

## Expert Analysis 4 Key Defenses In FBAR Liability

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Christopher Rajotte

In 2007 Bradley Birkenfeld blew the whistle on UBS's facilitation of U.S. tax evasion, and the status of offshore bank and financial accounts has not been the same since. The last decade has seen the Internal Revenue Service markedly increase its emphasis on enforcing U.S. tax law with respect to offshore bank and financial accounts owned by U.S. taxpayers.

A byproduct of the IRS's focus on offshore accounts has been an increase in enforcement of Foreign Bank Account Report (FBAR) filing obligations, at times resulting in the imposition of huge penalties. For instance, Ty Warner, the inventor of Beanie Babies, was required in 2013 to pay a penalty of \$53.6 million for failure to report his Swiss bank account on an FBAR for multiple years. That penalty was roughly 10 times the amount of tax Warner had evaded through use of the Swiss account.

A U.S. person (a citizen, green card holder or person with a substantial presence in the U.S. during the year) must file an FBAR if he or she has signatory authority over, or a financial interest in, one or more foreign bank or financial accounts with values exceeding \$10,000 (in the aggregate) at any point during the calendar year. As exemplified by the Warner case and others, failure to file FBARs can carry severe consequences, both civilly and criminally.

As a result of the IRS's increased enforcement of the FBAR filing obligation, defenses to civil and criminal liability have also developed. This article will discuss four of the key defenses to civil FBAR liability or ways to mitigate liability. This list of defenses is by no means comprehensive, but should be universally relevant in FBAR penalty exams or litigation.

The initial step should always be verification that an FBAR must be filed at all. Given the varied nature of financial accounts, and the global nature of the banking system, accounts which may on their face appear to be subject to the law may in fact not be. Likewise, individuals who appear to have an FBAR filing obligation may in fact not have one. Here, however, we assume the existence of a valid FBAR filing obligation.

### The Statute of Limitations

There are two key limitations periods relevant to civil FBAR liability. First, under 31 U.S.C. § 5321(b)(1), the IRS "may assess a

civil penalty [for failing to file an FBAR or filing an incorrect FBAR] at any time before the end of the 6-year period beginning on the date of the transaction with respect to which the penalty is assessed.”

For this purpose, the operative date occurs when the filing deadline passes without compliance. For years prior to 2016, FBARs were due by June 30 of the following year. Thus, for instance, the statute of limitations for a 2012 FBAR violation began on July 1, 2013, and will remain open through June 30, 2019.

For 2016 and later, the FBAR filing due date is the same as the 1040 filing date (typically April 15), but the Financial Crimes Enforcement Network (a division of the Treasury Department which administers FBAR filing, commonly referred to as FinCEN) has granted an automatic 6 month extension without the need to specifically request an extension. An FBAR penalty is assessed when the designated IRS official stamps the assessment form (IRS Form 13448).

The second key limitations period relates to the date by which the government must file a complaint to recover an assessed FBAR penalty. Under 31 U.S.C. § 5321(b)(2), the government must file a complaint within 2 years of the date of assessment.

If the two year period passes without the government filing a complaint, then the government’s ability to collect the penalty is limited to offsets of money the government owes the taxpayer (i.e. refunds of overpayments and social security payments). Note that if an FBAR penalty has been timely assessed, but the time period to file a complaint to collect the penalty has passed, it may be preferable to abide by the status quo and permit the IRS to offset government funds owed to the taxpayer.

That is because proactively filing a complaint in court to invalidate the penalty (for instance, because the taxpayer believes he or she had reasonable cause for the filing failure), may give the opportunity to reduce its assessment to judgment via a counterclaim, notwithstanding the fact that it is too late for the government to file its own complaint.

Compliance with these limitations periods should always be verified and, no matter what, the defense should be raised to avoid waiver of the defense. Often, during the course of an FBAR examination, the IRS revenue agent will request the taxpayer to sign a waiver of the assessment limitations period. Whether signing such a waiver is in your client’s best interest will inevitably come down to the client’s individual circumstances.

However, even if such a waiver is signed, there is some question as to whether the waiver is valid because, unlike an extension of time to

assess tax under Title 26 of the United States Code (that is, traditional tax penalties), Congress has not explicitly granted the IRS the ability to extend the assessment period under Title 31, which governs FBARs. See, e.g. *U.S. v. Garrity*, 15-cv-00243 (D. Conn.). Absent specific statutory permission to extend the limitations period, the validity of the waiver may come down to traditional contract principles.

### Reasonable Cause

Under 31 U.S.C. § 5321(a)(5)(B)(ii)(I), no FBAR penalty will be assessed if it is determined that the filing failure was due to reasonable cause. The meaning of reasonable cause is well known in the context of regular Title 26 penalties, such as for failure to file a Form 1040 on time.

With respect to failure to file a tax return on time, reasonable cause exists if the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time. *Treas. Reg. § 301.6651-1(c)(1)*. There is no statutory or official regulatory guidance on the meaning of reasonable cause in the context of FBAR penalties, so precedents derived from tax penalties should be utilized.

Recently, in *Moore v. United States*, 2015 WL 1510007 (W.D. Wash. April 1, 2015), the Western District of Washington characterized FBAR reasonable cause as when a violation occurs “despite an exercise of ordinary business care and prudence” and looked to tax law principles in its reasonable cause analysis.

