Paperwork and Punishment: It's Time to Fix FBAR

by Allison Christians

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The foreign bank account report is part of a regime designed to stop terrorists, money launderers, and tax evaders. Unfortunately, its increasingly draconian requirements and consequences now apply to millions of innocent bystanders who are collateral damage in the ongoing battle against financial crime. Their inclusion in the FBAR regime is a massive waste of both government and taxpayer resources, effectively criminalizing activities that are wholly unconnected to financial crime, and perversely, discouraging compliance. All of this is unnecessary because as the administrator of FBAR, the Treasury Department can immediately fix the problems. The difficulty is that FBAR is still relatively obscure to those not caught in its grasp, and the extent of the damage it is doing to U.S. taxpayers and to the integrity of the tax system is not fully appreciated. This damage is real, but it can be reversed by refocusing FBAR where Congress intended: on likely criminal activity. In short, the FBAR regime is broken and it is time for Treasury to fix it.

The Trouble With FBAR

FBAR came about in connection with the Bank Secrecy Act, a law passed in 1970 to counter money laundering and related criminal financial activities. It is widely acknowledged that the regime was not widely enforced until Congress amended the law in 2004, when it tied FBAR to ongoing and rapidly expanding counterterrorism efforts. Owing in part to this mission creep, and partly to simple neglect of basic technical niceties such as inflation adjustment, FBAR's impact has significantly broadened over the years, and it is now poised to inflict massive penalties on millions of individuals who should never have been in its sights. They have been brought into the regime not because they are likely financial criminals, money launderers, or terrorists, but merely because they live outside the United States.

FBAR is especially troublesome because it is as obscure as it is far-reaching, creating a trapdoor to harsh punishment even when there is no underlying crime to be detected. An individual must file an FBAR, separate and apart from any income tax filing, if at any time, even if only for a moment, the combined value of her non-U.S. checking, saving, retirement, and any other accounts reaches just $10,000. That number was set by the IRS in 1970 and never adjusted for inflation. Had it been so adjusted, the threshold would be closer to $60,000 today. At $10,000, the FBAR threshold is lower than the annual income tax filing thresholds for most taxpayers, which topped out at $22,400 last year. With such a low threshold, most individuals living permanently outside the United States who must file annual tax returns will also have to file an FBAR at some point, and likely will do so regularly. This means every one of these individuals is viewed as a potential terrorist in the eyes of federal regulators.

The overwhelming majority of these individuals own foreign bank accounts not because they are likely financial criminals, but rather very clearly because they live, study, and work in foreign countries. Most bank where they live. Many do not bank in the United States because they do not have any reason to do so, others because U.S. banks increasingly shy away from holding accounts for average-income nonresident persons, even if they are U.S. citizens. For American students studying abroad, a tuition scholarship simply passing through an account could easily trigger FBAR. For those whose connection to the United States is no more than an accident of birth, the idea that their everyday transactions in a neighborhood bank account could be considered a matter of U.S. national security would be laughable if it was not such a startling and distressing revelation.

Anecdotal evidence suggests that even individuals who have long been fully compliant annual tax filers have failed to file FBARs simply because they did not know about them, and neither Treasury nor the IRS has undertaken an effective educational campaign to inform them. For the vast majority of these taxpayers, FBAR noncompliance constitutes nothing but a paperwork crime: There is no underlying or associated criminal intent or activity. They simply did not conceive that anyone would view their normal, everyday banking as indicia of serious criminal intent. FBAR now inverts this perspective, but little has been done to inform the growing population of affected individuals. Given that the majority of annual income tax filers pay higher taxes where they live and therefore end up owing little or no U.S. tax after credits, innocence about the significance of FBAR can hardly be surprising. Certainly it does not deserve harsh sanction.

For those who become aware of their FBAR obligation, the filing experience is alarming, to say the least. The home of the FBAR is the Financial Crimes Enforcement Network, whose mission is to collect, analyze, and disseminate information that would be useful for law enforcement investigations involving serious financial crimes. Treasury describes FinCEN as the ''Financial Intelligence Unit of the United States.'' Filling out an FBAR currently requires visiting the FinCEN website, where the compliant taxpayer encounters messages about illicit financial flows, money laundering, and national security. The taxpayer must input extensive personal information, obtain an identification number that is separate and distinct from one's taxpayer identification number (normally a Social Security number), and navigate an online-only form that is characterized by known technical issues, including incompatibility with standard computer operating systems and software programs.

