

Taxes and Penalties on Unreported Foreign Assets: Who Foots the Bill?

by

Bryan C. Skarlatos

Michael Sardar¹

Brian and Helena are getting divorced. Brian has a successful electronics company that sells products around the world. Several years ago, a European customer owed a lot of money to Brian's company and Brian instructed the customer to divert part of the payment to a numbered bank account in the Channel Islands controlled by Brian. The account now has a little over one million dollars. Helena has always known about the account and now she is threatening to tell the judge, or worse, call the Internal Revenue Service, unless Brian agrees to her settlement proposal.

What can Brian do? What are the tax consequences? Could there be penalties? More importantly, does Brian have criminal exposure? And who bears the cost of all the taxes and penalties associated with the unreported foreign account: is it all Brian's burden; or is Helena jointly responsible?

Matrimonial lawyers often think of tax issues in terms of who is an "innocent spouse," but that does not fully capture the proper analysis required when dealing with unreported foreign assets. When such assets surface in a divorce, the most important issue is whether either of the spouses "willfully" failed to report the foreign assets because "willfulness" could trigger a criminal prosecution, or huge civil penalties, either of which could wipe out the marital estate. Secondly, there are issues relating to innocent spouse treatment under the Internal Revenue Code (I.R.C.) and separate issues relating to how a matrimonial court will allocate any tax liabilities relating to the unreported foreign account.

¹ Bryan C. Skarlatos and Michael Sardar are attorneys at Kostelanetz & Fink, LLP, a New York City law firm that focuses on civil and criminal tax controversies.

This article is not about how to find foreign assets. That is a question for a good forensic accountant, though it is important to understand that foreign accounts often can be traced through a careful review of bank statements and financial transactions. In addition, new laws are requiring foreign financial institutions around the world to report foreign accounts held by their U.S. customers to the Internal Revenue Service (IRS),² making it easier for the IRS, creditors, and spouses to uncover such accounts.

This article is about what to do when unreported foreign assets come to light in a divorce and will help practitioners evaluate the available alternatives and associated risks and costs. Part I outlines many of the various reporting requirements for foreign assets and the related civil penalties. Part II discusses the willfulness standard and when huge penalties, or even criminal prosecution and potential imprisonment, must be considered. Part III reviews the options available to a taxpayer who has foreign assets, including the voluntary disclosure programs that can be used to minimize the civil penalties and avoid criminal prosecution. Part IV addresses strategies for dealing with taxes and penalties when unreported foreign assets surface in a divorce case. The conclusion summarizes an analytical framework for approaching issues involving unreported foreign assets.

I. Foreign Asset Reporting Requirements and Related Penalties

The United States has a worldwide system of taxation. Every U.S. citizen or resident must report his or her worldwide income regardless of where the money is earned and regardless of whether any tax is due. U.S. taxpayers receive a tax credit for most foreign taxes paid, so the foreign income usually is not taxed twice.³ In addition, U.S. tax returns require U.S. taxpayers to report their ownership interest in foreign assets such as foreign accounts, foreign notes, and foreign entities, including corpora-

² I.R.C. §§ 1471-1474. The Foreign Account Tax Compliance Act (“FATCA”) was passed in 2010 as part of the HIRE Act. FATCA requires U.S. persons to report certain foreign assets to the IRS. FATCA also requires foreign financial institutions to report their U.S. clients to the IRS. These rules are discussed *infra* at Section III.

³ See I.R.C. § 901.

tions, partnerships, and trusts.⁴ Separately, U.S. taxpayers must file a Foreign Bank Account Report (“FBAR”) with the Treasury Department to report foreign financial accounts that, in the aggregate, exceed \$10,000 in any year.⁵ The FBAR requirement is separate from any tax return reporting obligations. These foreign asset reporting obligations are complex and overlapping, sometimes requiring the same foreign asset to be reported in several different ways. The bottom line is that all foreign income and most foreign assets must be reported to the IRS even if no money was earned or received here in the United States.

