

## 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.<sup>1</sup> However, the Panama Papers brought to the forefront a less well-known use of offshore accounts: hiding assets from a spouse during divorce proceedings.<sup>2</sup> The Panama Papers contain information about offshore accounts used by public officials, drug kingpins, money launderers, and perhaps surprisingly, high net worth divorcees.<sup>3</sup> The Panamanian firm featured prominently in the leak of information, Mossack Fonseca, has admitted to at least considering assisting wealthy individuals with hiding assets from their spouses who may have a claim to them in divorce proceedings.<sup>4</sup>

Given the ease associated with electronically transferring funds to countries today, it has become increasingly difficult to uncover assets that have been hidden offshore.<sup>5</sup> While in recent years there have been numerous efforts to combat offshore tax haven abuses, such as heavy penalties and new reporting

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1. See generally Carolyn Michelle Najera, *Combating Offshore Tax Evasion: Why the United States Should Be Able to Prevent American Tax Evaders from Using Swiss Bank Accounts to Hide Their Assets*, 17 SW. J. INT'L L. 205 (2011); Lawrence J. Trautman, *Following the Money: Lessons from the Panama Papers Part 1: Tip of the Iceberg*, 121 PA. ST. L. REV. 807, 809–10 (2017); Scott D. Michael, Zhanna A. Zierring & Young Ran Kim, *U.S. Offshore Account Enforcement Issues*, J. TAX PRAC. & PROC., Aug.-Sept. 2014, at 49.

2. See, e.g., Ana Swanson, *How the World's Wealthy Hide Millions Offshore — from Their Spouses*, WASH. POST (Apr. 19, 2016), [https://www.washingtonpost.com/news/wonk/wp/2016/04/19/how-the-worlds-wealthy-hide-millions-offshore-from-their-spouses/?utm\\_term=.b0638d4cf3ad](https://www.washingtonpost.com/news/wonk/wp/2016/04/19/how-the-worlds-wealthy-hide-millions-offshore-from-their-spouses/?utm_term=.b0638d4cf3ad) [<https://perma.cc/W5P2-W8R9>].

3. Will Fitzgibbon, *How the One Percenters Divorce: Offshore Intrigue Plays Hide and Seek with Millions*, INT'L CONSORTIUM INVESTIGATIVE JOURNALISTS (Apr. 3, 2016), <https://panamapapers.icij.org/20160403-divorce-offshore-intrigue.html> [<https://perma.cc/R2FJ-HNF8>]; Trautman, *supra* note 1, at 809–10; Swanson, *supra* note 2.

4. Swanson, *supra* note 2.

5. See *id.* (“The problem with most of these divorce cases is that it can take a fantastic amount of time and money to uncover offshore accounts . . .”).

requirements,<sup>6</sup> 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.<sup>7</sup> The spouses of wealthy tax evaders do.<sup>8</sup> 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.”<sup>9</sup>

The discovery process that is an integral part of divorce proceedings<sup>10</sup> 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.<sup>11</sup> The three elements of the crime of tax evasion are (1) willfulness, (2) an attempt to evade tax, and (3) additional tax due.<sup>12</sup> 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”)<sup>13</sup> 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.<sup>14</sup> 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

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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”).

8. *See* Swanson, *supra* note 2.

9. *Id.*

10. *See, e.g.*, Austin Sarat & William L.F. Felstiner, *Lawyers and Legal Consciousness: Law Talk in the Divorce Lawyer’s Office*, 98 YALE L.J. 1663, 1673 (1989) (detailing divorce lawyers’ common frustration with the “ineffectiveness of rules . . . governing the conduct of discovery”).

11. I.R.C. § 7201 (2012).

12. *See Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014*, INTERNAL REVENUE SERV., <https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012-revised> [<https://perma.cc/4DZP-D8H3>].

13. A refusal to comply with discovery requests generally results in the filing of one or more motions to compel. *See* FED. R. CIV. P. 37(a). For purposes of this Paper, it is assumed that such noncompliant spouses have also refused to comply with the reporting requirements outlined herein.

