, the penalty for not timely disclosing an interest in a foreign financial account may now greatly exceed $100,000 per violation.

C. The Application of the Non-Willful FBAR Penalty

Many articles have been written outlining the harsh consequences resulting from the increased willful penalty. However, few legal commentators have addressed the implications of the non-willful penalty. Therefore, we have chosen to dedicate the remainder of this article to the complex rules governing the non-willful FBAR penalty. The Jobs Act provides that in cases of non-willful violations, the IRS may impose a maximum penalty of up to $10,000 per violation. This means that a non-willful penalty may be assessed against a taxpayer for each undisclosed foreign account for each signature. As an example, the non-willful penalty could be double if each person in a married couple had signature authority in an undisclosed foreign account. The non-willful penalty could triple if the married couples' child had signature authority over the same previously undisclosed foreign account. To make matters worse, the non-willful penalty is assessed per year for each account that is required to be disclosed on an FBAR. Given the manner the non-willful penalty can be assessed, it is not too difficult to envision a nightmarish scenario in which the IRS assesses substantial non-willful penalties.

Section 5321(5)(A) is clear in the sense that the IRS has full discretion to impose a non-willful FBAR related penalty and the amount of the penalty. With that said, the controlling statute provides explicitly that the Secretary "may" impose a non-willful civil penalty, but is not required to impose a non-willful civil penalty in all situations. Section 5321(5)(A) provides that the Secretary may impose a civil "money" penalty on any person who violates, or causes any violation of, any provision of Section 5314. In other words, Section 5321 provided that the non-willful penalty should not automatically be assessed by the IRS. Instead, the IRS should carefully examine the facts and circumstances in determining whether the non-willful penalty should be assessed. The IRS should also examine the facts of each particular case in deciding the amount of the penalty to be assessed.

Some federal courts have noted the importance of word choices in a federal statute. For example, federal courts have consistently noted that when Congress uses a word such as "may" it means "may" and does not mean that a federal agency such as the IRS should interpret such a statute's wording to be "must" or "shall."[24] As of the date of the writing of this article, no reported decisions in any federal circuit regarding an assessment of a non-willful penalty have been decided. Given the lack of federal cases on point, it is unclear if the IRS will automatically assess a $10,000 penalty in cases involving the assessment of the non-willful penalty, or if the IRS will carefully consider all of the facts and circumstances of each case in determining whether to assess the non-willful penalty. It is also unclear if the IRS will consider assessing a penalty less than $10,000 per non-willful violation.

The statutory language of Section 5321 certainly has flexibility built in to provide the IRS with discretion to determine if and when to assess the non-willful penalty. The statute also provides the IRS with the discretion to assess a non-willful penalty on a sliding scale rather than to just assert the maximum penalty against every FBAR violation of a taxpayer. Given the wide latitude the IRS has been given in determining when to impose the non-willful penalty, should the IRS carefully review each offense on a case by case basis, the IRS has the opportunity to encourage

compliance with the law, and invite taxpayers to disclose previously undisclosed foreign financial accounts. On the other hand, given the broad scope of power entrusted to the discretion of the IRS under Section 5321 to impose the non-willful penalty, the IRS may decide to automatically assert the maximum penalty permitted under Section 5321.

The Internal Revenue Manual seems to indicate that the IRS has directed its Revenue Officers to use discretion in assessing the non-willful penalty. The Internal Revenue Manual contains numerous statements implying that the IRS will use its discretion in assessing the non-willful penalty such as the following:[25]

> 1) The examiner is expected to exercise discretion, taking into account the facts and circumstances of each case, in determining whether penalties should be asserted and the total amount of penalties to be asserted.
>
> 2) Whenever there is an FBAR violation, the examiner will either issue the FBAR warning letter, or determine a penalty.
>
> 3) Penalties should be asserted only to promote compliance with the FBAR reporting and recordkeeping requirements. In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future.

Although the Internal Revenue Manual makes it absolutely clear that it is unnecessary for IRS Revenue Agents to impose a non-willful penalty in every case and the Revenue Agents should take into account all the facts and circumstances of each case before asserting a non-willful penalty, the lack of any reported decisions regarding the non-willful penalty make it very difficult to determine if Revenue Agents will utilize their discretion properly in assessing the non-willful penalty. This lack of guidance puts taxpayers who mistakenly or unintentionally failed to disclose foreign account(s) in the unenviable position of having to predict if the IRS will assess the maximum FBAR penalty against them. Such a lack of predictability can prove problematic for those individuals considering whether or not to participate in the Offshore Voluntary Disclosure Program ("OVDP") offered by the IRS.[26] Individuals who mistakenly failed to disclose foreign financial accounts on an FBAR face two unattractive choices: potentially needlessly pay a large penalty to the IRS through the OVDP, or risk being assessed a much larger penalty outside the OVDP.