A. Tax Return Reporting Requirements

As mentioned above, all foreign income and some foreign assets must be reported on a U.S. tax return. It is helpful to separate the analysis of foreign *income* reporting requirements from the analysis of foreign *asset* information reporting requirements.

1. Foreign Income Reporting Requirements and Related Penalties

All income earned by an individual U.S. taxpayer from foreign sources must be reported each year on a Form 1040 U.S. tax return.⁶ Foreign source wages or commissions are reported either on the face of the return or on Schedule C. Foreign earned interest and dividends are reported on Parts I and II of Schedule B. Foreign earned capital gains and losses are reported on Schedule D. Foreign rents or flow through income from partnerships or similar entities are reported on Schedule E. In general, foreign source income is taxed in the same way that domestic income is taxed.⁷

⁴ See IRS Form 1040 Schedule B; IRS Forms 5471, 3520, 3520-A, 8865, 8938.

⁵ 31 U.S.C. § 5314; 31 C.F.R. § 1010.350.

⁶ Form 1040 is for individual taxpayers. Similar requirements apply to entities.

⁷ There are some special rules that, for example, may exempt a certain amount of foreign source earned income, or change the timing, characterization, and tax rate for income from certain foreign entities such as controlled foreign corporations and passive foreign investment companies. See I.R.C. § 911 (foreign earned income exclusion); I.R.C. §§ 1291-1298 (taxation of passive foreign investment companies).

A taxpayer who fails to report or pay tax on foreign source income is subject to the same tax penalties that apply to the failure to pay tax on domestic income. Tax penalties typically are a percentage of the understatement, i.e. the tax that should have been paid but was not paid. The penalties range from 20% for a negligent failure to pay or a substantial understatement of tax,⁸ to 75% for a fraudulent failure to pay.⁹ Interest runs on both the understatement of tax and the penalties.

In addition, there can be criminal penalties for failure to report income. The most common criminal tax charge is tax evasion.¹⁰ Other common criminal tax charges include filing a false return,¹¹ interference with the lawful function of the Internal Revenue Service,¹² and conspiracy to impede the IRS.¹³ A conviction for a tax crime often results in a sentence of imprisonment depending on the amount of money involved. Under the Federal Sentencing Guidelines, the recommended sentence for a tax crime involving more than \$12,500 of taxes is 10-16 months in prison.¹⁴ Because of the harsh consequences of a criminal conviction, the government must be able to prove beyond a reasonable doubt that the taxpayer “willfully” violated the law to convict a taxpayer of a tax crime.¹⁵

2. Foreign Asset Reporting Requirements and Related Penalties

There are many places on a U.S. tax return where U.S. taxpayers must disclose an interest in foreign assets. The most common tax return reporting requirements, and related penalties for failure to report, are outlined below.

a. Schedule B, Part III – Foreign Accounts and Trusts

Schedule B, Part III, asks whether the taxpayer has a “financial interest in, or signature authority over” a foreign financial

⁸ I.R.C. §§ 6662(b)(1), 6662(b)2).

⁹ I.R.C. § 6663.

¹⁰ I.R.C. § 7201.

¹¹ I.R.C. § 7206(1).

¹² I.R.C. § 7212.

¹³ 18 U.S.C. § 371.

¹⁴ See Federal Sentencing Guidelines Manual §§ 2T1.1 and 2T4.1.

¹⁵ The concept of willfulness is discussed *infra* at Section II.

account and whether the taxpayer received a distribution from, made a transfer to, or was a grantor of a foreign trust. Part III also advises the taxpayer that, if the taxpayer answers “yes” to either question, the taxpayer may have an obligation to file an FBAR or a Form 3520.¹⁶

