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FBAR Penalty Defenses

September 18, 2011

September 9, 2011 was the last day to submit to a letter request to enter Offshore Voluntary Disclosure Program (OVDP). According to the most recent [IRS](#) announcement, at least 11,000 such requests were filed. Some taxpayers will file “opt out” requests believing that they can get a better deal outside the OVDP program than the 25% Miscellaneous Civil Penalty applied to the highest single year foreign account balance. Why would such an presumption be true?

The [IRS](#) in its OVDP Frequently Asked Questions (51.1) suggests that some taxpayers, meeting the specific fact pattern should “opt out” as the total penalty calculation will be less under the FBAR civil penalty program. In fact, outside the specific fact pattern, taxpayers need to consider the option of “opting out” based upon several factors. First, the [IRS](#) examiner has broad discretion in making penalty decisions. Such decisions must be made in accordance with specific provisions of the Internal Revenue Manual, which states:

“Penalties should be asserted only to promote compliance with the FBAR reporting and recordkeeping requirements. In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBAR’s, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future” Does this mean that in any given case, an [IRS](#) examiner will not propose a penalty, hardly. But it does provide the basis upon which all the facts and circumstances of the non-compliance can be considered. In those cases where the facts are compelling an “opt out” may result in no penalty being assessed. This approach is more than a “reasonable cause” argument.

A reasonable cause argument is based upon reliance on a tax professional. The taxpayer bears the burden of proving that: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided the necessary and accurate information to the advisor; and (3) the taxpayer actually relied in good faith on the advisor’s judgment. Few of the “opt out” cases will necessarily meet the reasonable cause standard. In most cases the [IRS](#) examiner will first try to determine if there was criminal conduct and if not whether a willful penalty or non-willful penalty will

Law Offices of Sanford I. Millar

Office: 310-556-3007

Fax: 310-556-3094

Address: 1801 Avenue of the Stars, Suite 600
Los Angeles, CA. 90067

Email: smillar@millarlaw.net

www.millarlawoffices.com

be proposed. The default position will not be the first position of erring in favor of a warning letter. The deciding factors in the exercise of discretion will turn on the source of funds (U.S. or non-U.S), pre-tax or after tax (even if taxed in another jurisdiction), whether other information returns were required and filed, like Controlled Foreign Corporation Returns, and Report of Foreign Gifts, and whether several other factors providing insight into the reason for non-filing. Taxpayer cooperation with the examiner is also going to be important.

Put into simple terms, anyone contemplating the approach of “opting out” should not expect to use a defense that is other than open and forthright.

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