Dealing with FBARs

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The basic mechanism for a taxpayer to alert the IRS about the existence of a foreign financial account is Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) (FBAR). This *Practice Alert*, which is excerpted from a more extensive article in the August 2012 issue of the Journal of International Taxation (**Journal of International Taxtion ¶ 08201213**), discusses the rules underlying FBAR reporting, the penalty regime for noncompliant taxpayers, and the administrative guidance that bears on treatment of FBAR violations by the IRS. It also provides strategies for addressing failures to file FBARs.

FBAR filing requirement. Under 31 U.S.C. section 5311 et seq. and its regulations, a U.S. person that has a financial interest in or signature authority over one or more foreign financial accounts must file an FBAR if the total value of the accounts exceeds $10,000 at any time during the calendar year. The IRS must receive the FBAR on or before June 30 of the calendar year following the year for which the foreign financial account is being reported.

For purposes of FBAR reporting, a U.S. person includes individuals who are citizens or residents of the United States; thus, U.S. citizens who are permanently living outside the U.S. need to file FBARs for accounts held in their country of residence and other foreign locations. The term also includes but is “not limited to” a corporation, partnership, trust, or limited liability company organized under the laws of the U.S., any state thereof, the District of Columbia, a U.S. territory or insular possession, or an Indian tribe. (31 C.F.R. section 1010.350(b))

The scope of reportable financial accounts is broad. These include bank accounts, securities accounts, and other financial accounts. “Other financial accounts” cover mutual funds and other pooled funds that issue shares to the public, insurance policies and annuities with a cash value, accounts with brokers or dealers of futures or options in commodities, and accounts with persons whose business is accepting deposits as a financial agency. (31 C.F.R.section 1010.350(c)(3))

Penalties for failing to file an FBAR. There is a range of penalties for failing to file an FBAR. If a failure to file is due to negligence, a civil penalty up to $500 per account may be assessed. If there has been a pattern of negligent failures to file FBARs, a civil penalty up to $50,000 per account may apply. Imposition of these negligence penalties is rare. Other penalties are discussed below.

Non-willful failures to file. A civil penalty of up to $10,000 per account may be imposed if the nonfiling is not willful. (31 U.S.C. section 5321(a)(5)(B)(i)) This penalty can be avoided if two conditions are met: (1) the failure to file was due to reasonable cause, and (2) the balance in the account was subsequently properly reported on an FBAR. (31 U.S.C. section 5321(a)(5)(B)(ii)) Thus, if a taxpayer had reasonable cause regarding its failure to file for prior tax years and it now files the appropriate FBARs, the $10,000 penalty can be avoided.

For purposes of applying this rule, “reasonable cause” exists if a taxpayer exercises ordinary business care and prudence in determining its obligations but nonetheless is unable to comply with those obligations. In determining the existence of reasonable cause, each case must be judged individually, based on its own facts and circumstances.

One important issue is “once facts and circumstances changed, what attempt did the taxpayer make to comply?” Reasonable cause does not exist if, after the facts and circumstances that explain the noncompliant behavior cease to exist, the taxpayer fails to comply within a reasonable time.

Willful failures to file. If a failure to file FBARs is willful, the maximum civil penalty per account is much higher. “Willfulness” means the “voluntary, intentional avoidance of a known legal duty.” The ceiling for this penalty is the greater of $100,000 or 50% of the balance in the account at the time of the nonfiling. (31 U.S.C. section 5321(a)(5)(C)) The nonfiling is deemed to occur if the IRS does not receive the FBAR by June 30 of the calendar year following the year for which reporting is required.

A willful failure to file an FBAR can also result in criminal penalties. These can include a fine up to $250,000, imprisonment for up to five years, or both. (31 U.S.C. section 5322(a))

Guidelines for IRS personnel on filing of FBARs. In evaluating a taxpayer's exposure to penalties for any failure to file an FBAR, it is also important to consider the IRS's administrative guidance. In several places, the Internal Revenue Manual (Manual) provides important insights.