Arguments laying blame at the feet of accountants or other professionals for failing to advise clients of their FBAR filing obligation tend to not be successful, due in part to the fact that Schedule B of Form 1040 directly asks taxpayers whether they have signatory authority over or a financial interest in a foreign bank or financial account, and, if so, directs them to investigate their FBAR filing obligation. A stronger argument exists if the taxpayer asked their accountant or other advisor about the FBAR obligation and were mistakenly told they did not have an obligation to file one.

What can you do if the IRS disregards your reasonable cause argument and assesses a penalty? Recent litigation indicates that to secure preemptive judicial review of an IRS determination that the reasonable cause exception does not apply, the taxpayer must first pay at least a portion the penalty (i.e. for one year, if the penalty is based on violations for multiple years) and sue for a refund.

Prepayment judicial review initiated by the taxpayer does not appear to be available because the government has not waived sovereign immunity for that type of claim. See *Kentera v. United States*, 2017 WL

401228 (E.D. Wisc. Jan. 30, 2017). However, a taxpayer should be able to raise reasonable cause as a defense in an action filed by the government to collect the penalty without prepayment of the penalty.

### The Burden of Proof for Willfulness

Even if the IRS determines that an FBAR filing failure was not due to reasonable cause, the taxpayer can still argue that the failure was non-willful, thereby beneficially capping the maximum penalty.

The maximum penalty for a non-willful violation is \$10,000, 31 U.S.C. 5321(a)(5)(B)(i), which can represent a major reprieve for a failure to report a high-dollar account. Willfulness is a vast and an important subject, a full discussion of which is beyond the scope of this article. However, an important sub-question still being argued is the government's burden of proof for willfulness, either a preponderance of the evidence or the more rigorous clear and convincing evidence.

In Chief Counsel Advisory 200603026, the IRS came to the internal conclusion that a clear and convincing evidence standard was proper because that is the standard that applies to proving a civil fraud penalty. However, most courts have opted for the lower preponderance standard, under the rationale that a civil FBAR penalty, which only involves money, does not implicate important individual interests or rights and thus does not warrant a heightened burden of proof. See e.g. *United States v. McBride*, 908 F.Supp. 2d 1186 (D. Utah 2012); *United States v. Bohanec*, No. 15-cv-4347 (C.D. Cal).

In *Gubser v. IRS*, 2016 WL 3129530 (S.D. Tx. May 4, 2016), the taxpayer filed a declaratory judgment action seeking to compel application of the clear and convincing evidence standard. However, the court dismissed the action due to the taxpayer's lack of standing (there being no guarantee that application of the clear and convincing evidence standard would result in a decision to not assess a willful penalty against the taxpayer). The Fifth Circuit Court of Appeals recently affirmed the lower court's ruling, 2017 WL 991059.

While recent precedents favor the lower burden of proof, this issue should still be raised as persuasive arguments (such as analogy to the burden of proof for a civil tax fraud penalty) exist. A higher burden of proof may be the crucial difference between a non-willful or willful penalty.

### Penalty Mitigation Guidelines and the Eighth Amendment

The current statutory maximum willful penalty is the greater of \$100,000 or 50 percent of the balance of the account "at the time of the violation." 31 U.S.C. § 5321(a)(5)(D)(ii). The IRS takes the position that the date of the violation is the filing deadline. Thus,

the relevant account balance is the balance as of that date.

However, good arguments can be made that the last day of the year is the operative date. After all, the taxpayer is being punished for his failure to report his interest in the subject account during the previous year.

In *United States v. Bussell*, 2015 WL 9957826 (C.D. Cal. December 8, 2015), the court, without discussion regarding the relevant date, determined the penalty on the basis of the account value on December 31 of the year for which no FBAR was filed. Thus, precedent exists for either date.

The balances on the relevant dates should be examined, and whichever date favors your client should be advocated. For non-willful violations, the maximum penalty is \$10,000.

The limits described above apply per violation, so if a taxpayer violates the FBAR filing requirement with respect to multiple years and/or multiple accounts, penalties exceeding the total balance ever held in the at-issue account(s) could be assessed. Several taxpayers facing huge penalties under this rubric alleged that the IRS had violated the Eighth Amendment's prohibition against excessive fines and this position gained some traction in court. See e.g. *Bussell*.

In response, in May 2015, the IRS announced new guidelines for revenue agents determining FBAR penalties. Crucially, in most cases, a willful FBAR penalty will not exceed 50 percent of the highest aggregate balance during the years under examination. Internal Revenue Manual 4.26.16.6.5.3 (11-06-2015).

Further, "in no event will the total penalty amount exceed 100 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination." *Id.* Thus, willful violators will no longer be subject to penalties in amounts greater than they ever held in the subject accounts, and often much less.

The IRS has shown a willingness to apply the new standards to cases which arose before the new guidance was issued, so even if your client had a willful penalty assessed before May 2015, it is still worthwhile to pursue treatment under the new mitigation guidelines.

## Conclusion

The first line of defense to any FBAR penalty is compliance with the FBAR filing obligation. However, errors and mistakes are inevitable. When your client is facing the possibility of a civil FBAR penalty, make sure every possible defense is analyzed to ensure the best possible result for your client.

Chris Rajotte is an attorney with Fuerst Ittleman David & Joseph PL who focuses his practice on IRS penalty abatement requests, partnership tax issues and FBAR compliance, as well as a variety of other sophisticated federal tax issues.

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