D. Defenses to the Reasonable Cause Exception Under Section 5321

Under Section 5321, no non-willful penalty shall be imposed if the following 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.[27] Although the above exceptions appear relatively simple, these terms are poorly defined. At initial glance, the first element of the exception to the non-willful penalty seems relatively straightforward; all a taxpayer has to demonstrate is that there was a "reasonable cause" for not filing an FBAR informational return to satisfy the first prong of the Section 5321 test. Unfortunately, the term or concept of "reasonable cause" is not addressed in Section 5321 or in any applicable regulation. Although the term "reasonable cause" is not addressed in Section 5321 or any regulations, the concept of "reasonable cause" is referred to in the Internal Revenue Manual.

The Internal Revenue Manual contains the following statements to this effect, including the following:[28]

> 1) The [non-willful] penalty should not be imposed if the violation was due to reasonable cause.
>
> 2) If the failure to file the FBAR is due to reasonable cause, and not due to the negligence of the person who had the obligation to file, [a penalty should not be assessed].
>
> 3) Reasonable Cause and Good Faith Exception to ("IRC") Internal Revenue Code §6662 ("§6662") may serve as useful guidance in determining the factors to consider [in assessing FBAR penalties].
>
> 4) Although the tax regulation for §6662 does not apply to FBARs, the information it contains may still be helpful in determining whether the FBAR violation was due to reasonable cause.

The Internal Revenue Manual indicates that an examiner could consider defenses to the Section 6662 penalty in determining whether a taxpayer should be liable for the non-willful FBAR penalty. Section 6662 imposes a 20-percent accuracy related penalty to an underpayment of tax due to negligence. IRC Section 6664(c) states that

no penalty shall be imposed if it is shown that there was a reasonable cause for such understatement.

Therefore, if a taxpayer can show reasonable cause, the Section 6662 penalty will not be imposed. The reasonable cause exception in a Section 6662 penalty has been generally interpreted to mean the exercise of ordinary business care and prudence.[29] Where an individual exercises ordinary business care and prudence, the individual will not be liable for the Section 6662 penalty where the understatement results from a mistake of law or fact made in good faith and on reasonable grounds.[30] Those who represent individuals before the IRS understand that the most common reason taxpayers do not disclose foreign financial accounts on FBAR informational returns is ignorance of the filing requirement.

There are numerous reasons why many taxpayers are not aware of rules governing the FBAR informational returns. First, the applicable laws and regulations governing the disclosure of foreign financial accounts invite unintentional mistakes. This is because the rules governing FBAR informational returns can be found in Title 31 of the United States Code and not in the IRC, which can be found in Title 26 of the United States Code. As such, a taxpayer can read each and every IRC section along with each applicable regulation and never discover that he or she has a legal duty to file an FBAR.

Second, the term "foreign financial accounts" for FBAR purposes is confusing and misleading to many taxpayers. Most taxpayers mistakenly believe that only foreign bank accounts need to be disclosed on an FBAR informational return. However, as discussed earlier in this article, a taxpayer's legal duty encompasses the disclosure far beyond interests in foreign bank accounts. In fact, a taxpayer may have to disclose interests in securities accounts, mutual funds, certificate of deposits, life insurance policies, and more. Given the broad definition the government places on the term "foreign financial accounts," a taxpayer could easily omit the disclosure of a "foreign financial account" on an FBAR.

Third, and most importantly, the FBAR informational return is not part of an individual income tax return and the deadline for the filing of an FBAR is not April 15, as it is for individual income tax returns. Rather, the due date to file an FBAR informational return is June 30th. To make matters even more confusing, a taxpayer can file an extension with the IRS to file his or her individual income tax return late, while there are no extensions available to file an FBAR informational return after the June 30th due date. Since an FBAR is a separate and distinct form from an individual income tax return with a different filing deadline, a large number of taxpayers are unaware of the governing FBAR disclosures and deadlines.

