International Reporting Penalties—What to Expect and How to Fight Them

By Igor S. Drabkin

Igor Drabkin examines the international reporting penalties. His article focuses on the FBAR and IRS Forms 8938, 3520, 3520-A and the reasonable cause defense to them.

U.S. taxpayers are required to report their worldwide income. U.S. filing requirements include various and significant reporting requirements with respect to U.S. taxpayer's interest in certain foreign financial assets, foreign bank accounts, foreign partnerships, foreign corporations and foreign trusts. Heavy penalties, civil and criminal, can be imposed on those taxpayers who fail to file required information returns, or file them inaccurately or late. What are the penalties that can apply for noncompliance with international reporting? And how to defend them?

A. FBAR Penalties

Under the Bank Secrecy Act, each U.S. person must file FinCen Form104, Report of Foreign Bank and Financial Accounts (FBAR), if:

- the person has a financial interest in, or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign country, and
- the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

A U.S. person is not prohibited from owning foreign accounts; however, significant civil and criminal penalties may apply for failures to properly file FBARs when required.[1]

Criminal penalties for FBAR violations can result in a fine of $250,000 and five years of imprisonment.[2] If the FBAR violation occurs while violating another law (such as another tax law, which is often a case) the penalties can be increased to $500,000 in fines and 10 years of imprisonment.[3]

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In addition to the possible criminal penalties, the BSA imposes substantial civil penalties for violation of the FBAR rules.[4]

The amount of the civil penalty imposed for the FBAR violations depends on the type of the violation, *i.e.,* whether such violation is willful or not. Failing to file an FBAR can carry a civil penalty of $10,000 for each non-willful violation.[5] However, if the FBAR violation is found to be willful, the penalty can be the greater of $100,000 or 50 percent of the balance in the account at the time of the violation.[6]

Moreover, the FBAR penalty applies for each violation, *i.e.,* the penalty can be imposed with respect to each unreported account for multiple years. The statute of limitations for assessment of the FBAR penalties is six years from the due date of the return.[7]

In the recent case of *C.R. Zwerner* in the U.S. District Court, S. D. of Florida,[8] the Jury determined that the taxpayer was liable for multiple FBAR penalties, agreeing with the government assessment of 50-percent penalties for three years, resulting in the FBAR penalty equal to practically 150 percent of the account balance. FBAR penalties totaled $2,241,809 with respect to an offshore account that had a high balance of $1,691,054. After the jury verdict, the taxpayer raised an argument under the 8th Amendment, arguing that such a penalty represented an Excessive Fine. This legal issue remains unresolved, however, as the parties in Zwerner settled without the District Court ruling on the constitutional question.

Internal Revenue Manual 4.26.16.4.5.3 states that the test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. A finding of willfulness under the BSA must be supported by evidence of willfulness. The burden of establishing willfulness is on the IRS. If it is determined that the violation was due to reasonable cause, the willfulness penalty should not be asserted.

Further, willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements. In the FBAR situation, the only thing that a person need know is that he has a reporting requirement. If a person has that knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR. Under the concept of "willful blindness," willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements. Willfulness can rarely be proven by direct evidence, since it is a state of mind. It is usually established by drawing a reasonable inference from the available facts. The government may base a determination of willfulness in the failure to file the FBAR on inference from conduct meant to conceal sources of income or other financial information. For FBAR purposes, this could include concealing signature authority, interests in various transactions, and interests in entities transferring cash to foreign banks.

Chart 1 summarizes the civil and criminal penalties that may be asserted for not complying with the FBAR reporting and recordkeeping requirements.

CHART 1.*

Violation	Civil Penalties	Criminal Penalties	Comments
Negligent Violation	Up to $500	N/A	31 U.S.C. § 5321(a)(6)(A) 31 C.F.R. 103.57(h).
Non-Willful Violation	Up to $10,000 for each negligent violation	N/A	31 U.S.C. § 5321(a)(5)(B)
Pattern of Negligent Activity	In addition to penalty under Code Sec. 5321(a)(6)(A) with respect to any such violation, not more than $50,000	N/A	31 U.S.C. 5321(a)(6)(B)
Willful—Failure to File FBAR or retain records of account	Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation.	Up to $250,000 or five years or both	31 U.S.C. § 5321(a)(5)(C) 31 U.S.C. § 5322(a) and 31 C.F.R. § 103.59(b) for criminal. The penalty applies to all U.S. persons.
Willful—Failure to File FBAR or retain records of account while violating certain other laws	Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation.	Up to $500,000 or 10 years or both	31 U.S.C. § 5322(b) and 31 C.F.R. § 103.59(c) for criminal The penalty applies to all U.S. persons.
Knowingly and Willfully Filing False FBAR	Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation.	$10,000 or 5 years or both	18 U.S.C. § 1001, 31 C.F.R. § 103.59(d) for criminal. The penalty applies to all U.S. persons.