14. The Offshore Voluntary Disclosure Program (“OVDP”) from prior years has been replaced with the 2014 OVDP. Although there is no deadline for participating in the OVDP, the IRS has the ability to revise or end the program at any point. *See* INTERNAL REVENUE SERV., *supra* note 12.

proceedings. This would lead to two benefits: (1) more expedient family court proceedings and (2) more timely and accurate reporting of hidden offshore assets.

### I. THE DISCOVERY PROCESS AND NONCOMPLIANT SPOUSES

There is a predictable pattern in high net worth divorce proceedings that involves hiding assets from both a spouse and the IRS. In fact, it is not unusual for a spouse who is hiding money offshore in anticipation of a divorce to also hide his/her assets from the IRS.<sup>15</sup> Typically, a wealthy spouse opens an account under the name of a shell company in a tax haven country, such as Panama, and transfers assets into the company to hide them from his/her spouse.<sup>16</sup> During the divorce proceedings, the spouse can claim that investments are tied up in the sham corporation and then later lost.<sup>17</sup> At the same time, the wealthy spouse does not report the offshore account to the IRS, as required under Foreign Bank Account Report (“FBAR”) and Foreign Account Tax Compliance Act (“FATCA”) filing requirements, and engages in tax evasion.<sup>18</sup> Such spouses would qualify as noncompliant spouses.

Generally today, family lawyers attempt to use the discovery process, where documents must be exchanged by court order, to gather financial and other information.<sup>19</sup> Some hidden foreign assets are uncovered through an extensive

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15. See, e.g., Fred Abrams, *Divorce & Hidden Money: Whistleblowing, Tax Fraud & Tipping the IRS*, ASSET SEARCH BLOG (Feb. 13, 2014), <http://www.assetsearchblog.com/2014/02/13/divorce-hidden-money-whistleblowingtax-fraud-tipping-the-irs/> [<https://perma.cc/4959-7G6L>] (discussing one husband’s hiding money offshore in anticipation of divorce and concealing the same from the IRS, i.e., tax fraud).

16. See, e.g., Swanson, *supra* note 2 (providing an example of one spouse’s actions in preparation for a divorce proceeding).

17. See, e.g., *id.* (further elaborating upon one spouse’s representations during a divorce proceeding).

18. See *Taxpayers with Foreign Assets May Have FBAR and FATCA Filing Requirements in June*, INTERNAL REVENUE SERV. (June 10, 2015), <https://www.irs.gov/uac/newsroom/taxpayers-with-foreign-assets-may-have-fbar-and-fatca-filing-requirements-in-june> [<https://perma.cc/WC55-8RU6>]; see also Joanna Heiberg, *FACTA: Toward a Multilateral Automatic Information Reporting Regime*, 69 WASH. & LEE L. REV. 1685, 1692 (2012) (explaining how reporting can reduce “the incidence of and opportunities for tax evasion” (quoting Regulations Relating to Information Reporting by Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, 77 Fed. Reg. 9,022, 9,022 (proposed Feb. 15, 2012)) (internal quotation marks omitted)); Steven Toscher & Michael R. Stein, *FBAR Enforcement Is Coming!*, J. TAX PRAC. & PROC., Dec. 2003-Jan. 2004, at 27, 27–29.

19. See GARY N. SKOLOFF ET AL., VALUATION AND DISTRIBUTION OF MARITAL PROPERTY § 29.04 (updated 2017) (summarizing that almost every equitable distribution and community property state recognizes the need for financial discovery and citing *Ronnkvist v. Ronnkvist*, 331 N.W.2d 764, 765–66 (Minn. 1983) (“[P]arties to a marital dissolution proceeding have a duty to make full and accurate disclosure of all assets and liabilities to facilitate the trial court’s property distribution.”) and *Rothman v. Rothman*, 320 A.2d 496, 503–04 (N.J. 1974) (stating that the trial

court discovery process; however, the process inevitably is incomplete.<sup>20</sup> A family lawyer often must resort to filing motions to compel.<sup>21</sup> 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.<sup>22</sup> Ultimately, the family lawyer must subpoena financial documents of any known bank or other financial accounts.<sup>23</sup>

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.<sup>24</sup> 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.<sup>25</sup> Forensic accountants also rely on document review to conduct such tracing.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup> 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.<sup>29</sup>

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

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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 Dangers of Not Engaging in Financial Discovery*, 33 FAM. L.Q. 361, 373 (1999).