Taxpayers with unreported foreign accounts or trusts almost always check the boxes on Part III “no,” usually because they are hiding the foreign account or trust, or because their tax return preparer never asked about foreign assets and the preparer’s software program automatically defaulted to “no.” If the taxpayer intentionally checked a box “no,” the taxpayer could be at risk for a criminal prosecution for filing a false tax return. Further, checking the box “no” is one factor the IRS and courts consider in determining whether a taxpayer was willfully attempting to hide foreign assets.¹⁷

b. *Form 8938 – Statement of Specified Foreign Financial Assets*

Beginning in 2011, the Foreign Account Tax Compliance Act created a new requirement for taxpayers with foreign financial assets to report those assets on a new Form 8938 that is attached to the taxpayer’s Form 1040. I.R.C. section 6038D requires individual taxpayers to report their interest in “specified foreign financial assets” on the Form 8938 if the aggregate value of such assets exceeds \$50,000.¹⁸ “Specified foreign financial assets” include depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, (1) stocks or securities issued by foreign persons,

¹⁶ Both of these are discussed *infra* at Sections I(A)(2)(d) and I(B).

¹⁷ See *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012); IRM 4.26.16.4.5.3 (6).

¹⁸ I.R.C. § 6038D(a). The filing requirement is relaxed and filing is only required when the aggregate value of the specified foreign financial assets meets the following thresholds. Individual return: \$50,000 on the last day of the taxable year or \$75,000 at any time during the taxable year; Joint return: \$100,000 on the last day of the taxable year or \$150,000 at any time during the taxable year; Individual return of a U.S. citizen or resident living abroad: \$200,000 on the last day of the taxable year or \$300,000 at any time during the taxable year; Joint return of U.S. citizens or residents living abroad: \$400,000 on the last day of the taxable year or \$600,000 at any time during the taxable year. Temp. Treas. Reg. § 1.6038D-2T.

(2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, (3) an interest in a foreign estate or trust,¹⁹ and (4) any interest in a foreign entity.²⁰ In addition to bank accounts, this provision requires taxpayers to report things like foreign insurance policies, privately issued stocks and notes, and other interests in foreign entities. Importantly, taxpayers do not have to report non-financial assets like real estate, art, jewelry, and precious metals or stones.²¹

A taxpayer who fails to file a Form 8938, or who leaves assets off of a Form 8938, can be subject to a penalty of \$10,000.²² If the failure continues beyond 90 days after the IRS notifies the taxpayer of the failure by mail, the penalty increases by \$10,000 for each 30 day period, up to a maximum of \$60,000 for each taxable period.²³ Of course, a willful failure to file a Form 8938 is a badge of fraud that could subject the taxpayer to other penalties including potential criminal prosecution for filing a false tax return.

Failing to comply with Form 8938 reporting as required by section 6038D can have other negative consequences as well. If a taxpayer fails to file a Form 8938, the entire return is deemed incomplete and the ordinary three-year statute of limitations²⁴

¹⁹ An interest in a foreign trust or estate is reportable only if the taxpayer knows or has reason to know, based on readily accessible information, of the interest. Receipt of a distribution from the foreign trust or foreign estate constitutes actual knowledge. Temp. Treas. Reg. § 1.6038D-3T(c).

²⁰ I.R.C. § 6038D(b); Temp. Treas. Reg. § 1.6038D-3T.

²¹ While direct ownership of these kinds of assets do not have to be reported on a Form 8938, if the taxpayer holds the assets in a foreign entity or foreign financial account, then the taxpayer's interest in the foreign entity or account would have to be reported. For example, real estate held in a corporation would trigger the requirement to report the shares of the corporation. Or, gold held in an account at a foreign bank would trigger the requirement to report the foreign account. Moreover, just because the asset does not need to be reported does not mean that the income from the assets is exempt from tax. For example, directly held real estate may not be reportable, but the rent from the real estate still must be reported on the tax return and will be taxed.

²² I.R.C. § 6038D(d)(1).

²³ I.R.C. § 6038D(d)(2).