Given that many taxpayers are honestly ignorant of the FBAR filing requirements, a compelling argument can be made that many taxpayers who failed to timely file these informational returns acted with "reasonable cause." Whether such an argument will suffice to mitigate or remove a non-willful FBAR penalty will depend on the facts and circumstances of each case. With that said, any taxpayer taking the position that the failure to file an FBAR was reasonable and was the result of the ignorance of law must be prepared for the IRS' counter argument. The IRS will likely counter an argument based on the ignorance of law with the applicable instructions on a Schedule B of Form 1040. Part III on Schedule B of Form 1040 states the following: "At any time [during the tax year at issue], did you have an interest in a foreign country, such as a bank account, securities account, or other financial account?" The instructions go on to instruct a taxpayer with the interest in a foreign account to check the "yes" box and then disclose the account. The taxpayer is also told to consult the instructions to Schedule B for requirements related to foreign financial accounts; wherein it instructs, with no exceptions, that an FBAR must be filed by June 30 with the Treasury Department. Any taxpayer contemplating defending against the non-willful penalty must be prepared to address not only the failure to timely file an FBAR, but also the failure to follow the instructions provided for on Schedule B of a Form 1040.

It should be noted that even if a taxpayer were to successfully demonstrate that there was "reasonable cause" for not filing an FBAR informational return based on one of the arguments discussed above, the IRS and more importantly, a federal district court which would have jurisdiction over such a case may not be bound to entertain any such argument. This is because FBAR penalties are authorized under Title 31 and not Title 26. Many of the defenses as to "reasonable cause" discussed above are based on Title 26 of the IRC and case law analyzing the IRC. Since the law and case law for "reasonable cause" originate in Title 26 instead of Title 31, the favorable statements found in the Internal Revenue Manual and the IRC may not provide a taxpayer with binding authority as a defense to a FBAR non-willful penalty in a case brought before a federal district court.

E. Defenses to the Non-Willful Penalty Under a Reasonable Defense Theory

The second element to the penalty exception for a non-willful penalty under Section 5321 requires that the taxpayer demonstrate "the amount of the *transaction* or the

balance in the account *at the time of the transaction"* was properly reported. In order to determine if a taxpayer could satisfy the second element of Section 5321, we will first define the term "transaction" under the applicable federal regulation. According to 31 Code of Federal Regulations ("C.F.R.") section 103.11(ii), a transaction means a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition, and with respect to a financial institution includes a deposit, withdrawal, transfer between accounts, exchange of currency, loan, extension of credit, purchase or sale of any stock, bond, certificate of deposit, or other monetary instrument, security, contract of sale of a commodity for future delivery, option on any contract of sale of a commodity for future delivery, option on a commodity, purchase or redemption of any money order, payment or order for any money remittance or transfer or redemption of casino chips or tokens, or other gaming instruments or any other payments, transfer, or delivery by, through or to a financial institution, by whatever means effected.

Most taxpayers who hold an interest in foreign financial account do not have a "transaction" to disclose to the IRS. The regulation promulgated under 31 C.F.R. section 103.11(ii) broadly defines a transaction as a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition with respect to a "financial account." The vast majority of taxpayers who hold foreign financial accounts merely maintain a relationship with the institution whereby the organization agrees to hold money for the individual. A "transaction" for FBAR reporting purposes requires an act that goes beyond being an owner of a foreign bank account. Therefore, requiring an individual to disclose the balance in the account "at the time of the transaction" is problematic and makes little sense for most foreign account holders. If one were to follow the literal words of Section 5321, the only time a taxpayer would have to disclose the value of a foreign account on an FBAR is when a purchase, sale, loan, pledge, transfer, delivery, or other disposition occurs with respect to the foreign account.

In other words, the account holder would only be required to disclose on an FBAR when he or she deposited funds into a foreign account, withdrew currency, sold a monetary instrument, or arranged for a loan through a foreign financial institution. The act of merely holding currency in a foreign bank is not listed as a "transaction" anywhere in Title 31 or its applicable regulations. Since the act of maintaining an account with a foreign institution is not characterized as a "transaction" under the literal terms of 31 C.F.R. section 103.11, the IRS cannot assess the non-willful penalty against individuals who merely hold an interest in a foreign bank account that was not timely disclosed and failed to disclose that interest on an FBAR.

Even if the term "transaction" could somehow be broadened to include merely holding an interest in a foreign bank account, the second part of the Section 5321 relief test is also flawed. Section 5321(5)(B)(ii)(II) provides that no penalty shall be imposed if "the amount of the transaction or the balance in the account at the time of the transaction was properly reported." Unfortunately, unless a taxpayer files an FBAR informational return, it is not possible to disclose "the amount of the transaction or the balance in the account" on a tax return. As discussed earlier, a taxpayer discloses an interest in a foreign account on Schedule B of his or her tax return. Although the account is disclosed on Schedule B of the tax return, a taxpayer cannot state the "transaction or the balance in the account" on the tax return. A taxpayer can only advise the IRS that he or she has an interest in a foreign account and the country where the account is located. Nowhere on a Schedule B of a tax return can a taxpayer disclose the "transaction or the balance in the account." Given that it is literally impossible to disclose a transaction or the balance in a foreign account without the filing of an FBAR, the penalty relief discussed in Section 5321(5)(B)(ii)(II) cannot ever be satisfied.