20. See SKOLOFF ET AL., *supra* note 19, § 29.04[2] (noting that the initial step is document disclosure and that a single demand is not adequate); see also Marlene Moses & Beth A. Townsend, *Family Matter: Uncovering Hidden Assets in Divorce: Secret Closets and Covering Your Bases*, TENN. B.J., Sept. 2012, at 25, 27 (providing some examples of deliberately hidden assets). See generally Samuel V. Schoonmaker, III, William T. Fitzmaurice & Amy H. Hertzberg, *Hauling Foreign Assets and Income into U.S. Courts*, FAM. ADVOC., Spring 1993, at 46.

21. LARRY RICE & NICK RICE, *THE COMPLETE GUIDE TO DIVORCE PRACTICE: FORMS AND PROCEDURES FOR THE LAWYER* 306 (5th ed. 2017).

22. See generally KALMAN A. BARSON, *INVESTIGATIVE ACCOUNTING: TECHNIQUES AND PROCEDURES FOR DETERMINING THE REALITY BEHIND THE FINANCIAL STATEMENTS* (1986).

23. *Id.*

24. See Moses & Townsend, *supra* note 20, at 26.

25. *Id.*

26. Rebecca E. Hatch, *Uncovering Marital Assets in Divorce Proceedings*, 128 AM. JUR. TRIALS 337, § 7 (2013 & updated 2017); Moses & Townsend, *supra* note 20, at 26.

27. Swanson, *supra* note 2.

28. See *id.*

29. *Id.*

spouse relief.<sup>30</sup> 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.<sup>31</sup>

## 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.<sup>32</sup> 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.<sup>33</sup> 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 more timely and accurate disclosure.

Currently, even after hidden foreign assets have come to light during divorce proceedings, there are too many ways for a noncompliant spouse to mitigate the tax consequences of his/her bad behavior. Most importantly, the IRS will rely on voluntary disclosure in determining whether to criminally prosecute.<sup>34</sup> Voluntary disclosure takes place when in a manner that is truthful, timely, and complete, the taxpayer (a) evinces a willingness to cooperate, followed by such cooperation, with the IRS to determine accurate tax liability and (b) engages in a good faith effort to satisfy in full applicable tax, interest, and penalties.<sup>35</sup> Often, as stated above, the noncompliant spouse never chooses to reveal these assets. They are only uncovered through a family lawyer’s use of motions to compel and subpoenas and through the hiring of forensic accountants. Once tax fraud is apparent in divorce proceedings, “the judge may report the fraud to the IRS.”<sup>36</sup>

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30. See I.R.C. § 6015 (2012); Bryan C. Skarlatos & Michael Sardar, *Taxes and Penalties on Unreported Foreign Assets: Who Foots the Bill?*, 27 J. AM. ACAD. MATRIM. LAW. 83, 108 (2014) (“[W]hen spouses file joint tax returns, both spouses are jointly and severally liable for any tax and most penalties, other than tax fraud penalties . . . . In certain circumstances, a spouse can seek to be excused from such liabilities. This is generally known as ‘innocent spouse relief.’”).

31. Issues regarding innocent spouse relief and allocation of tax liabilities pertaining to unreported foreign account(s) are beyond the scope of this Paper. For a discussion of these issues, see Skarlatos & Sardar, *supra* note 30, at 102–20.

32. See I.R.C. § 7201 (2012).

33. FATCA, enacted in 2010 as part of the HIRE Act, requires U.S. persons to report specified foreign assets to the IRS on Form 8938 pursuant to I.R.C. § 6038D (2012) and FFIs to report U.S. customers to the IRS. See I.R.C. §§ 1471–1474 (2012).