²⁴ Ordinarily, the IRS is limited to three years from the date of filing a return to make adjustments to the return. There are, however, several exceptions to this rule.

does not begin to run on the entire return until the form is filed.²⁵ Only when the form is filed does the ordinary three-year statute of limitations begin to run.²⁶ Thus, failing to file Form 8938, leaves the *entire* tax return open to IRS scrutiny indefinitely. If, however, the failure to file Form 8938 is due to reasonable cause, the statute of limitations would begin to run on the original filing date of the return for all income items except for those that should have been reported on the Form 8938, which continue to be open indefinitely until the form is filed.²⁷ In addition, if a taxpayer omits from a tax return more than \$5,000 of income attributable to an asset that is reportable on Form 8938, such an omission is deemed to be a “substantial omission”²⁸ and a six-year statute of limitations and relevant penalties apply to the tax return.²⁹ This is so even if the asset was reported on the Form 8938.³⁰

*c. Form 5471 – Relationships with Foreign Corporation
and Form 8865 – Report of Foreign Partnership*

In addition to reporting the income earned from foreign partnerships and corporations, U.S. taxpayers must report their interests in such entities as well as certain transactions made with such entities. Foreign corporations and related transactions are reported on Form 5471, while Form 8865 provides similar reporting for foreign partnerships.³¹

In the case of both forms, the penalty for failing to timely file is \$10,000 for each violation.³² If the failure continues beyond 90 days after the IRS notifies the taxpayer of the failure, the penalty increases by \$10,000 for each 30 day period, up to a maximum of \$60,000 for each taxable period.³³ Where a taxpayer can demonstrate that the failure to file was due to reasona-

²⁵ I.R.C. § 6501(c)(8)(A).

²⁶ I.R.C. § 6501(c)(8)(A).

²⁷ I.R.C. § 6501(c)(8)(B).

²⁸ Ordinarily, a substantial omission is defined to be an omission of income equal to 25% or more of the amount actually reported.

²⁹ I.R.C. § 6501(a)(1)(A).

³⁰ See I.R.C. § 6501(a)(1)(A).

³¹ I.R.C. § 6038.

³² I.R.C. § 6038(b).

³³ In the case of Form 8865, certain filers are subject to a penalty equal to 10% of the unreported transaction in lieu of the \$10,000 penalty.

ble cause, no penalty can be imposed. Willful failure to file the form can lead to more severe civil and criminal penalties. Of course, failure to file the forms can itself be evidence of willfulness.

d. *Form 3520/ 3520-A – Relationships with Foreign Trusts, and Receipt of Foreign Gifts and Bequests*

A U.S. taxpayer who establishes a foreign trust must report the event to the IRS on Form 3520.³⁴ Similarly, a U.S. taxpayer who receives distributions from, or makes contributions to, a foreign trust must report such transactions on Form 3520.³⁵ Finally, a U.S. taxpayer who receives a gift or bequest from a foreign person must report that fact on Form 3520.³⁶ A gift or bequest from an individual or decedent is reportable if it exceeds \$100,000 in one tax year while a gift from a corporation or partnership is reportable if it exceeds \$15,102 in any one tax year.

The penalty for failing to file a Form 3520, or filing a false 3520, can be quite large. The penalty for failing to report a transaction with a foreign trust is the greater of \$10,000 or 35% of the amount of the transaction at issue (i.e. the amount of the distribution or transfer).³⁷ If a taxpayer fails to file a Form 3520 within 90 days of IRS notice that the Form is required, an additional \$10,000 penalty will be assessed for every 30 days of continued non-compliance. The total penalty, however, cannot exceed 100% of the amount of the transaction at issue. The penalty for failing to report a gift or bequest on Form 3520 is equal to 5% of the amount of the gift or bequest for each month that the form is not filed, not to exceed 25% of the amount of the gift or bequest.³⁸

In addition to the transaction-related information reporting required by Form 3520, a U.S. taxpayer that is treated as the

³⁴ I.R.C. §§ 6048(a) and (c).

³⁵ *Id.*

³⁶ I.R.C. § 6039F.

³⁷ I.R.C. § 6677.

