MARCH 22, 2023

Federal Courts Weigh in on the FBAR: Providing Relief from Outrageous Penalties

Authors: Zachary C. Kling, Jennifer Lee, Peter Glicklich and Michael H. Lubetsky

In this bulletin, we highlight two recent federal court cases in which U.S. taxpayers won major victories against the United States with respect to their obligations to report non-U.S. accounts on *FinCEN Form 114 – Report of Foreign Bank and Financial Accounts*, more commonly referred to as the FBAR. An individual U.S. taxpayer must file an FBAR for each year in which the taxpayer has a financial interest in, or signature authority over, foreign financial accounts if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year. In *Bittner v United States*, the Supreme Court of the United States (SCOTUS) addressed the extent to which the IRS can impose penalties for the failure to timely file complete and accurate FBARs. In *Aroeste v United States*, the United States District Court for the Southern District of California issued a decision interpreting a relatively new provision of the United States Internal Revenue Code (Code) that, under the Court's interpretation, allows certain resident aliens not to file FBARs for years in which they qualify for certain treaty benefits. We discuss each of these important decisions in turn.

Bittner v United States

In *Bittner v United States*, SCOTUS settled the question of the appropriate method of calculating strict liability penalties for the failure to timely disclose reportable accounts on an FBAR. Specifically at issue in *Bittner* was whether the $10,000 penalty for nonwillful failure to timely report accounts on an FBAR applies on a *per form* basis or on a *per account* basis. The difference can be enormous, as the litigant Alexandru Bittner discovered. Mr. Bittner is a dual resident of the United States and Romania and a successful businessman who had reportable interests in up to 61 accounts in Romania from the time when he lived and worked there before returning to the United States. His case did not involve any allegation of willful misconduct (which would have entailed a different set of much harsher penalties). Rather, upon his return to the United States, he consulted accountants to get himself up to date with his U.S. tax filings, which he did not keep up with while living abroad. As part of his effort to comply, he filed FBARs for each of the years from 2007 to 2011, but they were deemed deficient by the IRS for failing to disclose all accounts. Mr. Bittner filed corrected FBARs reporting all his accounts for each of the years 2007 to 2011 and found himself hit with $2.72 million of strict liability FBAR penalties for his trouble ($10,000 each for his collective 272 failures to timely report a foreign account).

The U.S. circuit courts that had ruled on this issue had split on how FBAR penalties should be calculated. The Ninth Circuit had endorsed the per form approach, which would result in the imposition of an aggregate $50,000 penalty in Mr. Bittner's circumstances. However, the Fifth Circuit, from which Mr. Bittner's appeal was heard, had endorsed the per account approach the IRS took in assessing $2.72 million in penalties against Mr. Bittner.

SCOTUS Decision

In a 5-4 decision featuring some unusual alliances among the justices, the Court endorsed the per form approach taken by the Ninth Circuit. The majority's opinion was penned by Justice Gorsuch and was joined in full by Justice Jackson and in part by Justices Roberts, Alito and Kavanaugh. The majority anchored its analysis in the wording of the penalty provision at issue, which uses different language from that in the provision of the law that clearly provides for per account penalties in the case of willful failures to report. IRS publications in which the service had repeatedly suggested FBAR penalties would not exceed $10,000 per form were also highlighted by the majority as support for their interpretation of the statute. In addition, the Court injected a healthy degree of common sense into its analysis by inspecting the incongruities that would be caused in certain circumstances were the government's position adopted:

> Consider someone who has a $10 million balance in a single account who nonwillfully fails to report that account. Everyone agrees he is subject to a single penalty of $10,000. Yet under the government's theory, another person engaging in the same nonwillful conduct with respect to a dozen foreign accounts with an aggregate balance of $10,001 would be subject to a penalty of $120,000.
>
> On the government's view, too, those who *willfully* violate the law may face lower penalties than those who violate the law *nonwillfully*. For example, an individual who holds $1 million in a foreign account during the course of a year but withdraws it before the filing deadline and then willfully fails to file an FBAR faces a maximum penalty of $100,000. But a person who errs nonwillfully in listing 20 accounts with an aggregate balance of $50,000 can face a penalty of up to $200,000. Reading the law to apply nonwillful penalties per report invites none of these curiosities; the government's per-account theory invites them all [internal citations omitted].

A section of the majority opinion also invoked the principle that statutes imposing penalties are to be strictly construed with any ambiguity resolved against the government and in favour of individuals. However, this section of the majority opinion was joined only by Justices Gorsuch and Jackson, indicating that the rest of the majority understood the statute to be clear on its face and were satisfied by the statutory interpretation or, perhaps, that they were unwilling to further endorse such principle in the context of a tax-penalty case.