34. See INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 9.5.11.9(1) (2009).

35. See *id.* § 9.5.11.9(3).

36. Abrams, *supra* note 15.

In a 2004 New York case, for example, a judge reported a husband to the IRS after an admission that he had not paid taxes.<sup>37</sup>

However, a spouse who has remained noncompliant over the course of several years of divorce proceedings will only be subject to criminal prosecution or to civil penalties if willfulness is shown.<sup>38</sup> Currently, the discovery process enables a noncompliant spouse to claim his/her failure to report hidden foreign assets was not willful. I would argue that discovery documents should include statements of reporting requirements to prevent a noncompliant spouse from getting away with tax fraud with little or no ramifications. In addition, such noncompliant spouses are still eligible to participate in voluntary disclosure programs.<sup>39</sup> I would propose that family lawyers should be able to report noncompliant spouses who meet certain thresholds to the IRS so that they will become ineligible for pre-clearance for the voluntary disclosure program.<sup>40</sup> The following section briefly outlines the reporting requirements for foreign assets that a noncompliant spouse would have failed to fulfill during the divorce proceedings and likely in prior years.

#### A. *Reporting Requirements – Foreign Assets*

Since the United States has historically used a worldwide system of taxation, all U.S. citizens and residents have been required to report worldwide income, regardless of whether such income is earned abroad. U.S. taxpayers may use a foreign tax credit or a foreign income exclusion to largely prevent double taxation.<sup>41</sup> Moreover, U.S. taxpayers have a legal duty to report their ownership interest in foreign assets, e.g., foreign accounts and foreign entities, such as corporations, partnerships, and trusts.<sup>42</sup> Finally, under a separate reporting

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37. *Hashimoto v. De La Rosa*, No. 350155/04, 2004 NY Slip Op. 51081(U), at 4 (Sup. Ct. N.Y. Cnty. 2004) (unpublished table decision); *see also Beth M. v. Joseph M.*, No. 203398/2001, 2006 NY Slip Op. 51490(U), at 15 & n.4 (Sup. Ct. Nassau Cnty. 2006) (unpublished table decision) (stating that husband was reported to IRS after admitting he failed to file tax returns for 1997-2001 and other years).

38. Matthew A. Melone, *Penalties for the Failure to Report Foreign Financial Accounts and the Excessive Fines Clause of the Eighth Amendment*, 22 GEO. MASON L. REV. 337, 345, 358 (2015); Skarlatos & Sardar, *supra* note 30, at 93–94 (“Of course, if the government cannot prove willfulness at all, then there is no risk of a criminal conviction and the civil penalties are much less severe.”).

39. *See Skarlatos & Sardar, supra* note 30, at 103–06 (explaining who can participate in voluntary disclosure programs and noting noncompliant spouses are not precluded).

40. Currently, a taxpayer can become ineligible for the OVDP if the IRS receives information pertinent to his/her undisclosed OVDP assets while a hypothetical question (e.g., from his/her attorney) is pending. INTERNAL REVENUE SERV., *supra* note 12.

41. *See* I.R.C. §§ 901, 911 (2012).

42. *See, e.g.*, INTERNAL REVENUE SERV., SCHEDULE B (FORM 1040A OR 1040): INTEREST AND ORDINARY DIVIDENDS (rev. 2017), <https://www.irs.gov/pub/irs-pdf/f1040sb.pdf> [<https://perma.cc/73SU-RCF2>]; INTERNAL REVENUE SERV., FORM 5471: INFORMATION RETURN OF U.S.

