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Recent Developments

FRAUD & NEGLIGENCE

The FBAR and the Fifth Amendment

Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), must be filed by U.S. persons and certain non-U.S. persons to report an interest in, or authority over, a foreign financial account. The FBAR must be *received* by Treasury by June 30 [1] to report foreign accounts held at any time (and for any length of time) during the previous year. A willful failure to file the FBAR is a felony. [2] **Michael Sardar**, an associate with the law firm of **Kostelanetz & Fink, LLP**, in New York City, analyzes one aspect of the FBAR filing requirement that tax practitioners may have overlooked—self-incrimination.

Generally, under the Supreme Court's decision in *Sullivan,* 6 AFTR 6753, 274 US 259, 71 L Ed 1037 (1927), a taxpayer may not refuse to file an income tax return on the ground that filing such a return would violate the taxpayer's Fifth Amendment privilege against self-incrimination. If, however, a specific question on a return seeks a response with regard to which the taxpayer may claim a privilege, the taxpayer may assert the privilege in response to that particular question. For example, in *Garner,* 37 AFTR 2d 76-1042, 424 US 648, 47 L Ed 2d 370, 76-1 USTC ¶9301, 1976-1 CB 371 (1976), the Court held that a taxpayer who had income from illegal gambling activities could have asserted the Fifth Amendment privilege and declined to reveal the source of his income. Nevertheless, a claim of privilege may not be used to "refuse to make any return at all." [3]

In certain situations, however, the mere filing of a form or return will serve to incriminate the taxpayer; if that is so, the specific-question approach of *Sullivan* and *Garner* would be of no help to a taxpayer. The FBAR, which serves no purpose other than to report foreign financial accounts, is such a form—the mere act of filing the form would tend to incriminate a taxpayer who has a foreign account but has failed to report the account in the past, even if the taxpayer attempts to assert the privilege with regard to specific sections of the form. In other words, filing an FBAR for the first time is the equivalent of saying "I have a foreign bank account and have not reported it previously," with the inevitable question arising whether the account existed in prior years. [4]

Marchetti. Acknowledging the possibility that simply filing a form may be incriminating, the Supreme Court has held that in some circumstances a taxpayer is justified in claiming privilege as to an entire return and the privilege may be raised as a defense to a blanket failure to file the return. In *Marchetti,* 21 AFTR 2d 539, 390 US 39, 19 L Ed 2d 889, 1968-1 CB 500 (1968), the Court ruled that a taxpayer could assert the Fifth Amendment privilege as a defense for failing to file certain tax returns that on their face would have disclosed that the taxpayer was engaged in illegal gambling activities. It noted that "[t]he central standard for the privilege's application has

been whether the claimant is confronted by substantial and 'real,' and not merely trifling or imaginary, hazards of incrimination."

A taxpayer who has maintained a foreign bank account, but has failed to properly report the account in the past, today *does* face a very real and substantial hazard of incrimination by filing a current FBAR. This hazard is emphasized by recent pronouncements by IRS officials that offshore activities will be the focus of future criminal investigations. [5] In *Marchetti,* the Supreme Court noted that the IRS Commissioner's pronouncements that the Service would disclose to criminal enforcement authorities the identities of taxpayers with gambling activities weighed in favor of upholding the privilege.

Another similarity between the FBAR and the income tax return in *Marchetti* (and thus a distinction between the FBAR and the income tax return at issue in *Sullivan*) is that the FBAR, which is governed by Title 31 and not by the Code, is not subject to the confidentiality provisions in Section 6103 that govern tax returns, and thus may be shared freely with other government agencies. This fact further increases the hazard of incrimination.

