

TILL OFFSHORE DO US PART: UNCOVERING ASSETS HIDDEN
FROM SPOUSES AND TAX AUTHORITIES

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INTRODUCTION

Governments and individuals around the world know that offshore accounts are used to hide assets from tax authorities.¹ However, the Panama Papers brought to the forefront a less well-known use of offshore accounts: hiding assets from a spouse during divorce proceedings.² The Panama Papers contain information about offshore accounts used by public officials, drug kingpins, money launderers, and perhaps surprisingly, high net worth divorcees.³ The Panamanian firm featured

requirements,⁶ a fundamental problem persists: the Internal Revenue Service (“IRS”) does not have the time or resources to untangle the intricate maze of corporate structures used by wealthy individuals to hide their assets offshore.⁷ The spouses of wealthy tax evaders do.⁸ In fact, the scope of divorce cases can far exceed that of federal tax investigations because they seek to “map the wealth of the some of the world’s richest people.”⁹

The discovery process that is an integral part of divorce proceedings¹⁰ is conducive to the unraveling of multiple chains of corporate ownership inherent in such “offshore planning.” Under Internal Revenue Code § 7201, tax evasion is a felony that carries either a large fine, five years imprisonment, or both.¹¹ The three elements of the crime of tax evasion are (1) willfulness, (2) an attempt to evade tax, and (3) additional tax due.¹² In this Paper, I will argue that discovery devices should be modified in order to impute knowledge of reporting requirements to a spouse refusing to comply with the discovery process (a “noncompliant spouse”)¹³ given the willfulness standard required for imposing the three categories of tax penalties and that noncompliant spouses should be ineligible for voluntary disclosure programs that allow taxpayers to avoid criminal prosecution and cap civil penalties.¹⁴ Strengthening the tax implications of failing to disclose assets in the divorce context would incentivize noncompliant spouses to comply with discovery from an early stage in the

6. *Id.*

7. See, e.g. David Voreacos, *IRS Criminal Cases Fall 12 Percent as Agents Head for Exits*, BLOOMBERG (Feb. 27, 2017, 2:59 PM), <https://www.bloomberg.com/news/articles/2017-02-27/irs-criminal-cases-fall-by-12-percent-as-agents-head-for-exits> [https://perma.cc/FE64-DZJD] (recognizing that the IRS’s Criminal Investigation Division, which, among other things, examines offshore tax evasion, has “limited resources”); *General Report of the Internal Revenue Service Advisory Council* INTERNAL REVENUE SERV. (Jan. 30, 2017), <https://www.irs.gov/tax-professionals/general-report-2> [https://perma.cc/96FZ-JDVK] (recognizing that the IRS has “limited resources

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court discovery process; however, the process inevitably is incomplete.²⁰ A family lawyer often must resort to filing motions to compel.²¹ Even in responding to these motions to compel, a truly recalcitrant spouse will continue to fail to disclose assets and provide incomplete or inaccurate information.²² Ultimately, the family lawyer must subpoena financial documents of any known bank or other financial accounts.²³

After obtaining documents through a subpoena, or less likely cooperation from the noncompliant spouse, a family lawyer conducts a review to determine whether any assets have mysteriously disappeared.²⁴ Ultimately, the other spouse must typically resort to hiring one or more forensic accountants that will trace assets and liabilities in order to uncover hidden assets.²⁵ Forensic accountants also rely on document review to conduct such tracing.²⁶ In fact, it is not uncommon to learn that in a single case there could be 100 people in twenty countries delving into a secret world of offshore intricacies accessible only to the wealthiest individuals.²⁷ Their main objective is to unravel a web of company ownership that leads back to the wealthy instigator of it all, i.e., the beneficial owner.²⁸ Noncompliant spouses frustrate their work by refusing to turn over documents or financial information. The requests for these documents are often ignored or completed only partially.²⁹

After the noncompliant spouse's hidden assets are uncovered in the family law setting, he/she also becomes subject to tax related penalties, which include criminal liability or civil penalties. The other spouse may qualify for innocent

judge must insist upon "full cooperation of the litigants" in a divorce proceeding to effectuate equitable distribution of marital property)); Andrew S. Grossman, *Avoiding Legal Malpractice in Family Law Cases: The Danger of Not Engaging in Financial Discovery*, 33 *M. L.Q.* 361, 373 (1999).