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.<sup>43</sup> An unreported foreign account may result in the imposition of huge penalties that far exceed the value of the unreported account.<sup>44</sup> Foreign asset reporting obligations are complex and require reporting the same foreign asset in multiple ways at times.<sup>45</sup> To summarize, all foreign income and the majority of foreign assets must be reported in the United States even if earned or kept abroad.<sup>46</sup> There are three possible categories of penalties for failure to comply: (1) criminal conviction,<sup>47</sup> (2) a 50% FBAR penalty,<sup>48</sup> and (3) a 75% civil tax fraud penalty.<sup>49</sup>

### B. Willful Violation Equals Three Possible Penalties

Once an IRS agent, a prosecutor, or a court determines that a noncompliant spouse has acted willfully in failing to meet reporting requirements, he/she is

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PERSONS WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS (rev. 2015), <https://www.irs.gov/pub/irs-pdf/f5471.pdf> [<https://perma.cc/YJ5R-EFWA>]; INTERNAL REVENUE SERV., FORM 3520: ANNUAL RETURN TO REPORT TRANSACTIONS WITH FOREIGN TRUSTS AND RECEIPT OF CERTAIN FOREIGN GIFTS (2016), <https://www.irs.gov/pub/irs-pdf/f3520.pdf> [<https://perma.cc/G9ZJ-28ZX>]; INTERNAL REVENUE SERV., FORM 3520-A: ANNUAL INFORMATION RETURN OF FOREIGN TRUST WITH A U.S. OWNER (2017), <https://www.irs.gov/pub/irs-pdf/f3520a.pdf> [<https://perma.cc/D3JC-VUV6>]; INTERNAL REVENUE SERV., FORM 8865: RETURN OF U.S. PERSONS WITH RESPECT TO CERTAIN FOREIGN PARTNERSHIPS (2016), <https://www.irs.gov/pub/irs-pdf/f8865.pdf> [<https://perma.cc/ZU6R-UPAA>]; INTERNAL REVENUE SERV., FORM 8938: STATEMENT OF SPECIFIED FOREIGN FINANCIAL ASSETS (2016), <https://www.irs.gov/pub/irs-pdf/f8938.pdf> [<https://perma.cc/L766-S7R4>].

43. DEP'T OF THE TREASURY, TD F 90-22.1: REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (rev. 2012), <https://www.irs.gov/pub/irs-pdf/f90221.pdf> [<https://perma.cc/CB4P-5G3W>]; *see also* Toscher & Stein, *supra* note 18, at 28. The "FBAR" must be filed electronically. *See* BSA E-FILING SYSTEM, [HTTP://BSAEFILING.FINCEN.TREAS.GOV/MAIN.HTML](http://bsae filing.fincen.treas.gov/main.html) [[HTTPS://PERMA.CC/F866-E823](https://perma.cc/F866-E823)].

44. Skarlatos & Sardar, *supra* note 30, at 102 ("The main reason to do a voluntary disclosure is to eliminate the chance of a criminal prosecution and avoid the chance of huge FBAR penalties that can exceed the value of the entire unreported account.").

45. *Id.* at 85.

46. *Id.* For a complete discussion of the tax return reporting requirements and related penalties, *see id.* at 85–93.

47. *Id.* at 93. Regarding criminal conviction, the government must show that the taxpayer willfully failed to report a foreign asset. *Id.* at 93.

48. *Id.* If a taxpayer can prove reasonable cause for failing to file an FBAR, e.g., he/she told a tax preparer who neglected to file the FBAR about the foreign account(s), no penalty will be imposed. *See* INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.26.16.4.3.1 (2008) [hereinafter IRM 2008]. However, if the taxpayer cannot prove reasonable cause for failing to file an FBAR, a non-willful violation of the FBAR reporting requirement may result in a civil penalty up to \$10,000 if it occurred after October 22, 2004. 31 U.S.C. § 5321(a)(5)(B) (2012).

49. Skarlatos & Sardar, *supra* note 30, at 93. Regarding the 75% penalty, the government must show that the taxpayer willfully under-reported his/her income tax. *Id.* at 93.

