FBAR PENALTIES

Moore Requires "More" Scrutiny of IRS-Imposed FBAR Penalties Under the Administrative Procedures Act

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On April 1, 2014, the United States District Court for the Western District of Washington issued an important ruling about the calculation of the penalty for failure to file a Foreign Bank and Financial Account Report (FBAR). In Moore v. United States, the taxpayer failed to file an FBAR for several tax years. The IRS imposed a non-willful $10,000 penalty for each of the tax years 2005 to 2008. Moore made several arguments in his defense. First, he argued that he had "reasonable cause" for failure to file the FBAR. Second, Moore challenged the IRS's method of calculating the penalties. While the court concluded that Moore failed to file an FBAR for each relevant year, it directed the IRS to demonstrate how it satisfied its obligations under the Administrative Procedure Act (APA) not to act "arbitrarily" or "capriciously." The decision in Moore provides much needed judicial guidance and demonstrates that the IRS cannot arbitrarily impose penalties.

This article will discuss the FBAR penalty itself. Next, Moore's precursors McBride and Williams are revisited. Finally, we review the Moore decision and consider its implications for high-net-worth individuals and family members with non-U.S.-based accounts.

A. Understanding the FBAR Penalty

In 1970, Congress passed the Bank Secrecy Act. The purpose of the Act was to force persons with a connection to the United States to disclose and maintain records of their interests in foreign financial accounts. Congress hoped that the disclosure and records retention requirements would prevent money laundering, terrorism, tax evasion, or similar crimes. The FBAR, authorized by 31 U.S.C. § 5314(a), was among the specific provisions contained in this legislation. In its current form, the FBAR requires non-exempt persons to make annual disclosures of any "financial interest in, or signature or other authority over, a bank securities, or other financial account in a foreign country." According to the FBAR instructions and enabling regulations, a person must file an FBAR if six elements are satisfied: (i) a "U.S. person," (ii) had a "financial interest" in, or "signature authority" over (iii) one or more "financial accounts" (iv) located in a "foreign country," and (v) the aggregate value of the account or accounts exceeded $10,000, (vi) at any time during the calendar year.

While a complete explanation of each of these technical terms is beyond the scope of this article, some definitions bear mentioning:

• A "U.S. person," for instance, means a U.S. citizen, U.S. resident, domestic partnership, domestic corporation, domestic estate, or domestic trust.

• The definition of "financial interest" is less straightforward. A person has a direct financial interest in an account if the person is the owner on record or holds legal title to the account (even if the account is beneficially owned by another). Indirect financial interests arise where the titleholder or owner of the account is: (i) the person's agent, nominee, or attorney, (ii) a corporation whose shares are owned, directly or indirectly, more than 50% by the person, (iii) a partnership in which the person owns greater than a 50% profit interest (again, directly or indirectly), (iv) a trust in which the person has a direct or indirect 50% present beneficial interest or derives more than 50% of the current income, (v) a trust for which the U.S. person is the grantor and has an ownership interest in the trust for U.S. tax purposes, or (vi) any other entity, if the entity was created for the purpose of evading the FBAR filing rules.

• A person holds "signature authority" if he or she can control the disposition of property in an account by written or other instructions to the institution that maintains it. This rule sweeps broadly as employees with signing authority over company accounts may be required to file.

• The phrase "financial account" (or "reportable account," per the regulations) is similarly broad and can include a variety of bank or investment accounts. A number of accounts are expressly exempt, including certain government and military entities, financial institutions, other financial services providers, retirement plans, and IRAs.

• "Foreign country" means any country or territory except the United States and its territories.

• The instructions define "aggregate value" to mean the sum of the maximum yearly values of the reportable foreign accounts. To determine the maximum value of an account, taxpayers may rely on periodic account statements. If no periodic statements are available, the taxpayer must reasonably approximate the highest balance in the account during the year.

1. Pre-2004 Penalties

Prior to 2004, penalties could only be imposed for "willful" violations of the FBAR filing duty. The amount of the penalty per violation was either $25,000 or the amount in the account, whichever was greater, subject to a cap of $100,000 per offense.

2. Post-2004 Penalties

Currently, penalties are imposed for both "willful" and "nonwillful" failures to file. Nonwillful failures carry a maximum penalty of $10,000 per account per year. Willful violations, on the other hand, are punishable by a fine equal to the greater of $100,000 per unreported account or 50% of the balance of the account. There is generally no ceiling or cap on the amount of penalties that may be imposed. However, on May 15, 2015, the IRS issued important guidance which directed examining agents to impose essentially only one willful FBAR for only one tax year in situations where several tax years are under examination and the IRS examining agent has concluded that the failure to file an FBAR for each of these years was willful.