20. See SKOLOFF ET AL., *supra* note 19, §9.04[2] (noting that the initial step is document disclosure and that a single demand is not adequate); see also Marlene Moses & Beth A. Townsend, (0-10.5()32equ1.7(0081 Tw.2.62 00 Td [96 188.28 315.244er)24082CL082O(-)10.5()52 237.6 315.24163.24082O ,

spouse relief.³⁰ However, there are complications under the current law that are addressed in a subsequent article. This Paper assumes that the tax-evading spouse is solely liable, i.e., there are no joint and several liabilities.³¹

II. CURRENT CONSEQUENCES FOR NONCOMPLIANT SPOUSES IN TERMS OF REPORTING REQUIREMENTS

Once hidden assets are disclosed during divorce proceedings, the most important issue becomes whether a noncompliant spouse “willfully” failed to report his/her foreign assets.³² This is because a willful failure could result in criminal prosecution or enormous civil penalties as discussed more fully in this section. Moreover, new reporting laws, such as FATCA, require foreign financial institutions (“FFIs”) around the globe to report bank accounts held by U.S. customers to the IRS.³³ While these new reporting laws make it easier for the IRS, creditors, and spouses to find hidden foreign accounts, I would argue that strengthening the consequences of failing to comply with these tax reporting laws and requirements in the context of divorce proceedings would result in

obligation, U.S. taxpayers are required to file a FBAR with the Treasury Department for each foreign financial account that has a balance over \$10,000 at any time during the taxable year.⁴³ An unreported foreign account may result

subject to criminal prosecution or enormous tax and FBAR penalties.⁵⁰ In fact, willfulness is the standard for all three categories of penalties to which a noncompliant spouse may be subject: (1) criminal conviction,⁵¹ (2) a 50% FBAR penalty,⁵² and (3) a 75% civil tax fraud penalty.⁵³ As a result, proving willfulness is the key to strengthening the implications of failure to comply with reporting requirements.⁵⁴

The only difference in terms of the willfulness standard that applies to each penalty category is the level of proof required. For a criminal conviction, the level of proof is “beyond a reasonable doubt” whereas for the civil FBAR or civil fraud penalty cases, the level of proof is “clear and convincing.”⁵⁵ If the

ignorance of the law may be used as a defense.⁶¹ In other words, a taxpayer may claim that he/she did not know there was a legal requirement to disclose a foreign asset, and as a result, willfulness cannot be proven.⁶²

In light of the definition for willfulness, the discovery process should embody informing a noncompliant spouse of the legal duty to disclose foreign assets through complying with reporting requirements. Once a noncompliant spouse has provable knowledge of reporting requirements, if he/she still refuses to comply, the government would be able to easily establish willfulness.⁶³ At that point, the noncompliant spouse would have intentionally violated a known legal duty, which is the very definition of willfulness.⁶⁴

1. Discovery Devices & Willfulness

There are several discovery devices⁶⁵ that could be used to impute knowledge to a noncompliant spouse and thus help the government meet its burden of proof in showing a willful violation. As stated earlier, noncompliant spouses are able to claim a lack of knowledge of reporting requirements after having been served with numerous requests for financial documents during the discovery process.⁶⁶ As stated earlier, family lawyers in this context often must rely on subpoenas and motions to compel, as well as the work of forensic accountants, to gain a full picture of assets, especially those that have been hidden offshore in anticipation of divorce.⁶⁷ Only through the expenditure of much time and money are the hidden assets brought to light. The noncompliant spouse who has refused to disclose assets at every turn can escape both criminal liability and civil penalties, which require a showing of willfulness, simply by claiming that he/she had no knowledge of reporting requirements.

This stark reality begs an important question: Why not include in discovery requests statements that will impute knowledge of reporting requirements to such noncompliant spouses? Following is a discussion of how certain discovery devices, namely (1) interrogatories, (2) requests for production of documents,

61. *United States v. McBride*, 908 F. Supp. 2d 1186, 1206 (D. Utah 2012); Steven Toscher & Lacey Strachan, *Proving Willfulness in Civil FBAR Cases*, 34 *U. ILL. L. REV.* 15, 18 (2003); Skarlatos & Sardar, *supra* note 30, at 94.

62. Skarlatos & Sardar, *supra* note 30, at 94.

63. *Cheek v. United States*, 498 U.S. 192, 202 (1991) (stating that once the government proves knowledge of a legal duty, “the knowledge component of the willfulness requirement” has been satisfied).