³⁸ I.R.C. § 6039F. In addition, the IRS may then treat the gift or bequest, which would ordinarily not be taxable income, as taxable income. I.R.C. § 6039F(c)(1)(A).

owner of a foreign trust under the “grantor trust rules”³⁹ of I.R.C. sections 671 to 679, also must report the activities of the trust on a yearly basis on Form 3520-A.⁴⁰ Failure to file a 3520-A subjects the U.S. taxpayer to a penalty equal to the greater of \$10,000 or 5% of the gross value of the trust treated as owned by the U.S. person.⁴¹ Furthermore, if the taxpayer fails to file a Form 3520-A within 90 days of IRS notice that the form is required, an additional \$10,000 penalty will be assessed for every 30 days of continued non-compliance. The total penalty, however, cannot exceed 100% of the gross value of the trust treated as owned by the U.S. taxpayer. Again, a willful failure to file, or falsely filing, a Form 3520/3520-A could lead to a criminal prosecution.

B. Report of Foreign Bank Account

In addition to the tax return reporting requirements discussed above, the Treasury Department has separate rules that require U.S. persons to report their interest in, or signatory authority over, foreign bank and financial accounts to the U.S. government on an FBAR form.⁴² This reporting obligation was first established in 1970 when the Bank Secrecy Act was enacted. The purpose of the FBAR reporting requirements is to assist the government in collecting information that has “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.”⁴³

FBARs are required under the banking law, not the tax law, so they are not tax forms. FBARs are information returns and do not require the payment of any tax. The FBAR is not filed with the tax return. Instead, it must be filed with the Treasury

³⁹ Generally, a grantor trust is treated as being owned by a U.S. taxpayer, who is then taxed on all of the trust’s income, even if the income is not distributed. I.R.C. § 671. In essence, a trust that is subject to the grantor trust rules is disregarded for income tax purposes and the grantor is taxed directly on the trust’s activities.

⁴⁰ I.R.C. § 6048(b).

⁴¹ I.R.C. § 6677.

⁴² 31 U.S.C. § 5314; 31 C.F.R. § 1010.350; Form FinCEN 114.

⁴³ 31 U.S.C. § 5311.

Department on or before June 30th of the calendar year following the year in which the U.S. person had an interest in, or signature or other authority over, the foreign account.⁴⁴ The deadline for filing the FBAR cannot be extended.⁴⁵

FBARs require U.S. persons to report all foreign financial accounts held during the year if the aggregate amount of all accounts exceeded \$10,000 on any single day during the year. The term “financial account” is defined broadly to include any bank account, brokerage or securities account, securities derivatives or other financial instruments account, checking account, debit-card or pre-paid card account, and insurance policies.⁴⁶ The FBAR requires information such as the name, address and taxpayer identification number of the person filing the report; the type and identity of the bank account(s); the name of the bank(s) at which the account(s) is held; the maximum value of the account(s) for the calendar year reported; and certain other information.

Failing to timely file an FBAR, or filing an incomplete or false FBAR, can result in a range of penalties, depending on whether the violation can be excused by reasonable cause, was negligent, or was willful. If the taxpayer has reasonable cause for failing to file or filing a false FBAR, then no penalty will be imposed. The burden is on the taxpayer to prove reasonable cause. The most obvious and common example of reasonable cause is that the taxpayer told a return preparer about the account but the return preparer failed to advise the taxpayer that an FBAR was required.⁴⁷

A non-willful, or negligent, violation of the FBAR rules where the taxpayer cannot prove reasonable cause for the violation can result in a penalty of up to \$10,000 for each failure.⁴⁸ A willful violation can result in huge civil penalties of as much as the greater of \$100,000 or 50% of the value of the account at the

⁴⁴ 31 C.F.R. § 1010.350. *See also* 31 U.S.C. § 5314.

⁴⁵ Instructions to Form FinCEN 114.

⁴⁶ *Id.*

⁴⁷ *See* IRM § 4.26.16.4.3.1 (07-01-2008).