Beyond the criminal stigma associated with entering oneself in a crime enforcement registry, the basic mechanics of the FBAR filing experience create unnecessary worry. The odd format makes it difficult to save and review previously filed forms; in some cases, a saved document, reopened, is blank again. Unable to review and print, some taxpayers cannot be confident that what was input is what the IRS sees upon receipt. Finally, there is no verification from the IRS that the information has been received intact and deemed accurate. The taxpayer has little choice but to hope that all is well, until notified otherwise, in which case, fear — and penalties — can mount quickly.

Little Room for Error

The FBAR penalty structure is harsh at best and tremendously unfair at worst. An FBAR failure or mistake attracts a one-size-fits-all punishment, which rapidly escalates according to a formula that is known only to the IRS. The instructions claim that a taxpayer can avoid penalties by showing a ''reasonable cause,'' but they also state that a ''non-willful'' mistake or failure carries a $10,000 penalty, regardless of the amount of money actually at stake. Willfulness is not adequately defined, but it includes intentionally failing to learn about the FBAR. There is precious little guidance to be had outside of anecdotal experience conveyed by compliance professionals.

If the taxpayer is found willful — which might even include willful blindness — FBAR penalties rise dramatically and can ultimately include criminal liability. The Tax Court has determined it lacks jurisdiction to resolve FBAR disputes, and FBAR penalties cannot be discharged in bankruptcy. Penalties could apply if a person fails to file an FBAR, fills it out incompletely or incorrectly, fills it out on paper, or submits it past the deadline. The punishments appear to apply even to minors: The instructions state that ''Generally, a child is responsible for filing his or her own FBAR report.'' There are no extensions for most FBAR filings, very few exceptions, and no way to fix past mistakes without fear of penalty.

The potential punishment for even innocent and inconsequential FBAR mistakes is so excessive relative to the crime that the National Taxpayer Advocate has repeatedly called for review and reform. Indeed, accidentally failing to timely and accurately report an account with just $50 in it ostensibly earns the exact same punishment as accidentally failing to timely and accurately report an account with $500 million. Nonwillful penalties are just that — imposed regardless of the context.

It cannot be noted without irony that for a regime created to catch hard-core financial criminals, FBAR now criminalizes something we would hardly consider a serious crime — namely, a paperwork mistake. Yet this is the reality of FBAR for many individuals today.

The 'American' Taxpayer: Myth and Reality

The fact that FBAR has ended up as a front line of attack against terrorism suggests that lawmakers imagine that ''ordinary Americans'' are unaffected by this regime. They may be working under the assumption that international financial rules only apply to sophisticated and wealthy elites, foreigners, and criminals. This is very clearly not the case. FBAR's gradual expansion or mission creep arguably results from a basic incompatibility between reality and an everyday vision that lawmakers and others appear to have of the U.S. taxpayer as an American residing within the 50 states. Rule writers often appear to forget that regulating on the basis of citizenship affects millions of average-income persons living ordinary, law-abiding lives permanently in other countries.

Consider that in a review of the FBAR regime in 1996, Treasury estimated that just 150,000 individuals were then subject to reporting. In hindsight, that seems like a significant underestimate, given that just three years later the Bureau of Consular Affairs estimated the population of U.S. persons residing permanently outside the United States at about 3.8 million. With such a low filing threshold, the vast majority would have likely fallen within the FBAR reporting requirements at some point, and likely repeatedly. Now that population is estimated to be 6 million to 7 million and could be even higher, so the FBAR target population is also commensurately broader.

Adding insult to injury, much of the information required on the FBAR form is duplicative of IRS forms that nonresident U.S. persons already must file, including Form 8938, ''Statement of Specified Foreign Financial Assets.'' These forms are so duplicative that the IRS even has a comparison chart on its website to help taxpayers navigate the two nearly — but not quite — identical sets of obligations. The Government Accountability Office issued a report (GAO-12-403) two years ago documenting the duplication and noting that it unnecessarily ''increases the compliance burden and adds complexity that can create confusion, potentially resulting in inaccurate or unnecessary reporting.'' Treasury has not explained its rationale for extracting redundant information from individuals who are trying to comply with an already burdensome paperwork requirement. Even if such a rationale exists, there can be no justification for using a separate filing system that unfairly labels this population of taxpayers as suspected criminals who may constitute a threat to national security.