Pursuant to the Manual, regarding an FBAR violation, an IRS examining agent is not required to impose a penalty. Rather, if “the facts and circumstances of a particular case do not justify asserting a penalty,” the agent may instead issue an FBAR warning letter (Letter 3800). (IRM section 4.26.17.4.2)

Even if an IRS examining agent determines that imposition of a penalty is appropriate, he is not required to impose the maximum statutory penalties described above. Rather, the “actual amount of the penalty is left to the discretion of the examiner.” (IRM section 4.26.16.4.6(1)) The IRS has established mitigation guidelines for FBAR penalties pertaining to both non-willful and willful failures to file FBARs, which authorize the imposition of a penalty lower than the statutory maximum.

Procedure for filing a delinquent FBAR. The instructions to the current FBAR say that if a delinquent report is filed, a statement explaining the reason for the late filing must be attached.

Strategies for addressing failures to file FBARs. If a U.S. person is delinquent in filing FBARs, the surrounding facts should be examined before concluding that the most severe penalties will result. This is what the Manual directs IRS examiners to do.

It may be that one or more FBAR violations by an entity such as a corporation or a partnership were caused by an uninformed advisor. If the entity has changed advisors and, based on new counsel, intends to comply with reporting requirements in the future, the entity should first promptly file the delinquent FBARs.

In the accompanying explanatory statements, it would be advisable to stress the role of the deficient prior advisor in the past nonfilings and to make it clear that, with the retention of the new advisor, the entity intends to comply with all FBAR filing requirements going forward.

Since, according to the Manual, the reason for the IRS to assert FBAR penalties is to improve future compliance, the delinquent entity in this case may be able to persuade the IRS that a minor penalty, or simply the issuance of a warning Letter 3800, is the appropriate sanction.

A similar result may be possible if past nonfilings were due to incompetent management. Assuming a change in executives, once past delinquencies have come to light, the entity should promptly file the late FBARs and attach explanatory statements attributing the delinquencies to past management.

As with the deficient advisor, these statements should say unequivocally that the entity will be compliant in the future. It would also be helpful if any executives remaining with the entity declare (perhaps in an affidavit appended to an explanatory statement) that those no longer with the company were responsible for FBAR compliance and that delinquencies were not known outside this group.

If the delinquent entity is part of a corporate group, and affiliates of the entity have been FBAR compliant, it may be helpful to contrast their behavior with that of the noncompliant company, to indicate that the FBAR violations were not a result of a general policy to disregard FBAR requirements.

For any delinquency, it is important to explain the business reason for establishment of the foreign account or accounts in question. FBAR requirements were introduced in the Bank Secrecy Act of 1970 (BSA). One purpose for the enactment of the BSA was to combat money laundering and other illegal activities carried on through overseas accounts. Assuming that foreign accounts facilitate the normal business of the delinquent taxpayer, the reason or reasons for those accounts should be clearly and fully described in any explanatory statement that accompanies a late FBAR.

The frequency of any nonfiling is another important factor. When an IRS examiner is determining whether an FBAR violation was willful, recurrent violations are evidence of this state of mind. Accordingly, if the nonfiling of an FBAR was a one-time event, perhaps something that fell through the cracks, for example, in the year when the delinquent entity combined with or was taken over by another company, the occurrence of the unusual transaction should be highlighted in the explanatory statement for the late FBAR.

If a taxpayer has argued that, under the facts and circumstances of its case, lower penalties or only a warning letter are the appropriate remedy, but the examiner disagrees, an administrative appeal of the examiner's decision is available. The Manual lists the procedures to be followed. (IRM section 4.26.17.4.7)

Conclusion. The statutory penalty regime that applies to delinquent FBAR filings is daunting. Before concluding that the worst penalty results are a given, all facts related to the delinquency should be examined in the hope that these facts will lead an examiner to conclude that a lesser sanction is appropriate.