⁴⁸ 31 U.S.C. § 5321(a)(5)(B). The penalty for non-willful violations applies only to FBAR violations occurring after October 22, 2004 (i.e. FBARs due on or after June 30, 2005). Prior to October 22, 2004, no penalty existed for non-willful violations. In the case of a non-willful failure, no penalty will be imposed if the failure is due to reasonable cause. 31 U.S.C. § 5321(a)(5)(B)(ii).

time of the violation.⁴⁹ There is a six-year statute of limitations for failing to file an FBAR or filing a false FBAR, so the 50% penalty can be imposed for a total of six years. This can lead to crushing penalties that far exceed the value of the account, for the mere failure to file the FBAR. Importantly, these penalties are imposed against the U.S. person, not against the account, so even if the penalty exceeds the value of the account, the U.S. person will still be personally liable for the full amount of the penalty. In addition, there can be criminal penalties for a willful failure to file, or falsely filing, an FBAR.⁵⁰

II. The Importance of Willfulness

Willfulness is one of the most important factors to consider in determining how to approach unreported foreign assets because the size and severity of the potential tax problem depends on whether one or both of the spouses acted willfully. Willfulness is the standard for criminal prosecutions and for the most onerous FBAR and tax fraud penalties. To get a criminal conviction, the government must prove that the taxpayer willfully failed to report the foreign assets. Similarly, to impose the 50% civil FBAR penalty, the government must prove that the taxpayer willfully failed to file the FBAR or filed a false FBAR. To impose the 75% civil tax fraud penalty, the government must prove that the taxpayer willfully understated his or her income tax.

The willfulness standard is the same for all of these penalties. The only difference is that, for a criminal case, the government must prove willfulness beyond a reasonable doubt, whereas in civil FBAR penalty or civil fraud penalty cases, the government only has to prove willfulness by clear and convincing evi-

⁴⁹ 31 U.S.C. § 5321(a)(5)(C). Prior to October 22, 2004, the maximum civil penalty for willful violations was the greater of \$25,000 or the balance in the account at the time of violation, up to a maximum of \$100,000. With respect to an unfiled FBAR, the violation occurs on the due date for filing the FBAR. Therefore, the maximum statutory penalty for failing to file a 2013 FBAR would be determined by reference to the value of the account on June 30, 2014 – the deadline for the 2013 FBAR.

⁵⁰ 31 U.S.C. § 5322

dence.⁵¹ This means that the difference between a criminal case and a civil case is the amount of evidence the government can muster to meet its burden of proof. If the government has a lot of evidence of willfulness, then it can prove its case beyond a reasonable doubt and the taxpayer is at risk of being criminally prosecuted. However, if there are holes in the evidence, or if the taxpayer has some plausible explanations, then the government may only be able to prove willfulness by clear and convincing evidence and may not pursue a criminal case. 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.

Willfulness is defined as “an intentional violation of a known legal duty.”⁵² This is a subjective standard. It means that the taxpayer knew that he or she was supposed to report the foreign asset, but intentionally chose not to do so. Ignorance of the law is actually a defense. If the taxpayer can prove that he or she had no idea that the asset had to be reported, then the taxpayer did not act willfully.⁵³

The willfulness standard is complemented by the concept of “willful blindness.” Willful blindness means that a person is aware of the high likelihood of a fact or legal duty but nevertheless intentionally looks away, or makes him or herself blind to the existence of the fact or duty. This concept is also known as “conscious avoidance,” whereby one consciously avoids what he or she knows is likely to be true. Willful blindness or conscious avoidance has been equated to willfulness in tax and FBAR criminal prosecution and civil penalty cases.⁵⁴ This means that if spouses, like Brian and Helena in the example above, were aware of a high likelihood that they had to report the foreign account to the government but failed to do so, they could be criminally prosecuted or subjected to huge FBAR penalties.

It is very difficult to prove what was going on inside a person’s mind and what that person did or did not know at the time

⁵¹ IRS Chief Counsel Memorandum 2006603026 (Jan. 20, 2006); *but see* United States v. Williams, 489 Fed. Appx. 655 (4th Cir 2012), *McBride*, 908 F. Supp. 2d 1186, discussed *infra* in text at note 60.

⁵² United States v. Pomponio, 429 U.S. 10 (1976).

⁵³ IRS Chief Counsel Memorandum 2006603026.

