

Legislative Recommendation #35**Modify the Definition of “Willful” for Purposes of Determining Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts****SUMMARY**

- *Problem:* Penalties for failure to disclose foreign assets on a Report of Foreign Bank and Financial Accounts (FBAR) are steep and grow even steeper when the IRS determines a taxpayer’s failure was “willful.” The IRS has become increasingly aggressive in asserting that taxpayers’ failures to file are willful, which can lead to draconian penalties for good-faith errors.
- *Solution:* Increase the burden of proof on the IRS for declaring a failure “willful” and reduce the maximum penalty for willful violations involving small accounts.

PRESENT LAW

The Bank Secrecy Act requires U.S. citizens, residents, and entities to report foreign accounts to the Treasury Department’s Financial Criminal Enforcement Network (FinCEN) when the combined value of those accounts exceeds \$10,000 at any time during the calendar year.¹ They must do so on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

31 U.S.C. § 5321(a)(5) imposes civil penalties for failing to report the accounts. The penalty amount depends on whether the failure was non-willful or willful. For a non-willful violation, the maximum civil penalty is \$10,000 (adjusted for inflation), subject to a reasonable cause exception.² Under 31 U.S.C. § 5321(a)(5)(C)(i), the maximum civil penalty for a willful violation is the greater of \$100,000 (adjusted for inflation) or 50 percent of the account balance at the time of the violation. For violations occurring over multiple years, the IRS has adopted a policy, set forth in the Internal Revenue Manual (IRM), that limits the total amount of penalties to 50 percent of the highest aggregate balance of all unreported foreign accounts for all years under examination, which can be increased to 100 percent for willful violations.³

REASONS FOR CHANGE

The maximum FBAR penalty is among the harshest civil penalties the government may impose.

FBAR penalties are so steep there is debate about whether they violate the prohibition against excessive fines in the Eighth Amendment to the U.S. Constitution.⁴ In August 2024, the U.S. Court of Appeals for the Eleventh Circuit held that the Eighth Amendment’s prohibition against excessive fines applies to FBAR penalties and partially reduced the taxpayer’s penalty after finding it was “grossly disproportionate” to the offense of failing to disclose the foreign account.⁵ This decision creates a split among the circuits, as the U.S.

1 31 U.S.C. § 5314; 31 C.F.R. § 1010.350.

2 31 U.S.C. § 5321(a)(5)(B)(i); *see also Bittner v. United States*, 598 U.S. 85 (2023) (holding that the \$10,000 cap applies on a per-FBAR report, not per-account, basis).

3 IRM 4.26.16.5.4.1, Penalty for Non-willful Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016; IRM 4.26.16.5.5.3, Penalty for Willful FBAR Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016.

4 *See, e.g.,* Matthew A. Melone, *Penalties for the Failure to Report Foreign Financial Accounts and the Excessive Fines Clause of the Eighth Amendment*, 22 *Geo. Mason L. Rev.* 337 (2015).

5 *United States v. Schwarzbaum*, 114 F.4th 1319 (11th Cir. 2024).

Court of Appeals for the First Circuit held in 2022 that the Eighth Amendment does not apply to FBAR penalties.⁶

An example illustrates the potential severity of the FBAR penalties, particularly for smaller accounts. Assume an account holder maintains a balance of \$25,000 in a foreign account that they willfully fail to report. The IRS may, under the statute, impose a penalty of over \$100,000 per year (the exact amount depends on the year since the \$100,000 is adjusted for inflation) and may go back six years, producing an aggregate statutory maximum penalty of over \$600,000. While the IRS should not impose such a severe penalty under the IRM, the IRM is simply a set of instructions to help IRS employees do their jobs. It is not binding and can be changed at any time.

In this example, the penalty exceeds the account balance because the statute provides that the maximum penalty is the *greater of* \$100,000 (adjusted for inflation) or 50 percent of the account balance. The \$100,000 cap only applies to accounts with balances below \$200,000 like the one in the example; for higher balance accounts, the maximum statutory penalty is limited to 50 percent of the account balance. The National Taxpayer Advocate recommends Congress address this disparity by limiting the maximum statutory penalty for a willful FBAR violation to 50 percent of the account balance for all accounts.

While the distinction between willful and non-willful violations makes sense in concept, its application can lead to unduly harsh results. If the IRS chooses to assert a violation was willful, it is very difficult for a taxpayer to prevail. One reason is because Form 1040, U.S. Individual Income Tax Return, includes Schedule B, which is titled “Interest and Ordinary Dividends” and is used by taxpayers to report such income. Schedule B contains a question at the bottom that asks whether the taxpayer has a foreign account and references the FBAR filing requirement. The IRS has argued, and some courts have agreed, that since taxpayers are presumed to know the contents of their return when they sign it under penalty of perjury, a failure to file an FBAR form is willful where a taxpayer filed a tax return that includes Schedule B (because it mentions the FBAR filing requirement).⁷ Further making it difficult for taxpayers to prevail is that courts generally have allowed the government to prove willfulness in FBAR cases by a “preponderance of the evidence,” rather than requiring the government to meet the higher standard of “clear and convincing” evidence, which is typically the standard in tax fraud cases.⁸

These practices are unfair to taxpayers. Tax forms and instructions contain a lot of verbiage, and few if any taxpayers have a complete understanding of all lines, questions, and instructions on a return or schedule – or even read them all. Additionally, it is common for individuals who have lived in foreign countries or have immigrated to the United States to maintain foreign bank accounts, and they may overlook the reporting requirement for benign reasons.

Account holders who do not file FBAR forms due to negligence, inadvertence, or similar causes are appropriately subject to penalties for non-willful violations, which have a reasonable cause exception. But they should not face uncertainty regarding possible application of the harsh penalties for willful violations. The National Taxpayer Advocate recommends Congress clarify that the IRS must prove a violation was willful without relying on the Schedule B or its instructions and must do so by clear and convincing evidence.

6 *United States v. Toth*, 33 F.4th 1, 15-19 (1st Cir. 2022), *cert. denied*, 143 S.Ct. 552 (2023).

7 Not all courts have accepted the IRS’s argument. For two recent examples discussing key cases in this area, see *United States v. Saydam*, No. 22-cv-07371-DMR, 2024, WL 3407677 (N.D. Cal. July 12, 2024) and *United States v. Nicksich*, No. 1:22-CV-02411-SCJ2024, WL 3915240 (N.D. Ga. July 8, 2024).

8 See, e.g., *United States v. Vettel*, No. 4:21CV3099, 2024 WL 2012352 (D. Neb. Apr. 11, 2024); *United States v. Reyes*, 133 A.F.T.R.2d 2024-468 (E.D.N.Y. 2024); *United States v. Garrity*, 304 F. Supp. 3d 267 (D. Conn. 2018); *United States v. Bohanec*, 263 F. Supp. 3d 881 (C.D. Cal. 2016); *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012).

RECOMMENDATIONS

- Clarify that the government has the burden to establish willfulness by clear and convincing evidence before asserting a civil willful FBAR penalty and that the government cannot meet this burden by relying on the Schedule B attached to a return.
- Remove subsection (I) in 31 U.S.C. § 5321(a)(5)(C)(i) so that the maximum statutory civil penalty for a willful FBAR violation is 50 percent of the account balance at the time of the violation.