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International Tax ADVISORY ■

DECEMBER 16, 2019

Federal Circuit Court of Appeals Weighs In on Willful FBAR Penalties

For the past few years, taxpayers and the IRS have been battling in court over whether the maximum amount of willful failure penalties for FBAR violations is (1) $100,000, as provided in a 1987 regulation; or (2) the greater of $100,000 or 50 percent of the account balance, as provided in a 2004 amendment to the Bank Secrecy Act (BSA). Lower courts have split on the question, but a recent decision by the U.S. Court of Appeals for the Federal Circuit ruled in favor of the IRS, declaring the BSA's penalty provision controlling.

The BSA gives the Department of the Treasury authority to collect information from U.S. persons who have financial interests in, or signature authority over, financial accounts in non-U.S. financial institutions. To this end, U.S. persons are required to report such financial interest or signature authority on FinCEN Form 114 (the foreign bank account report or FBAR) if certain conditions are met.

As amended in 2004, the BSA provides that the Treasury may impose civil penalties for FBAR violations and that in the case of willful violations, the maximum penalty "shall" be increased to the greater of $100,000 or 50 percent of the account balance. However, regulations promulgated under the BSA (but predating the 2004 amendment) provide that the Treasury may assess a willful FBAR penalty of $25,000 or up to the balance of the account but no greater than $100,000.

In *United States v. Colliot* (W.D. Tex. 2018), the IRS asserted FBAR penalties of more than $500,000 for a taxpayer's failure to report four accounts in one year. The taxpayer argued that the penalties should be reduced because they exceeded the regulatory cap of $100,000. The taxpayers in *United States v. Wahdan* (D. Colo. 2018), facing similarly large penalties, including some equal to half of the unreported account balances, made a similar argument. In both cases, the IRS countered that the BSA, as amended in 2004, should prevail over the inconsistent regulation.

The courts sided with the taxpayers in both *Colliot and Wahdan*, reasoning that the BSA grants the Treasury discretion in assessing FBAR penalties. To those courts, the regulation and its non-amendment after the 2004 statutory change represent the Treasury's exercise of its delegated authority consistent with the BSA. The court in *Wahdan* refused to assume that the Treasury had just "overlooked the differences" between the statute and the regulation for 14 years.

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But the Court of Federal Claims in *Norman v. United States* (2018) and *Kimble v. United States* (2018) sided with the IRS, concluding that the statutory provision prevailed over the regulation and upholding penalties in excess of the regulatory cap. The court analyzed the language of the statute before and after the 2004 amendment. Prior to the amendment, the statute provided that the Treasury "may" impose a civil penalty for willful FBAR violations and capped the penalty amount at $100,000. As amended, the statute still provides that the Treasury "may" impose civil penalties; however, in the case of willful violations, the statute provides that the penalties "shall" be increased to the greater of $100,000 or 50 percent of the account balance.

In *Norman*, the court found the amended statutory language to be unambiguous as supported by its view that Congress intended the penalties for willful violations to be increased. It observed that the *Colliot* court had relied on the general language vesting the Treasury with "discretion" to determine FBAR penalties but ignored the specific 2004 statutory mandate that in the case of willfulness, the penalty "shall" be increased to the greater of $100,000 or 50 percent of the account balance. In other words, once the Treasury exercised its discretion to impose a penalty, it had to abide by the penalty amount prescribed in the statute in the case of willful violations. Because *Norman* involved willful violations, the statute superseded the regulation.

In *Kimble*, the court also noted that Internal Revenue Manual Section 4.26.16.4.5.1 (issued in 2008) expressly indicated that the existing regulatory cap on willful FBAR penalties had not been amended to reflect the amended statute's new penalty ceiling and warned that the statute was self-executing. The court also found the decisions in *Colliot* and *Wahdan* in conflict with the Federal Circuit's decision in *Barseback Kraft AB v. United States* (1997). In *Barseback*, the court held that an agency's regulations for certain contracts were not binding after Congress subsequently transferred responsibility for such contracts to a new agency – even though the old regulations were not formally withdrawn. Citing *Norman*, the *Kimble* court concluded that the regulatory cap was no longer valid because the 2004 amendment to the BSA essentially nullified the inconsistent regulation under the pre-2004 law.

The taxpayer in *Norman* appealed to the Federal Circuit, arguing that the lower court erred in finding that the amended law superseded the regulation. But the appellate court affirmed the lower court's decision. The Federal Circuit flatly rejected the taxpayer's position that a regulation is valid until it is withdrawn, a position that would otherwise prevent any amended statute from taking effect until any preexisting inconsistent regulations were amended or withdrawn. Moreover, the court held that the later-in-time statute's use of the word "shall" removes the IRS's discretion to set the amount of willful FBAR penalties and thus makes the regulatory cap invalid as it is no longer consistent with the statute. The law's use of the word "may" in connection with the imposition of FBAR penalties is intended, in the appellate court's view, to give the IRS discretion only as it pertains to the threshold question of whether to impose an FBAR penalty at all in any particular case. But once the IRS determines to impose a willful FBAR penalty, the statutory penalty scheme must apply.

While the appellate court decision is binding only on lower courts in the Federal Circuit, it does not bode well for taxpayers hoping to limit their FBAR penalties under the regulation. Now we wait to see if a circuit split develops – or if the Treasury ever gets around to changing or withdrawing its regulation altogether.

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