*Civil and Criminal Penalties may be imposed together. 31 U.S.C. § 5321(d).

The IRS has developed and adopted Mitigation Guidelines for FBAR penalties, which provides a tiered approach to the penalties and can provide some relief to taxpayers with smaller accounts.[9] The Internal Revenue Manual directs that "... examiners are to use discretion, taking into account the facts and circumstances of each case, in determining whether a warning letter or penalties that are less than the total amounts provided for in the mitigation guidelines are appropriate."[10] The IRM reminds examiners that "[t]he sole purpose for the FBAR penalties is to serve as a tool to promote compliance with respect to the FBAR reporting and recordkeeping requirements."[11]

IRM Exhibit 4.26.16-2 establishes various levels of the penalties, based on the balance in the accounts. *See* Chart 2.

FBAR penalties may be waived for "reasonable cause." Internal Revenue Manual 4.26.16.4 provides that the IRS is supposed to use reasonable cause and good faith exception standards developed under Code Sec. 6662 and Reg. §1.6664-4.

CHART 2.*

Non-Willful (NW) Penalties	
To qualify for Level I-NW, determine aggregate balances	If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 at any time during the year, Level I – NW applies to all violations. Determine the maximum balance at any time during the calendar year for each account. Add the individual maximum balances to find the maximum aggregate balance.
Level I-NW Penalty is	$500 for each violation, not to exceed an aggregate penalty of $5,000 for all violations.
To qualify for Level II-NW, determine account balance	If Level I-NW does not apply and if the maximum balance of the account to which the violations relate at any time during the calendar year did not exceed $250,000, Level II-NW applies to that account.
Level II-NW penalty is	$5,000 for each Level II-NW account violation, not to exceed 10 percent of the maximum balance in the account during the year
To qualify for Level III-NW	If Level I-NW does not apply and if the maximum balance of the account to which the violations relate at any time during the calendar year was more than $250,000, Level III-NW applies to that account.
Level III-NW is	$10,000 for each Level III-NW account violation, the statutory maximum for non-willful violations.
Willfulness Penalties	
To qualify for Level I, determine aggregate balances	If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000, Level I applies to all accounts. Determine the maximum balance at any time during the calendar year for each account. Add the individual maximum balances to find the maximum aggregate balance.
Level I penalty is	The greater of $1,000 per violation or five percent of the maximum balance during the year of the account to which the violations relate for each violation.
To qualify for Level II, determine account balance	If Level I does not apply and if the maximum balance of the account to which the violations relate at any time during the calendar year did not exceed $250,000, Level II applies to that account.
Level II penalty is per account	The greater of $5,000 per violation or 10 percent of the maximum balance during the calendar year for each Level II account.
To Qualify for Level III	If the maximum balance of the account to which the violations relate at any time during the calendar year exceeded $250,000 but did not exceed $1 million, Level III applies to that account.
Level III penalty is per account.	The greater of (a) or (b): (a) 10 percent of the maximum balance during the calendar year for each Level III account, or (b) 50 percent of the closing balance in the account as of the last day for filing the FBAR.
To qualify for Level IV	If the maximum balance of the account to which the violations relate at any time during the calendar year exceeded $1 million, Level IV, the statutory maximum, applies to that account.
Level IV penalty is per account the statutory maximum	The greater of (a) or (b): (a) $100,000, or (b) 50 percent of the closing balance in the account as of the last day for filing the FBAR.

* Exhibit 4.26.16-2 (07-01-2008), *Normal FBAR Penalty Mitigation Guidelines for Violations Occurring After October 22, 2004* (available at http://www.irs.gov/irm/part4/irm_04-026-016.html#d0e529).

B. Information Return of U.S. Persons with Respect to Certain Foreign Corporations (Form 5471) and Certain Foreign Partnerships (Form 8865)

U.S. citizens and U.S. residents who are officers, directors, or shareholders in certain foreign corporations are responsible for filing Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Form 5471 is due with the timely filed income tax return of the affected individual, including the extensions.

In determining whether the "reasonable cause" defense exists, taxpayers and their representatives need to review all the relevant facts and circumstances.

Penalties for failure to file Form 5471 information return is established by Code Sec. 6038(a). The penalty with respect to Form 5471 equals to $10,000 for each annual accounting period of each foreign corporation for failure to furnish the required information within the time prescribed.[12] Furthermore, additional penalties apply if the information is not provided by the taxpayer within 90 days of the notification by the IRS that such information is required.[13] A $10,000 penalty (per foreign corporation) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. This additional penalty is limited to a maximum of $50,000 for each failure.[14]

The penalty may be abated for reasonable cause.[15] To show that reasonable cause exists, the person required to report such information must have filed for all open years (not on extension) and must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement. For failure to file Form 5471, the written statement must contain a declaration that it is made under the penalties of perjury.[16] Reasonable cause defense, however, does not apply to the continuation penalty.