Of course the main difference between an FBAR and an income tax return is the purpose that each serves, and thus the government's interest in receiving them. Courts must weigh "the competing interest of the state and the individual when evaluating the constitutionality of a disclosure requirement." [6] The government's interest in receiving income tax returns is "critical" [7] because, unlike an FBAR, an income tax return is not merely an informational return; it is instead the return on which the fisc relies for the financial survival of the nation. The government's interest in collecting taxes is significantly greater than its interest in receiving a non-revenue-generating reporting form like the FBAR. This greater interest weighs in favor of circumscribing the Fifth Amendment privilege in the context of an income tax return, but not for the FBAR.

The filing of an FBAR can be distinguished from the facts in *Marchetti,* however. In *Marchetti,* the return to be filed by the taxpayer was inherently incriminating because it revealed that the taxpayer was engaged in gambling activity, which was "widely prohibited." The Court noted that those engaged in wagering were "inherently suspect of criminal activities." It can be argued that the FBAR is not inherently incriminatory, because the mere filing of an FBAR is not an admission of any crime; having a foreign bank account is not per se illegal.

Nevertheless, for taxpayers who have failed to file the FBAR in the past, a current filing would be inherently incriminatory and, in the words of *Marchetti,* "would readily provide evidence which will facilitate their convictions." Furthermore, if a taxpayer believes he is currently under investigation, or that such investigation is imminent, the argument in favor of the privilege is yet stronger because, by filing the FBAR, the taxpayer would "provide information ... which would surely prove a significant 'link in a chain' of evidence tending to establish his guilt." (Footnotes omitted.) Unlike an income tax return, and very similar to the wagering return at issue in *Marchetti,* "every portion of" a current FBAR filed by a previous non-filer has "the direct and unmistakable consequence of incriminating" the taxpayer.

Sturman. Although *Marchetti* is the most analogous Supreme Court case, the only court to have directly addressed the issue of the Fifth Amendment privilege as it relates to the FBAR, the Sixth Circuit, decided this issue contrary to *Marchetti*'s reasoning. In *U.S. v. Sturman,* 951 F2d 1466 (CA-6, 1991), the court concluded that an individual may *not* assert the Fifth Amendment

privilege as a defense for not filing an FBAR. The court explained that, under *Marchetti,* a reporting requirement would violate the Fifth Amendment if "(1) the disclosure is directed against a 'selective group inherently suspect of criminal activity'; (2) the

requirements are imposed in an 'area permeated with criminal statutes'; and (3) the reporting requirements would have placed the subject in real danger of self-incrimination." The Sixth Circuit decided that an FBAR does not meet those requirements. The court opined that "[t]he Bank Secrecy Act applies to all persons making foreign deposits, most of whom do so with legally obtained funds. The requirement is imposed in the banking regulatory field which is not infused with criminal statutes."

The Sixth Circuit's reasoning is arguably flawed, however, or at least obsolete in light of the current IRS focus on offshore activities. While foreign bank accounts may, as the court noted, often be established with legally obtained funds, the source of the funds in the account is irrelevant to whether an FBAR is required—and many taxpayers who initially establish a foreign account with legal-source funds then fail to report the account or pay taxes on the income earned in the account.

Moreover, the declaration of purpose for the portion of Title 31 in which the FBAR reporting requirements are found (31 U.S.C. section 5311) provides: "It is the purpose of this subchapter ... to require certain reports or records where they have a high degree of usefulness in *criminal,* tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism." (Emphasis added.)

Thus, the FBAR reporting requirements are arguably indeed directed at a "selective group inherently suspect of criminal activity" and are indeed imposed in an area permeated with criminal statutes. In the current enforcement environment, filing a first FBAR in connection with a long-established foreign account would definitely place a taxpayer "in real danger of self-incrimination" within the meaning of *Sturman.*

Further, the circuit court in *Sturman* focused on the fact that particularly with regard to Sturman, whose Fifth Amendment claim related to funds that were derived from an illegal source, "the disclosures do not subject the defendant to a real danger of self-incrimination since the source of the funds is not disclosed." Thus, the court implicitly conceded that, where an FBAR disclosure itself would expose a particular individual filer to a real danger of self-incrimination, the outcome might be different.

