Cross-Border Banking and Out-of-this-World Penalties

A United States citizen or resident that owns (or has signatory authority over) an account at a foreign bank with a value in excess of $10,000 annually must file a Report of Foreign Bank and Financial Account (or "FBAR") with the Treasury Department. The FBAR is separate from – and in addition to – any duty to report foreign income on regular income tax returns.

FBAR enforcement efforts have slowly been escalated over the past decade or so. First, the penalties for non-filing were significantly increased. Second, foreign banks are now being forced to disclose information about U.S. account holders. These efforts have significantly enhanced risks for taxpayers with unreported foreign accounts.

What's at Stake?

Taxpayers with delinquent FBAR filing obligations have a lot to lose.

For starters, penalties for a "non-willful" failure to file may be as high as $10,000 per violation, per year. However, the IRS generally will not assess multiple FBAR penalties for a given year in which a taxpayer holds multiple unreported accounts. In addition, this penalty may be waived or reduced if the IRS determines that the violation was due to "reasonable cause" or other factors.

Taxpayers who are found to have "willfully" violated the FBAR provisions face even stiffer fines; maximum penalties are equal to the greater of $100,000 or 50% of the highest aggregate balance of the account per year. The IRS has generously ruled in internal guidance that this penalty should in no event exceed 100% of the highest aggregate account balance over the period under examination. To the extent an account has declined in value over the noncompliance period, though, the penalty under the standard may easily exceed the current balance. This is a real possibility considering recent market headwinds at the start of 2016.

How willful is "willful"? The answer is not clear, but recent case developments indicate that "willfulness" in this context may be lower than many other intent-based penalty provisions found in the Internal Revenue Code.

Taxpayers facing criminal charges can be hit with additional penalties of up to $250,000 and/or five years in prison. It should also be noted that all FBAR-related penalties are on top of whatever income tax liability that a taxpayer may have associated with unreported foreign accounts, which depending on the nature of the accounts, may be significant.

Is there any other way to fix this?

Taxpayers have a few different options in trying to clear up FBAR noncompliance without facing criminal liability or confiscatory penalties. Although the particular program details are continuously being updated, the Offshore Voluntary Disclosure Program ("OVDP") terms have largely remained the same since in 2012.

The OVDP offers taxpayers an opportunity to avoid the top of the FBAR penalty spectrum, but participation carries a hefty flat-rate price. Taxpayers can expect a flat FBAR penalty equal to 27.5% of the highest-aggregate account balance of unreported foreign accounts over a mandatory eight-year disclosure period. In the event the foreign account was maintained at a bank already under IRS scrutiny, the penalty increases to 50%. The look-back period under the OVDP also extends liability for unreported income associated with the account to eight years, whereas the statute of limitations would usually be shorter.

An alternative "Streamlined" disclosure program offered by the IRS features a 5% account balance FBAR penalty, and calls for a shorter three-year disclosure period for income taxes due. Although at first blush the lower penalty appears enticing, the Streamlined disclosure program has some significant limitations. Among many drawbacks is the fact that a Streamlined filing by a taxpayer will not result in a binding closing agreement, potentially leaving FBAR issues open after the disclosure has been made. The lack of certainty as to resolution is compounded by the fact that at the early stages a taxpayer surrenders what is likely their most valuable piece of leverage; their identity as an anonymous foreign account holder.

The Streamlined filing critically requires a taxpayer to explain the specific reasons for the failure to report any foreign accounts and certify under penalty of perjury that the conduct was “non-willful.” As noted earlier, considering that the definition of “willful” in the FBAR reporting context is judicially unsettled, unless a taxpayer has a very good reason for not reporting a foreign account, the decision to participate in the Streamlined program should be carefully analyzed by a taxpayer and his or her tax advisor.

Other Considerations

Taxpayers who have unreported foreign bank accounts need to weigh all options carefully before acting. For example, just closing a foreign bank account may seem like a viable resolution to avoid continuing FBAR liability, but this act itself may inadvertently trigger reporting by the foreign bank (and scrutiny by the IRS). Similarly, since OVDP and the Streamlined process are not available to taxpayers who are already under examination, a “wait and see” approach may further reduce options. For this reason, it is advisable to have a plan in place before making any decisions with respect to resolving FBAR compliance issues.

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