B. The Williams and McBride Decisions

The distinction between "willful" and "nonwillful" FBAR violations is of crucial importance. Two cases have provided guidance on the facts necessary to satisfy the "willfulness" level of the violation.

Williams v. United States, involved an individual who had opened two Swiss bank accounts through a UK entity known as ALQI Holdings (ALQI). The taxpayer earned more than $800,000 from 1993 to 2000 but never disclosed the accounts. Swiss officials eventually became aware of the accounts, and agreed to freeze them in response to a request from U.S. authorities. On his 2000 return, the taxpayer checked "no" in response to a question inquiring as to whether he had any interests in foreign financial accounts. Consistent with this response, he also failed to file his 2000 FBAR. The taxpayer, in 2001, correctly completed his return and filed the requisite FBAR form. In 2003, he pled guilty to charges of federal tax fraud and evasion. The IRS imposed two "willful" FBAR penalties of

$100,000 (one for each of the undeclared accounts, for a total penalty of $200,000) in connection with the taxpayer's erroneous 2000 return. The issue, in this case was whether the taxpayer's failure to file was "willful." According to the government, the taxpayer's signature on his 2000 tax return represented prima facie evidence that he knew of the FBAR requirement. However, the district court rejected this argument, pointing to the fact that the accounts had already been disclosed to the Swiss and U.S. governments at the time the taxpayer filed his return. The court reasoned that since the taxpayer had no incentive to lie on his return, his failure to file the FBAR was likely the result of good faith ignorance rather than willfulness.

A Fourth Circuit panel vacated the district court's decision and remanded for further proceedings. It found that on these specific facts, the taxpayer's conduct was, at a minimum, "reckless," which it held to be sufficient to prove willfulness in the civil context. Unlike the McBride court below, the appeals court accepted the government's "signature" theory of liability, stating in dicta that taxpayers should be charged with constructive knowledge of the contents of returns bearing their signature. It also stated that even if the taxpayer lacked actual knowledge of the requirement, his ignorance of the contents of a return that he signed stemmed from "a conscious effort to avoid learning about the reporting requirements." On remand, the district judge stated that although the Fourth Circuit had settled the issue of the taxpayer's liability as a matter of law, the amount of the penalties imposed was subject to judicial review in accordance with the Administrative Procedure Act's "arbitrary and capricious" standard. The court went on to find that that there was ample evidence in the administrative record of the case to support the specific penalty amounts.

United States v. McBride also addressed the distinction between "willful" and "nonwillful" FBAR violations. In McBride, the taxpayer engaged in a scheme to avoid reporting income, which involved a number of non-U.S. shell entities. Stripped to its essential elements, the scheme was created so that the taxpayer's mobile-phone clip company would overpay its Taiwanese manufacturer on every product, with the excess being passed on to entities controlled by the original company. These shell entities held bank accounts in various foreign jurisdictions. The court found that the taxpayer intended to evade taxes and had accordingly failed to disclose the existence of the various holding entities on an FBAR. Following Williams, the court held that willfulness may be satisfied by "recklessness" as well as actual knowledge. Given the facts in the record, the court could have easily disposed of this issue simply on the basis of the taxpayer's conduct. Instead, it found willfulness on a theory similar to that espoused by the Williams court, stating that taxpayers are presumed to have constructive knowledge of all instructions contained in a signed tax return. As such, McBride inappropriately comes close to transforming "willfulness" into a strict liability standard.

C. Implications of the Moore Decision

The Moore decision provides important guidance on the application of the APA and Eighth Amendment to the IRS imposed FBAR penalty. In Moore, the taxpayer had owned a foreign account since 1989 but had never filed an FBAR or otherwise disclosed the account to U.S. authorities. The account was initially at a Bahamian bank in the name of a wholly-owned Bahamian corporation. The taxpayer later transferred the balance to the Bahamian branch of a Swiss bank. In 2003, the amount in the account was finally transferred to a bank in Switzerland, where it remained. Throughout this period, the balance in the account fluctuated between $300,000 and $550,000.