As opposed to the defendant in *Sturman,* a person under criminal investigation, or a previous nonfiler, *would* incriminate himself by merely filing an FBAR, even though the form on its face does not necessarily disclose illegal activity. Such a filing would essentially be equivalent to a filing by the defendant in *Sturman* that would have disclosed that he had illegal-source income, and the court appears to have conceded that requiring a filing in that circumstance would violate the Fifth Amendment privilege.

Today, a taxpayer fearing self-incrimination may be well advised not to file an FBAR. Filing the FBAR and then attempting after the fact to preclude its use in a criminal proceeding would prove unsuccessful, because the Supreme Court has indicated that, post-*Marchetti,* an individual must claim the Fifth Amendment privilege by refusing to make the requested disclosure, or else waive

the privilege. [8] Thus, although there is no clear precedent holding that the Fifth Amendment privilege would apply in the context of an FBAR filing today, a taxpayer should weigh the risks of filing, which would definitively waive the privilege, against the benefits of failing to file and the arguments that can be made that such failure would be justified under *Marchetti,* despite *Sturman.* [9] In taking such a position caution is advised, however—a failed Fifth Amendment argument can lead to a taxpayer's indictment for yet an additional criminal act. [10]

Conclusion. Although the issue is unresolved, it appears that in certain circumstances a taxpayer can make a persuasive argument—distinguishing the Sixth Circuit's decision in *Sturman* on the grounds discussed above—that the filing of an FBAR would amount to self-incrimination in violation of the Fifth Amendment, and that the failure to file an FBAR is therefore justified.

1

Unlike tax returns, which may be deemed to be filed on mailing, the FBAR is only deemed to have been filed when received; see 31 C.F.R. sections 103.24 and 103.27(c). For more on the filing requirements generally, see Weinstein and Packman, "FBAR—Foreign Bank Account Reporting Obligations: A Primer for the Practitioner," 106 JTAX 44 (January 2007).

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31 U.S.C. section 5322(a).

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Sullivan, 6 AFTR 6753, 274 US 259, 71 L Ed 1037 (1927).

4

See Fink, *Tax Controversies Audits, Investigations, Trials,* §10.07 at page 10-46, fn. 241 (LexisNexis, 2009).

5

See "Commissioner Shulman's Senate Finance Testimony on Ponzi Schemes and Offshore Tax Evasion Legislation," 3/17/09, available at www.irs.gov/newsroom/article/0,,id=205374,00.html.

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U.S. v. Dichne, 612 F2d 632 (CA-2, 1979).

7

Carlson, 45 AFTR 2d 80-1223, 617 F2d 518 (CA-9, 1980).

8

Minnesota v. Murphy, 465 US 420, 79 L Ed 2d 409 (1984) "(In other words, a taxpayer making incriminating disclosures on a return filed after *Marchetti* ... could not necessarily prevent the use of those disclosures in a criminal prosecution because he had been afforded an effective way to assert the privilege. Murphy's situation, we believe, is analogous to that of the post-*Marchetti* taxpayer: Since he could have asserted the privilege effectively but failed to do so, his disclosures cannot be viewed as compelled incriminations"). See also U.S. v. Barnes, 604 F2d 121 (CA-2, 1979), *cert den.* (failure to claim privilege with regard to the amount of taxpayer's income waived the privilege).

9

Even if a taxpayer ultimately decides not to file an FBAR on Fifth Amendment grounds, the taxpayer should consider pursuing a voluntary disclosure to the IRS, if possible. A successful voluntary disclosure is one of the best methods available to taxpayers to end the cycle of noncompliance while virtually eliminating the threat of criminal prosecution.

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See Josephberg, 103 AFTR 2d 2009-1657, 562 F3d 478 (CA-2, 2009) (court upheld indictment for failure to file income tax returns where taxpayer, on Fifth Amendment grounds, failed to file

current returns while being investigated for criminal tax violations).