In addition, failure to file Form 5471 or incomplete forms may result in the reduction of foreign tax credits. Any person who fails to file or report all information required within the time prescribed will be subject to a 10 percent reduction of the foreign taxes available for credit under Code Secs. 901, 902 and 960. If the failure continues 90 days or more after the date that the IRS mails notice, an additional five-percent reduction is made for each three-month period, or fraction thereof, during which the failure continues.[17]

Beginning in 2008, the IRS began automatic assessment of penalties under Code Sec. 6038(b)(1).

Additional penalties may apply for failure of U.S. persons to report transfer of property in excess of $100,000 to a foreign corporation.[18] The penalty is 10 percent of the asset value for nonintentional violations, up to $100,000, with no limitation for intentional valuations.[19] Similar penalties applied for U.S. persons who fail to report certain interests, transfers, acquisitions and disposition in foreign partnerships, which need to be reported on Form 8865.[20]

C. Statement of Specified Foreign Financial Assets (Form 8938)

Form 8938, *Statement of Specified Foreign Financial Assets,* became required beginning with the tax year 2011 under the terms of the Foreign Account Tax Compliance Act (FATCA). Certain U.S. taxpayers holding financial assets outside the United States must report those assets to the IRS, using Form 8938.[21] In summary, Form 8938 should be filed by those taxpayers whose specified foreign financial assets are more than $50,000 (for single or married filing separate) or $100,000 (if married and filing jointly) at the end of the year, or exceed $75,000 (single or married, filing separate), or $150,000 (married, filing jointly) at any time during the year.[22] These thresholds are higher for individuals residing abroad.

"Specified foreign financial assets" include financial accounts (*e.g.,* bank accounts, mutual funds, hedge funds, private equity funds) that are maintained by a foreign financial institution including financial institutions that are organized under the laws of a U.S. possession; stocks or securities issued by foreign persons; any other financial instrument or contract held for investment that is issued by foreign person or has a foreign person as a counterparty; and any interest in a foreign entity.[23]

Taxpayers may be subject to penalties if they fail to timely file a correct Form 8938 or if there is an understatement of tax relating to an undisclosed specified foreign financial asset.

A failure to file a complete and correct Form 8938 by the due date (including applicable extensions), you may be subject to a penalty of $10,000.[24] If a taxpayer does not

file a correct and complete Form 8938 within 90 days after the IRS mails a notice of the failure to file, such taxpayer may be subject to an additional penalty of $10,000 for each 30-day period (or part of a period) during which you continue to fail to file Form 8938 after the 90-day period has expired. The maximum additional penalty for a continuing failure to file Form 8938 is $50,000.[25]

In addition, underpayment of tax as a result of a transaction involving an undisclosed specified foreign financial asset, may be subject to a penalty equal to 40 percent of that underpayment.[26]

The IRS provides the following examples of underpayments due to transactions involving an undisclosed specified foreign financial assets:

- Taxpayer does not report ownership of shares in a foreign corporation on Form 8938 and Taxpayer received tax distributions from the company that you did not report on your income tax return.
- Taxpayer does not report ownership of shares in a foreign company on Form 8938 and Taxpayer sold the shares in the company for a gain, failing to report the gain on income tax return.
- Taxpayer does not report a foreign pension on Form 8938 and Taxpayer received a taxable distribution from the pension plan that Taxpayer did not report on your income tax return.

If underpayment of tax is due to fraud, Taxpayer must pay a penalty of 75 percent of the underpayment due to fraud.[27]

Reasonable cause exception also applies to Form 8938 violations.[28] If the failure to report the information required in Code Sec. 6038D(c) and Temporary Reg. §1.6038D-4Tis shown to be due to reasonable cause and not due to willful neglect, no penalty will be imposed under Code Sec. 6038D(d) or this section.[29]

Form 8938 also has a "Duplicative Reporting" exception.[30] If Specified Foreign Financial Assets are reported on one or more of following forms for same tax year, then the taxpayer does not have to report them on Form 8938:

- Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*
- Form 5471, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*
- Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*
- Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*

However, in order for the exception to apply, Form 8938 must identify Form on which SFFA reported, and quantity of this form filed.