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

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.”<sup>55</sup> If the government has large amounts of evidence that the taxpayer acted willfully in failing to report a foreign asset, it will have an easier time meeting the higher burden of showing willfulness “beyond a reasonable doubt.”<sup>56</sup> However, if the government does not have much evidence of willfulness or the taxpayer is able to offer cogent excuses, then the government may only be able to meet the “clear and convincing” standard of proof and will not be able to seek a criminal charge.<sup>57</sup>

C. *Definition of Willfulness and How the IRS Can Help Establish It Through the Discovery Process*

There are a number of factors that establish willfulness, and the devices used in the discovery process should be modified to make proving willfulness easier.<sup>58</sup> The definition of willfulness is “an intentional violation of a known legal duty.”<sup>59</sup> A taxpayer who knows he/she should report a foreign asset, but intentionally refuses to do so, has acted willfully.<sup>60</sup> The problem is that

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50. *Id.* at 103.

51. *Id.* at 93. Regarding criminal conviction, the government must show that the taxpayer willfully failed to report a foreign asset. *Id.* at 93.

52. *Id.* at 93; *see* 31 U.S.C. § 5321(a)(5)(C); *see also* IRM 2008, *supra* note 48, § 4.26.16.4.3.1.

53. Skarlatos & Sardar, *supra* note 30, at 93. Regarding the 75% penalty, the government must show that the taxpayer willfully under-reported his/her income tax. *Id.* at 93.

54. *See* United States v. Link, 202 F.2d 592 (3d Cir. 1953) (recognizing that the government has the burden of proving willfulness).

55. Skarlatos & Sardar, *supra* note 30, at 93–94.

56. *Id.* at 94.

57. *Id.*

58. The concept of “willful blindness” also applies to “willfulness.” However, this standard is more difficult to prove since it involves conjecture about a person’s thoughts when the tax return is filed. *Id.* at 94–95. Accordingly, this Paper will focus upon imputing knowledge to the noncompliant spouse so that the government’s burden of proof required for establishing willfulness may more easily be met.

59. United States v. Pomponio, 429 U.S. 10, 12 (1976).

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

ignorance of the law may be used as a defense.<sup>61</sup> 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.<sup>62</sup>

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.<sup>63</sup> At that point, the noncompliant spouse would have intentionally violated a known legal duty, which is the very definition of willfulness.<sup>64</sup>

### 1. Discovery Devices & Willfulness

There are several discovery devices<sup>65</sup> 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.<sup>66</sup> 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.<sup>67</sup> 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,

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61. *United States v. McBride*, 908 F. Supp. 2d 1186, 1206 (D. Utah 2012); Steven Toscher & Lacey Strachan, *Proving Willfulness in Civil FBAR Cases*, L.A. LAW., Apr. 2003, at 15, 18; 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.

66. Skarlatos & Sardar, *supra* note 30, at 94 (explaining how ignorance can be used as a defense).

67. *See supra* Part I.

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.<sup>68</sup> 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.<sup>69</sup>

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.<sup>70</sup> Interrogatories may require the answering party to provide "papers, documents, or photographs" that are relevant in responding.<sup>71</sup> 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.<sup>72</sup> 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.<sup>73</sup> This is referred to as a request for production of documents.<sup>74</sup> 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

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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 LAW & 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, § 34.

71. *Id.*

72. See *Cheek v. United States*, 498 U.S. 192, 202 (1991) (recognizing that the government need only prove knowledge of the "pertinent legal duty" to establish willfulness).

73. Hatch, *supra* note 26, § 36.

74. See *id.*

reporting obligations.<sup>75</sup> To achieve a more fair result, requests for production of documents, as with interrogatories, should include a statement of reporting requirements that references specific forms and schedules.

Third, depositions, which involve oral examination of a party,<sup>76</sup> also serve as a keen opportunity to impute knowledge that in turn will make willfulness easier to prove. A deposition notice may also include the requirement of producing documents or other items at the oral examination.<sup>77</sup> Documents turned over during the deposition may be marked as exhibits and used during the examination.<sup>78</sup> However, typically, financial documents are requested before the taking of the deposition. The family lawyer taking the deposition of a noncompliant spouse (who has refused to provide documents) could begin the deposition by reading a short uniform statement of reporting requirements. Since depositions are transcribed by a stenographer,<sup>79</sup> a deposition transcript could be given to the government to enable it to meet its burden of proof in a criminal prosecution once the compliant spouse is able to determine some of the hidden assets through other means.<sup>80</sup>