The poor statutory verbiage of Section 5321 has apparently not escaped the notice of the IRS. Almost eight years has elapsed since the enactment of the Jobs Act and there is still not one reported decision from a federal court in regards to the validity of non-willful penalty. The lack of cases prosecuting the non-willful penalty seems to indicate the Government's unwillingness to put the Section 5321 penalty to a judicial test.

III. CONCLUSION

The enactment of the heavy-handed non-willful penalty shows just how serious the Government is about eliminating the compliance problem regarding offshore accounts. The potential penalty for a non-willful FBAR violation can be financially devastating. For those who mistakenly failed to disclose a foreign financial account on an FBAR informational return, the choice is difficult; either enroll in the OVDP and pay steep penalties, thereby avoiding the possibility of larger penalties, or these individuals can take their chances outside the program. To make matters worse for taxpayers seeking to make a decision on how to proceed, federal law governing the assessment of the non-willful penalty and the procedures available to forgive or mitigate the non-willful penalty seem to be hopelessly ambiguous.

Even though federal law and the regulations seem hopelessly ambiguous regarding this matter for taxpayers who innocently or mistakenly failed to file an FBAR return

disclosing an interest in a foreign account, many taxpayers will find comfort in the fact the IRS is not required to assert the non-willful penalty in every situation of noncompliance. Rather, the non-willful penalty statute provides the IRS discretion in assessing the penalty. This is echoed in various provisions of the Internal Revenue Manual calling for the IRS to exercise its discretion in assessing the non-willful penalty. Despite the clarity of the law and provisions of the Internal Revenue Manual, it is unclear if IRS Revenue Agents will assist on automatically assessing the non-willful penalty or if IRS personnel will exercise their discretion in determining whether or not to assess the non-willful penalty.

If the IRS utilizes a heavy-handed approach, and elects to impose the maximum non-willful FBAR penalty when the facts do not warrant the non-willful penalty, many taxpayers will be forced to litigate the assessment of the non-willful penalty. Whether or not an individual can successfully mount a defense will likely require the taxpayer to demonstrate his or her ignorance of the rules governing disclosing foreign financial accounts on an FBAR. Given the ambiguities regarding the timing of disclosing a foreign financial account and the type of account or "transaction" that needs to be disclosed on an FBAR, it is not too hard to imagine many scenarios in which a taxpayer can demonstrate his or her ignorance of the FBAR rules. Given that these ambiguities could work in the favor of many taxpayers who innocently or mistakenly failed to disclose foreign accounts on an FBAR informational return, the IRS should be on notice that an arbitrary assessment of a non-willful penalty could invite litigation that could result in unfavorable judicial decisions.

ENDNOTES

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2. C.F.R. § 103.29.

3. U.S. DEPT OF THE TREASURY, TD F 90-22.1, Report of Foreign Bank and Financial Accounts (OMB No. 1545-2038) (January 2012)(General Instructions) /31 C.F.R. § 103.24.

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Cheek v. United States*, 498 U.S. 192, 201 (1991).

21. 31 U.S.C. § 5321(a)(5)(A)(2000).

22. 31 U.S.C. § 5321(a)(5)(C)(i).

23. 31 U.S.C. § 5321(a)(5)(A)(2000).

24. See *McMullen v. United States*, 50 Fed. Cl. 718, 735 (2001).

25. IRM 4.26.16.4 (07-01-2008).

26. To participate in the 2012 OVDP, taxpayers must file or amend their tax returns, amend previously filed FBARs, and pay all delinquent taxes, interest, and penalties for tax years 2003 through 2011 if applicable. Under the OVDP, taxpayers will be subject to a 27.5 percent penalty on the highest aggregate account balances and foreign assets, such as foreign real property, for the 2003 through 2011 tax years. If the value of the undisclosed account balances was less than $75,000 at all times during the 2003 through 2011 tax years, the penalty is reduced to 12.5 percent. In certain situations, the participant in the OVDP can qualify for a 5 percent penalty on the aggregate account balances.

27. 31 U.S.C. § 5321(B)(i).

28. IRM 4.26.16.4.3.1 (07-01-2008).

29. *United States v. Boyle*, 269 U.S. 241, 246 (1985).

30. *Scott v. Comm'r*, 61 T.C. 654 (1974).