OFFSHORE TAX ENFORCEMENT & HIGH NET WORTH DIVORCE

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2 Uses of offshore accounts

- (1) Hide assets from tax authorities
- (2) Hide assets from a spouse who may have a claim to them in divorce proceedings (Panama Papers)
Roadblocks to uncovering offshore accounts

- Our current “willfulness” standard and “innocent spouse relief” standard
- Spouses who hide offshore assets/accounts during divorce proceedings (“non-compliant spouses”) may claim they did not act “willfully” and thus avoid criminal prosecution and fines. Such spouses remain eligible for tax amnesty programs, such as the Offshore Voluntary Disclosure Program.
Roadblocks to uncovering offshore accounts

- However, spouses who uncover such offshore assets/accounts often are ineligible for innocent spouse relief, i.e., relief from joint and several liability.
Roadblocks to uncovering offshore accounts

- As a result, we are protecting the spouse who has hidden offshore assets/accounts from criminal prosecution, civil penalties, and some degree of tax liability while disincentivizing the “innocent” spouse who uncovers the assets/accounts from reporting them to the IRS.
A comprehensive solution

- Step 1: Non-compliant spouses should be deemed to have acted "willfully." Also, their names should be added to the ineligibility list for voluntary disclosure.

- Step 2: Their spouses/former spouses who uncover such offshore assets/accounts should be deemed eligible for innocent spouse relief.
Willfulness

- **Willfulness** – Applies to the spouse hiding offshore assets (“non-compliant spouse”)
  - Standard for criminal conviction and penalties

- Problem with willfulness (i.e., an intentional violation of a known **legal duty**): A taxpayer may claim that he/she did not *know* there was a **legal requirement** to disclose a foreign asset/account, and as a result, willfulness cannot be proven.
Innocent spouse relief

- **Innocent Spouse Relief (3 types under I.R.C. section 6015)** – Sought by the spouse who finds the hidden offshore assets/accounts
  - Relief from joint and several liability
- Problem with relief for **Taxpayers No Longer Married** (i.e., section 6015(c)): A taxpayer is ineligible for relief if the IRS demonstrates “actual knowledge” of any item giving rise to the deficiency at the time the return was signed.
Efforts to combat offshore tax abuse

- Numerous efforts in recent years, e.g., heavy penalties and new reporting requirements (FATCA and FBAR)
- IRS? – not enough time or resources
- Spouses of wealthy tax evaders in divorce proceedings? – have both
2 uses of offshore accounts=uncovering hidden Foreign assets

- **“Non-compliant spouse”** – a spouse refusing to comply with the discovery process during a divorce and likely a tax evader as well

- **Family Law Context** – motions to compel, subpoenas, forensic accountants

- **Tax Context** – failed to comply with reporting requirements regarding foreign assets/accounts (IRS Form 1040 Schedule B; IRS Forms 5471, 3520, 3520-A, 8865, 8938; & FinCEN Form 114 (FBAR))
Step 1: Non-compliant spouses
Willfulness & voluntary disclosure ineligibility

- Willfulness required for all 3 possible penalties:
  1. a criminal conviction;
  2. a 50% FBAR penalty; or
  3. a 75% civil tax fraud penalty

- Willfulness is “an intentional violation of a known legal duty.”

- A taxpayer who knows he/she should report a foreign asset/account but then intentionally refuses to do so
Discovery devices & Willfulness

- Modify discovery devices to impute knowledge of reporting requirements to non-compliant spouses
  
  (1) Interrogatories,
  
  (2) Requests for production of documents, and
  
  (3) Depositions
No voluntary disclosure for non-compliant spouses

- **Voluntary disclosure** – allows taxpayers to escape criminal liability and to mitigate civil penalties (currently suspended)

- **4 Requirements:**
  1. Timely – not already subject to audit;
  2. Undisclosed income or assets legally derived;
  3. Truthful cooperation with information requests; and
  4. **Payment or good faith arrangement to pay taxes, penalties, and interest owing**
No voluntary disclosure for non-compliant spouses cont.

- Subject to conditions, a non-compliant spouse’s name should be added to a list that makes him/her ineligible for a voluntary disclosure program if he/she fails to make a disclosure within a prescribed time frame.

- Deadline would work in tandem with the discovery process timeline
Step 1: Solutions

- Non-compliant spouses unnecessarily prolong the discovery process and fail to comply with foreign asset reporting requirements.

- Solution: (1) add statements of reporting requirements to discovery devices (willfulness) and (2) add their names to an ineligibility list for voluntary disclosure

- This would result in more expedient family court proceedings and more timely and accurate reporting of hidden offshore assets.
Step 2: “innocent” spouse relief under 6015(c)

- Knowledge of a Tax Understatement:

I.R.C. section 6015 (c) refers to knowledge of a tax understatement. However, courts have held that **knowledge of the underlying facts** giving rise to a deduction or omission of income is enough for ineligibility.

Requests for innocent spouse relief are routinely denied even where there has been financial abuse.
Step 2: “innocent” spouse relief under 6015(c)

“Actual Knowledge” under I.R.C. section 6015 (c) –

Facts & Circumstances test under Treas. Reg. section 1.6015-3(c)(2)(iv)

- Deliberately avoid learning about an item on the tax return?
- Had an ownership interest in the property that resulted in an erroneous item on the return
Step 2: “innocent” spouse relief under 6015(c)

Omitted Income Cases

Key Question: Whether the “innocent spouse” had knowledge of the receipt of the income, not knowledge of the source of the income?

Hypo 1 (Eligible): The wife knows the husband owns corporate stock but does not know a dividend has been paid.

Hypo 2 (Ineligible): The wife knows that $150,000 was received but does not know the source.
Step 2: solution

- Innocent spouse relief under I.R.C. section 6015(c) should be available for a spouse who has knowledge of the receipt of the income but who did not know that it came from hidden offshore assets/accounts (later discovered).
Conclusion

- “Non-compliant spouses” - Statements of reporting requirements should be added to discovery devices to establish willfulness, and their names should be added to an ineligibility list for voluntary disclosure.

- “Innocent” spouses – “Innocent” spouses who had knowledge of the receipt of income but who did not know that it came from hidden offshore assets/accounts (later discovered) should be eligible for innocent spouse relief under I.R.C. section 6015(c).