A rather unlikely group of four justices, led by Justice Barrett who was joined by Justices Thomas, Sotomayor and Kagan, disagreed with the majority's analysis and filed a dissent. In the dissent, Justice Barrett notes that the law requires U.S. citizens and residents to file "reports" on each of their foreign bank accounts in a manner prescribed by the Secretary and also allows the Secretary to impose a $10,000 penalty for failing to file a report. According to the dissent's interpretation of the statutory provisions at issue, the FBAR is not a single "report," but rather a "form" that may include many reports. Luckily for Mr. Bittner, however, this analysis did not prevail.

The decision is certainly a major relief for Mr. Bittner, but is also a major victory for U.S. taxpayers with financial ties to other countries. Most taxpayers do their best to comply with their FBAR reporting obligations, but can do so only if they are aware of the need to make such reports. Further, even if a person is aware of the need to file an FBAR, they do not always have all the information necessary to timely disclose each account – whether because the account was unknowingly inherited by them or they were signatories over accounts of which they were not aware, neither situation being all that uncommon. The Court's approach is a welcome limit to the government's authority to penalize taxpayers for such nonwillful failures. While $10,000 is still a stiff penalty, it is far better than the draconian penalties, potentially many multiples of $10,000, that taxpayers previously faced for unwittingly failing to timely disclose foreign accounts on an FBAR.

Aroeste v United States

Aroeste v United States addressed the question whether tax treaty residency affects whether a person who is otherwise a U.S. person for federal tax purposes has an FBAR filing obligation. Only U.S. persons (i.e., U.S. citizens and residents) are required to file an FBAR, a requirement imposed by the *Bank Secrecy Act* (BSA) and codified separately from the tax law. However, regulations under the BSA define a "resident of the United States" by reference to section 7701(b) of the Code and the regulations thereunder defining a "resident alien." Under section 7701(b), a "resident alien" includes a lawful permanent resident of the United States (more commonly referred to as a "green card holder"). Section 7701(b)(6), however, provides that a person will not be treated as a permanent resident (and thus a resident alien) in any year in which the person "commences to be treated as a resident of a foreign country under provisions of a tax treaty between the United States and the foreign country, the individual does not waive the benefits of such treaty applicable to residents of the foreign country, and the individual notifies the Secretary of the commencement of such treatment." This section of the Code was intended to cause the U.S. departure tax to apply to long-term green card holders who claim such treaty benefits. This case is the first in which a court has ruled on the section's application in the context of being a U.S. person for purposes of the FBAR.

The United States argued that the plain language of section 7701(b)(6) should be disregarded for purposes of imposing FBAR penalties. The government argued that "Mr. Aroeste's status under the Treaty [was] irrelevant because the Treaty solely concerns residency for purposes of income tax and excise tax assessments under Title 26 of the United States Code, whereas FBAR penalties are assessed under Title 31." However, Mr. Aroeste asserted that "if [he] was treated as a Mexican resident under the Treaty, that fact would disqualify him from being counted as a 'United States person' under the FBAR regulations" because section 7701(b)(6) would cause him not be a resident alien under the Code and thus the FBAR regulations.

The District Court did *not* decide that Mr. Aroeste was in fact not required to file an FBAR in any given year. Its ruling was limited to concluding that he would not be a lawful permanent resident or resident alien within the meaning of section 7701(b) *if* he was treated as a resident of Mexico under the treaty (and met the other requirements of section 7701(b)(6)) in a given year, and, accordingly, would not have been required to file FBARs for those years. Specifically, the Court held that "Mr. Aroeste's tax residency under the Treaty is directly relevant to – indeed is outcome determinative of – the issue whether he was required to file the FBARs at issue."

Although the United States may yet appeal the decision and ultimately succeed, the Court's analysis in *Aroeste* is persuasive and seemingly apparent from a plain reading of the relevant statutes and regulations. So, while the outcome of the case is promising for affected taxpayers and provides authority for them to potentially claim relief from FBAR filing, taxpayers should tread cautiously in relying on the case to forgo filing their FBARs because other districts could endorse the government's interpretation. In addition, the regulations under section 7701(b) provide that claiming residency under a tax treaty results in a person treated as not a resident alien only for purposes of computing the person's U.S. income tax (i.e., not for other information reporting required under the Code). Green card holders who claim non-U.S. residency under a treaty should consult their advisers to determine the applicability of the *Aroeste* ruling to their particular situations.

Conclusion

While these cases provide valuable relief, U.S. taxpayers with international ties still have a heavy compliance burden, with significant penalties associated with any failures. Failure to file a timely and accurate FBAR still carries a $10,000 penalty. In addition, dual-resident taxpayers who claim treaty residency in a foreign country may still have an obligation to file other international information reports, including Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, which carries $10,000 penalties if not timely and accurately filed with the IRS. Accordingly, taxpayers should continue (or begin) working with their advisers to comply with their U.S. international information-reporting obligations or risk significant penalties.

Key Contacts: Jennifer Lee, Elie Roth and Rhonda Rudick