## 2. Current Case Law in the FBAR Context

An examination of how courts have recently analyzed willfulness in the FBAR context bolsters my argument. In *United States v. Williams*,<sup>81</sup> the Fourth Circuit reversed the lower court's ruling and held that the taxpayer did in fact willfully fail to file FBARs, which resulted in the imposition of FBAR civil penalties.<sup>82</sup> In making its decision, the Fourth Circuit relied on three principles, the first of which is particularly relevant for these purposes: conduct designed to conceal income or additional financial information can establish willfulness.<sup>83</sup> Regarding this principle, the court noted that the taxpayer stated on a tax return worksheet from his accountant that he did not have a foreign bank account.<sup>84</sup>

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75. See, e.g., CAL. CIV. PROC. CODE §§ 2023.010(g), 2023.030(d) (“Disobeying a court order to provide discovery [is a misuse of the discovery process.]”); see also *In re Marriage of Eustice*, 242 Cal. App. 4th 1291, 1309 (4th Dist. 2015) (noting that ex-husband engaged in “willful discovery abuse” by refusing to produce discovery documents for over two and a half years which resulted in the unavailability of material evidence).

76. Hatch, *supra* note 26, § 38.

77. *Id.*

78. *Id.*

79. Ezra Siller, *The Origins of the Oral Deposition in the Federal Rules: Who's in Charge?*, 10 SETON HALL CIR. REV. 43, 46 (2013).

80. See FED. R. EVID. 801(d)(2) (opposing party statements are admissible if offered against the opposing party).

81. 489 F. App'x 655 (4th Cir. 2012).

82. *Id.* at 656, 659.

83. See *id.* at 659.

84. *Id.* at 656–57.

The court determined this was evidence of conduct designed to conceal income and used it to impose FBAR penalties against him.<sup>85</sup>

More than likely, obtaining a tax return worksheet from a noncompliant spouse would be a difficult (though not impossible) task and probably require a subpoena of the tax accountant. Also, the court had to rely heavily upon Williams' guilty plea, i.e., admission that he failed to report foreign accounts to the IRS or the Treasury Department as part of an intricate tax scheme.<sup>86</sup> Requiring a guilty plea to establish willfulness restricts the ability of courts to impose civil FBAR penalties and is more than likely not a common occurrence. A noncompliant spouse's refusal to turn over information regarding foreign assets should already be deemed evidence of "conduct 'meant to conceal . . . income.'"<sup>87</sup> A more direct way of establishing a noncompliant spouse's willfulness in the FBAR context would be to include statements of foreign asset/income reporting requirements on the discovery devices mentioned.

In cases involving a noncompliant spouse, the government should be able to point to the noncompliant spouse's behavior during discovery to establish willfulness instead of having to rely on finding a tax worksheet given to an accountant and a guilty plea. A noncompliant spouse's behavior by its nature is "conduct 'meant to conceal . . . income.'"<sup>88</sup> That is why motions to compel and subpoenas must be used to obtain any documents; even in the face of motions to compel and subpoenas, noncompliant spouses persist on concealing their income, which should satisfy the standard set forth in *Williams*. However, to make their willfulness even clearer, the discovery devices should include statements of reporting requirements. Including such statements of reporting requirements would make it even easier for the government to prove that a noncompliant spouse has acted willfully in failing to report hidden foreign assets. The government need only point to the statements of reporting requirements contained in the interrogatories, requests for documents, etc. The noncompliant spouse's decision to ignore written statements of reporting requirements contained in discovery requests would enable the government to show willfulness and thus impose civil FBAR penalties under *Williams*.

In another case that resulted in the imposition of FBAR penalties, *United States v. McBride*,<sup>89</sup> the taxpayer was held to have willfully failed to file FBARs due to certain egregious actions, including describing his offshore structuring as tax evasion himself.<sup>90</sup> Because McBride had signed his income tax returns, knowledge of the FBAR reporting requirement was imputed to him.<sup>91</sup> However,

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85. *See id.* at 659.