64. *Id.*

65. There are also financial disclosure forms that require the parties to report income, expenses, debts, and assets; however, since a noncompliant spouse does not have to provide much supporting information for the information listed, this Paper focuses on obtaining the actual documentation for foreign assets. 2T4 0 Tw 1

and (3) depositions, could be used in this manner and thus alleviate the government's burden in proving willfulness in a criminal prosecution or in assessing civil penalties.⁶⁸ The threat of successful criminal prosecution or the imposition of huge civil penalties should encourage noncompliant spouses to comply with discovery and reveal hidden assets to the tax authorities.⁶⁹

First, interrogatories may be used to impute knowledge of the legal duty to report hidden foreign assets to the IRS. Interrogatories are written questions sent to a party (the "answering party") that are responded to in writing under oath and then remitted to the sender.⁷⁰ Interrogatories may require the answering party to provide "papers, documents, or photographs" that are relevant in responding.⁷¹ Interrogatories should include a straightforward statement of the legal duty to report hidden foreign assets to the IRS by reference to specific forms and schedules. Once the answering party is served with the interrogatories, he/she has knowledge of such legal duty. If the answering party is a noncompliant spouse, the government can easily meet its burden of proving willfulness and subsequently seek criminal prosecution.⁷² A warning to that effect could also be included with the interrogatories. This would incentivize a potential noncompliant spouse to disclose hidden foreign assets both to the IRS and to his/her spouse.

Second, requests for production of documents may be used in a similar manner to provide inescapable knowledge of the legal duty to disclose hidden foreign assets. After a family law action commences, a party may request documents or other items in the possession, custody, or control of the other party or a person served with a notice or subpoena.⁷³ This is referred to as a request for production of documents.⁷⁴ Noncompliant spouses refuse to comply with these requests, which leads to unnecessary prolonging of the divorce proceedings. At the same time, noncompliant spouses also fail to disclose information ascertainable from the documents he/she is hiding to the IRS in violation of reporting requirements. The noncompliant spouse "willfully" abuses the discovery process and should also be deemed to "willfully" violate IRS

68. See SKOLOFF ET AL., *supra* note 19, §29.04[6][a] (listing, in addition to an initial document demand, other appraisal devices, including oral depositions and interrogatories).

69. See, e.g., Jeff T. Casey & John T. Scholz, *Beyond Deterrence: Behavioral Decision Theory and Tax Compliance*, 25 *TAX & SOC'Y REV.* 821, 821 (1991) (addressing tax compliance behavior and stating that compliance behavior generally is viewed as "an intelligent response to governmental enforcement policies" including sanctions).

70. Hatch, *supra* note 26, §4.

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his failure to comply with the legal duty to file the FBAR was deemed either reckless or due to willful blindness.⁹² The court then had to find that recklessness is adequate to show willfulness in terms of imposing a civil FBAR penalty.⁹³ If a court is not willing to make the same determination regarding “willfulness,” a noncompliant spouse could escape civil FBAR penalties and escape any meaningful financial consequences despite his/her deliberate concealing of assets over the course of a multi-year divorce proceeding. A better course of action is to include statements of reporting requirements in discovery devices and impute to the noncompliant spouse knowledge of such requirements. Although Williams and McBride

assets.¹⁰⁰ The taxpayer only needs to send the IRS Criminal Investigation Division a letter that identifies himself/herself and any financial institution that holds unreported assets.¹⁰¹ The IRS then runs a check against a list of taxpayers whom the IRS or the Department of Justice has previously identified and will then inform the taxpayer whether he/she is “pre-cleared” and therefore may make a disclosure.¹⁰² In most cases, a noncompliant spouse would need to request pre-clearance before making a disclosure.¹⁰³

B. Noncompliant Spouses’ Proposed Ineligibility for ~~Pre~~Clearance

Instead of allowing noncompliant spouses an opportunity to enter a voluntary disclosure program after evading the discovery process for prolonged periods of time, there should be a shortened window for these taxpayers. Once a motion to compel has been filed against a noncompliant spouse and has either remained pending for a given period, e.g., six months or longer, or has been granted, and the other spouse can prove an offshore connection in the form of (1) at least one known foreign account (whether disclosed or not); (2) prior offshore business activity; or (3) frequent trips abroad, the noncompliant spouse’

