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Legal Sidebar

Is the Penalty for Failing to Report Overseas Accounts (FBAR) Unconstitutional?

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Under the Bank Secrecy Act, U.S. persons with a financial interest in or signature authority over foreign bank accounts and other financial accounts may be required to file a Report of Foreign Bank and Financial Accounts (FBAR) with the Treasury Department (for more information, see this CRS report). As the IRS has explained, FBAR is a tool the government uses to identify or trace funds used for illegal purposes and to discover unreported income earned or kept overseas.

If a person fails to file an FBAR, the IRS can impose a civil penalty. The penalty is limited to (1) the greater of $100,000 or 50% of the balance of each unreported account if the failure was willful; or (2) $10,000 per account if the failure was not willful. Additionally, persons who willfully fail to file are subject to criminal penalties, including a fine of up to $250,000 and/or up to five years in prison.

Some have questioned whether the maximum civil penalty violates the Constitution's Eighth Amendment, which prohibits the imposition of "excessive fines." The argument is that the penalty may be excessive because it can exceed the amount in the unreported account. For example, in a 2013 case, the IRS asserted penalties equal to 50% of the taxpayer's unreported Swiss bank account for each of the four years the government claimed he willfully failed to file FBARs: $723,762 in 2004; $745,209 in 2005; $772,838 in 2006; and $845,527 in 2007. During those years, the account's balance was approximately $1,500,000—thus, the total penalties were twice the amount in the account. While the taxpayer argued the penalties violated the Eighth Amendment, the case was settled before a court examined the argument.

Determining whether the FBAR civil penalty is unconstitutional raises two questions: (1) whether the Eighth Amendment applies to the penalty (i.e., whether it is a "fine" for purposes of the Eighth Amendment) and (2) if so, whether the penalty is excessive. For purposes of the Excessive Fines Clause, a fine is a payment to a government as punishment for an offense. The focus of the inquiry over whether a particular payment is a fine is on whether the required payment is intended to be punitive, although it may also have a remedial (e.g., compensatory) purpose. Factors showing that a payment proscribed by statute is intended to be punishment include its historical treatment as such; its imposition relates to culpability (e.g., the statute has an "innocent owner" defense); and it has a purpose of deterrence and/or retribution. The Supreme Court has applied the Excessive Fines Clause in criminal cases and civil forfeiture cases.

Assuming a court were to characterize the FBAR civil penalty as a fine for purposes of the Eighth Amendment, the second question in determining its constitutionality is whether it is excessive. The Supreme Court has explained that a fine is excessive if it "is grossly disproportional to the gravity of a defendant's offense." The analysis, therefore, is dependent on the facts of a specific case. The Court has articulated three general principles applicable when determining whether a fine is excessive: (1) the degree of the defendant's culpability; (2) the relationship between the penalty and the harm caused by the defendant's actions; and (3) the sanctions imposed for comparable misconduct.

In the seminal 1998 case, *United States v. Bajakajian*, the Supreme Court examined the constitutionality of a forfeiture imposed on an individual who failed to comply with a reporting requirement imposed on persons leaving or entering the United States with more than $10,000 in currency. The individual was convicted of willfully violating the law when he failed to report $357,144. The statutory penalty allowed for forfeiture of the property involved in the offense, and the government sought forfeiture of the entire $357,144.

The Supreme Court held that the full forfeiture would violate the Excessive Fines Clause. The Court emphasized several factors in concluding that the forfeiture was grossly disproportionate to the offense. First, the Court determined that the offense caused minimum harm since it was merely a reporting requirement (i.e., the government was only deprived of information); did not cause loss to the public treasury; did not involve fraud; and was unrelated to other illegal activities. The Court also concluded that the gravity of the offense and the individual's culpability in comparison with other potential violators of the statute were minimal. This was evidenced by the fact that he was not the type of offender (e.g., money launderer, drug trafficker, or tax evader) that the statute was aimed at, as well as the fact that the maximum fine for his conduct under the Federal Sentencing Guidelines was $5,000.

While the Court held the forfeiture to be excessive, the Court also discussed the deference that should be given to Congress's decisions about proper punishment. The Court wrote that "judgments about the appropriate punishment for an offense belong in the first instance to the legislature" and "[r]eviewing courts … should grant substantial deference to the broad authority that legislatures necessarily possess in determining the types and limits for crimes."

It appears there have only been two cases—both decided in 2015—in which courts have considered whether the FBAR civil penalty violates the Eighth Amendment. In September 2015, a federal district court held that the penalty is not facially unconstitutional. Under the Supreme Court's jurisprudence, a party alleging that a law is unconstitutional on its face "must establish that no set of circumstances exists under which the Act would be valid*."* Applying that standard here, the district court rejected the facial challenge because it determined that the penalty would be constitutional in at least some cases. Citing to the Supreme Court's statement in *Bajakajian* that Congress's determination of penalties is due "substantial deference," the court examined the legislative intent behind the penalty, particularly a statement by the Senate Finance Committee that improving FBAR compliance "is vitally important to sound tax administration, to combating terrorism, and to preventing the use of abusive tax schemes and scams." The court concluded that the maximum penalty, while severe, was established to ensure that it "is not merely a cost of doing business for tax evaders, terrorists, and organized criminals," and therefore, "given the ills it combats, it is an appropriate penalty in at least some circumstances." Because no penalties had been imposed on the plaintiffs, they did not allege that the penalties would be excessive as applied to them. (The plaintiffs also alleged that the Foreign Account Tax Compliance Act (FATCA) is unconstitutional; for more information, see this Legal Sidebar).

In July 2015, a federal district court rejected the argument that an FBAR civil penalty of $40,000 was unconstitutional when imposed on an individual who failed to report an account worth between $300,000 and $550,000. The court held that the penalty was not disproportional when it was only approximately 10% of the account, reasoning that the government's interest in enforcing the law was "at least roughly proportional" to the penalty amount. Neither one of these cases has yet been appealed.

The IRS issued an internal agency memorandum in May 2015 that provides interim guidance to IRS employees on how to calculate the FBAR penalty. Among other things, the guidance provides that, in no instance, should the total penalty ever exceed 100% of the highest aggregated balance of all unreported accounts during the years in which an FBAR was not filed.

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