86. *Williams*, 489 F. App'x at 660.

87. *Id.* at 659.

88. *Id.*

89. 908 F. Supp. 2d 1186 (D. Utah 2012).

90. *Id.* at 1190, 1212.

91. *Id.* at 1208.

his failure to comply with the legal duty to file the FBAR was deemed either reckless or due to willful blindness.<sup>92</sup> The court then had to find that recklessness is adequate to show willfulness in terms of imposing a civil FBAR penalty.<sup>93</sup> 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* deal with willfulness in the FBAR civil penalty context, there is no reason why willfulness could not be proven beyond a reasonable doubt, the standard required for criminal prosecution. The potential exposure to criminal liability should serve as a deterrent to a continued failure to cooperate with the discovery process and to continue to violate reporting requirements throughout divorce proceedings.<sup>94</sup>

### III. TAKING AWAY THE POSSIBILITY OF VOLUNTARY DISCLOSURE FOR NONCOMPLIANT SPOUSES

Currently, a taxpayer who has failed to disclose foreign assets may participate in what is known as a voluntary disclosure program in order to escape criminal liability and to prevent at least some civil penalties.<sup>95</sup> There are four requirements for participation in a voluntary disclosure program: (1) a “timely” disclosure; (2) undisclosed income or assets which were legally derived; (3) truthful cooperation with requests for information; and (4) payment or a good faith arrangement to pay taxes, penalties, and interest owing.<sup>96</sup> The first two requirements are threshold requirements.<sup>97</sup> This Paper assumes that the offshore assets have been legally derived.

#### A. *Current Pre-Clearance Procedure*

“Timely” means that the noncompliant spouse is not already subject to an IRS investigation or audit.<sup>98</sup> If the IRS has already started an investigation or audit, the noncompliant spouse is ineligible for the voluntary disclosure program.<sup>99</sup> A “pre-clearance” procedure enables taxpayers to determine whether there is an IRS investigation or audit underway before disclosing the unreported

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92. *Id.* at 1210.

93. *Id.* at 1209.

94. See discussion *supra* Section II.C.1.

95. Skarlatos & Sardar, *supra* note 30, at 103–04; INTERNAL REVENUE SERV., *supra* note 12.

96. Skarlatos & Sardar, *supra* note 30, at 103.

97. See *id.*

98. See *id.*

99. *Id.*

assets.<sup>100</sup> 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.<sup>101</sup> 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.<sup>102</sup> In most cases, a noncompliant spouse would need to request pre-clearance before making a disclosure.<sup>103</sup>

*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’s name should be added to a separate list that makes him/her ineligible for the disclosure program if he/she does not make a disclosure within a prescribed time frame, e.g., ninety days. By giving the noncompliant spouse a deadline for starting the disclosure process that works in tandem with the discovery process timeline, the IRS can assist with the uncovering of hidden assets and promote compliance with reporting requirements, which ultimately will generate more revenue in the form of taxes, penalties, and interest.

CONCLUSION

Allowing a noncompliant spouse the opportunity to avoid criminal liability and civil penalties easily as well as to continue to mitigate taxes through entering a voluntary disclosure program leads to an unjust result. The discovery process is unnecessarily prolonged, and accurate reporting is unnecessarily delayed by enabling noncompliant spouses to face only minor consequences for failing to comply. Such flagrant disregard of the family law discovery process and reporting requirements should not go unreprimed. The solution is to add statements of reporting requirements to discovery devices to enable the government to prove willfulness and to allow family lawyers dealing with noncompliant spouses to have their names added to the list the IRS uses to determine ineligibility for voluntary disclosure pre-clearance. These two changes will serve as a powerful disincentive for continued noncompliance and

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100. *Id.*

101. Skarlatos & Sardar, *supra* note 30, at 104.

102. *Id.*

103. *Id.* at 105.

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will result in more expedient divorce proceedings and greater compliance with reporting requirements.