One important change that was effectuated by FATCA and enactment of Code Sec. 6038D and Form 8938 is the change to the statute of limitations for assessment under Code Sec. 6501. Under the new rules, the statute of limitations is extended to six years after a taxpayer's return is filed if the taxpayer omits $5,000 from gross income attributable to a specified foreign financial asset, without regard to the reporting threshold or any reporting exceptions.[31] If the taxpayer fails to file or properly report an asset on Form 8938, the statute of limitations for the tax year is extended until the taxpayer provides the required information.[32] If the failure is due to reasonable cause, the statute of limitations is extended only with regard to the item or items related to such failure and not the entire tax year.

Penalties for failure to comply with the reporting requirements related to foreign assets and accounts can be onerous.

D. Form 3520 and Form 3520-A

U.S. taxpayers are required to file information returns with respect to certain foreign trusts. Failure to file such information returns, Form 3520 and Form 3520-A, may be subject to penalties under Code Sec. 6677.

Failure to report transactions involving foreign trusts on Form 3520 can result in the amount of 35 percent of the gross value of the distributions received from a foreign trust or transferred to a foreign trust.[33] With respect to failure to report certain foreign gifts, the penalty is imposed in the amount of five percent per month, up to 25 percent of the gift amount.[34] Failure to report ownership interests in a foreign trust with U.S. owner on Form 3520-A can result in a penalty of $10,000 or four percent of the gross value of the trusts' assets.[35]

Similar to other penalties, Form 3520 and 3520-A penalties may be waived for reasonable cause.[36] The fact that disclosure is a crime in another country is not considered reasonable cause.

E. Reasonable Cause Defense

As discussed above, most of the penalties related to compliance with foreign accounts and assets can be waived or abated for reasonable cause. In determining whether

reasonable cause and good faith exists, the IRS will use standards developed under Code Sec. 6662 and Reg. §1.6664-4.

An exception to the Code Sec. 6662(a) penalty is set forth in Code Sec. 6664(c)(1) and reads: "No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." Regulations interpreting Code Sec. 6664(c) state:

> The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Treas. Regs. §1.6664-4(b)(1). The determination of whether the taxpayer acted with reasonable cause and in good faith depends on the pertinent facts and circumstances, including the knowledge and experience of the taxpayer and the reliance on the advice of a professional, such as an accountant. Sec. 1.6664-4(b)(1), Income Tax Regs.

In determining whether the "reasonable cause" defense exists, taxpayers and their representatives need to review all the relevant facts and circumstances. The following factors may be helpful in this analysis: good faith; ordinary care and prudence; reasonable reliance on a professional advice; first time mistake; sufficient disclosure on return; education and sophistication of taxpayer; out of ordinary circumstances, such as death, illness or injury of the taxpayer, a natural disaster, fire or other emergency.[37]

F. Conclusion

Penalties for failure to comply with the reporting requirements related to foreign assets and accounts can be onerous. Taxpayers and tax professionals are encouraged to familiarize themselves with the rules and requirements imposed by the Internal Revenue Code and Bank Secrecy Act to avoid criminal or civil exposure for lack of compliance.

ENDNOTES

1 31 USC §§5321, 5322.
2 31 USC §5322(a).
3 31 USC §5322.
4 31 USC §5321.
5 31 USC §5321(a)(5)(B).
6 31 USC §5321(a)(5)(C).
7 31 USC §5321(b).
8 *C. Zwerner, Civil Docket Case #1:13-cv-22082-CMA.*
9 *See* IRM 4.26.16.4.5 (July 1, 2008).
10 IRM 4.26.16.4.4(3) (July 1, 2008).
11 IRM 4.26.16.4.4(3) (July 1, 2008).
12 Code Sec. 6038(b)(1).
13 Code Sec. 6038(b)(2).
14 Code Sec. 6038(b)(2).
15 Code Sec. 6038(c)(4).
16 IRM 20.1.9.4.5.
17 *See* Code Sec. 6038(c)(2).
18 Code Sec. 6038B.
19 Code Sec. 6038B(c).
20 Code Secs. 6038, 6038B and 6046A.
21 Code Sec. 6038D.
22 Code Sec. 6038D(a); Temporary Reg. §1.6038D-2T(a)(1).
23 Code Sec. 6038D(b); Temporary Reg. §§1.6038D-1T(a)(6), 3T(a)(2).
24 Code Sec. 6038D(d)(1).
25 Code Sec. 6038D(d)(2).
26 Code Sec. 6662(j)(3).
27 Code Sec. 6663.
28 Code Sec. 6038D(g).
29 Temporary Reg. §1.6038D-8T.
30 Temporary Reg. §1.6038D-7T(a).
31 Code Sec. 6015(e).
32 Code Sec. 6015(c)(8).
33 Code Sec. 6677(a) and (b).
34 Code Sec. 6039F.
35 Code Secs. 6048(b) and 6677.
36 Code Sec. 6677(d).
37 Reg. §1.6664-4(a) and IRM 20.1.5.6.1.