In 2009, the taxpayer considered entering the IRS's 2009 Offshore Voluntary Disclosure Program but ultimately decided against it. Nonetheless, he filed six years of back tax returns and six years of late FBARs (2003 to 2008). In response, the IRS examined the taxpayer's returns and imposed four $10,000 FBAR penalties for each of the four years spanning 2005 to 2008 for a total of $40,000. This penalty was the largest the IRS could have imposed given the six-year statute of limitations. The taxpayer learned of the decision in a 2011 IRS letter, which neglected to explain the agency's reasons for recommending the maximum penalty as opposed to a smaller amount. On January 23, 2012, the IRS formally assessed a $10,000 penalty against the taxpayer for the 2005 tax year, apparently out of concern that the statute of limitations would prohibit an assessment of the penalty for that year.

1. Application of the Administrative Procedures Act

The taxpayer requested an appeal of that penalty and of the additional penalties proposed in the 2011 letter. He insisted that the penalties should be abated because he had "reasonable cause" for his failure to file under 31 U.S.C. 5321(b)(5)(B)(ii)(I). In response to the taxpayer's submissions, the IRS responded with a brief, terse letter rejecting any abatement.

Moore brought an action in U.S. district court, asserting that the IRS had failed to comply with the Administrative Procedure Act. He also argued that the IRS had violated the Eighth Amendment's Excessive Fines Clause and Fifth Amendment's Due Process Clause, among other constitutional provisions. The court concluded the taxpayer was liable for the civil FBAR penalty for all applicable years. It also rejected the taxpayer's "reasonable cause" contention, holding that there was sufficient evidence in the record showing the taxpayer to be at least on inquiry notice of the FBAR filing requirement (citing Williams in support of this proposition).

Regarding the taxpayer's APA arguments, however, the court engaged in a considered analysis of the IRS's APA obligations with respect to the agency imposition of the FBAR penalty. Ultimately, the court reached two conclusions. First, it held that IRS agency action is presumptively subject to judicial review under the APA to determine whether it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law" under Title 5 U.S.C. § 706(2)(A). Second, the court stated that IRS actions must comport with APA section 555(e), which requires that a denial of a "request" be accompanied by "a brief statement of the grounds for denial." According to the court, the 2012 appeals letter did not satisfy the "brief statement" requirement, and it contained no explanation as to why the IRS had chosen to impose the maximum $10,000 penalty for each year.

The government argued that the IRS agent provided a detailed summary memorandum of the reasons for recommending the maximum penalty. However, the court rejected this argument because the memorandum was never made available to the taxpayer and was only produced in response to the taxpayer's lawsuit. The memorandum itself was also inadequate; like the letter, it failed to adequately explain the ultimate decision to impose penalties. The court ordered the IRS to supplement the record with additional facts or memoranda explaining the decision to impose the maximum penalty. It warned that if the IRS failed to do so, it would rule that the penalties were assessed "arbitrarily" and "capriciously," in violation of the APA.

The Moore decision acknowledges that the APA applies to IRS-imposed FBAR penalties. It also confirms that the IRS, like other federal agencies, is generally subject to the APA and must abide by its strictures. Given the potential for frighteningly high penalty amounts, particularly with respect to willful violations, the Moore decision reveals that the IRS's FBAR penalty discretion is constrained by certain rational, legal standards and taxpayers must receive timely notice of the agency's reasons for imposing the penalty. Even for taxpayers whose willfulness or underlying liability is not in doubt, the penalty amount must be just and supported by a reasoned analysis before it is imposed.

2. Application of the Excessive Fines Clause

The taxpayer in Moore also argued that his $40,000 penalty violated the Excessive Fines Clause of the Eighth Amendment. While the court concluded that the penalty in this case was not disproportionate in relation to unreported accounts worth between $300,000 and $550,000 the court indicated that a larger penalty may have presented a closer question. The Moore decision demonstrates that the Eighth Amendment has application to the FBAR penalty. Willful violations carry arguably severe penalties of up to 50% of the balance of the undeclared account for each year of nondisclosure. Additionally, the decision makes clear that an IRS imposed penalty can violate the Constitution if not reasonably applied.

D. Conclusion

The Moore decision provides critical guidance on the application of FBAR penalties. The opinion shows that the IRS's imposition of FBAR penalties is not without bounds. The amount of the penalty must be rationally related to the size of the account and the amount of the tax due. The IRS must also conduct a real analysis of the appropriate penalty and provide its reasoning to the taxpayer in a timely manner. If the IRS does not comply with these requirements, an FBAR penalty should be reduced or completely abated.

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