Fixing FBAR

It wasn't always this way for FBAR. When it was first adopted, Treasury's instinct was to integrate foreign account reporting with the annual federal tax filing regime. The IRS created Form 4683, and then included a line in the 1040 very clearly instructing taxpayers to fill out this new form if they had any foreign accounts. Form 4683 instructed the taxpayer to avoid redundant reporting of information that she provided elsewhere in her return. In the intervening years, FBAR has transformed from this integrated system — targeted to a narrow and specific population, involving a clearly understandable and easy route to compliance — to a regime that is the polar opposite in every respect. This transformation has massively diluted Treasury's ability to identify criminal activity, and now many individuals are being punished for paperwork crimes where there are no grounds for suspicion of any actual criminal activity. There must be a better way.

As I argued two years ago in this column, a same-country exception is one appropriate and workable solution for many (not all) permanently overseas U.S. persons. (Prior analysis: *Tax Notes Int'l*, July 9, 2012, p. 157.) An individual's neighborhood checking account is simply not an appropriate FBAR target. It is equivalent to a domestic account and can safely be treated as such. After all, it is only by including citizenship in the definition of residence that the United States deems nonresident individuals to actually reside within the 50 states; by the same token, it would be simple and sensible to deem their local accounts to reside here, as well.

Exempting accounts in the taxpayer's country of actual residence is a partial and imperfect solution to be sure, and ideally it is temporary, pending the long-overdue adoption of residence as the proper basis for personal income taxation in the United States. But a same-country exception would at least remove the unwarranted stigma of criminality, not to mention the byzantine filing burden, for a large number of nonresident U.S. persons who simply wish to comply with their annual tax filing obligations.

Nongovernmental organizations representing overseas U.S. persons have picked up on this idea and have suggested it to lawmakers. To date, no legislation has been proposed. But Treasury could very clearly effect the necessary reforms immediately under the express terms of its statutory authority to implement FBAR. The law plainly conveys Congress's intent that this regime avoid undue burdens on people who are unlikely to be engaged in financial crimes, and provides that Treasury can exempt groups of persons, categories of accounts, and even countries, from FBAR's reach.

Beyond adopting appropriate exemptions, the most effective way to address many FBAR issues would be to reintroduce it into the regular tax compliance channel, going back to its roots and reintegrating it into the annual tax filing regime. Treasury could eliminate FBAR as a separate form and merge its information requirements into existing tax forms. In the alternative, the FBAR form could be reintegrated into the 1040 schedules.

In integrating FBAR, it is clear that the criminal stigma should be removed for the millions of taxpayers now exposed to this regime, that thresholds should be raised significantly to focus the target appropriately, that penalties should be made proportionate to offenses, and that deadline and other exceptions should be allowed as appropriate due to exceptional circumstances. At a bare minimum, the IRS should make the form available as a regular PDF on its website like all the other tax forms, accepting that some people still file on paper (as is their right), and having a link so people who choose to e-file can do so.

If national security truly requires that almost every U.S. person living overseas file an FBAR, then the benefits that would accrue from normalizing the regime are clear. Like the income tax, the less onerous the paperwork for bank account reporting, the greater compliance can be expected from most taxpayers (who are law abiding) and the more enforcement resources can be reserved for addressing behavior that is actually criminal.

U.S. persons living permanently in other countries may disagree with the U.S. policy of taxing citizens on a global basis. A harsh regime that involves extensive and duplicative financial reporting with a criminal stigma attached is a recipe for deepening resentment. If the United States takes the sensible route in adopting residence-based taxation, the extreme cost of FBAR filing, measured in dollars and time spent as well as an increasingly fragile taxpayer morale, will disappear along with millions of unnecessary annual returns showing no tax owing. This will free up scarce administrative resources, allowing the IRS to turn its focus where it belongs: on those who are determined to cheat and evade the system to the detriment of everyone. Until then, it is in the interest of all taxpayers, the IRS, and the income tax as a whole that FBAR compliance be a normal rather than criminal experience, and that it be no more difficult than is absolutely necessary. ◆