⁵⁴ *McBride*, 908 F. Supp. 2d 1186.

the tax return was filed.⁵⁵ It is like trying to guess what number somebody is thinking of if they don't tell you. Absent an admission, the only way the government can prove what was going on in a taxpayer's mind is to look at circumstantial evidence and then infer what the taxpayer must have been thinking. Such circumstantial evidence is often referred to as "badges of fraud."

Badges of fraud are objective facts which tend to establish that the taxpayer knew that what he or she was doing was wrong. For example, a double set of books, false invoices, dummy companies, or extensive cash dealings, are all objective facts, or badges of fraud, which tend to prove that the taxpayer was trying to hide things from the IRS. In the context of unreported foreign assets, common badges of fraud include the use of a bank secrecy jurisdiction. If the account or asset is in a bank secrecy jurisdiction, such as Switzerland, and there is no other reason for the account or asset to be located there, then the IRS can argue for the inference that the taxpayer was trying to use bank secrecy laws to hide the account. Similarly, if the account or asset was held in the name of a pseudonym, or numbered account, or in the name of an entity like a foreign corporation or trust, the IRS will argue that the taxpayer set the account up that way to conceal the taxpayer's interest in the account. If the foreign financial institution used a "hold mail" designation and did not send bank statements to the taxpayer in the United States, the IRS will take the position that the taxpayer was trying to hide ownership of the account.

Often, taxpayers do not tell their accountant or their tax return preparer about foreign assets, even when those assets are a substantial portion of the taxpayer's net worth. The IRS will assert that this proves the taxpayer did not want to disclose the account. Of course, large amounts of unreported income and tax can provide a powerful motivation not to report foreign assets and, therefore, can be indicative of an intent to conceal foreign assets. These are just a few examples of the types of evidence, or badges of fraud, the IRS will look for to prove that the taxpayer willfully failed to report the foreign account or assets.

⁵⁵ Willfulness depends on the taxpayer's state of mind at the time the tax return or FBAR was filed, or the due date if no return or FBAR was filed. What the taxpayer subsequently learned and did can be relevant, but is not directly determinative of the issue.

Two recent cases illustrate the way in which a court will analyze willfulness for purposes of the civil FBAR penalty. In *United States v. Williams*,⁵⁶ the Fourth Circuit reversed a federal district court decision holding that the taxpayer did not willfully fail to file FBARs reporting his foreign account, and ruled that willful FBAR penalties should be imposed.⁵⁷ The court of appeals outlined three principles it considered important: (1) willfulness in the FBAR context can be inferred from conduct meant to conceal income or other financial information; (2) “willful blindness” is sufficient to meet the willfulness standard and can be inferred where a taxpayer is subjectively aware of a high likelihood of a statutory requirement or liability, but purposefully avoids learning of that requirement or liability; and (3) “in cases where willfulness is a statutory condition of civil liability, courts have generally taken it to cover not only knowing violations of a standard, but reckless ones as well.”⁵⁸

Applying these principles, the court of appeals held that Williams willfully failed to file an FBAR for the following reasons. First, the court found that Williams’ signature on his 2000 tax return was prima facie evidence that he knew the contents of the return and, therefore, the reference to the FBAR on Schedule B put him on “inquiry notice of the FBAR requirement.”⁵⁹ Further, the fact that Williams testified at trial that he did not read line 7a of Schedule B (the foreign account question) was evidence that Williams made a “conscious effort” to avoid learning of the FBAR requirement. Second, Williams completed a tax return worksheet given to him by his accountant and indicated on the worksheet that he did not have a foreign account, which the court found was evidence of conduct meant to hide the foreign account. Finally, the court placed great emphasis on Williams’ guilty plea allocution (in connection with a tax crime; he was not criminally charged with an FBAR violation) in which he admitted that he failed to report the foreign accounts to the IRS or the Department of the Treasury as part of a larger scheme of tax

⁵⁶ 489 Fed. Appx. 655 (4th Cir 2012).

⁵⁷ *Id.*

⁵⁸ *Id.* at 657.

⁵⁹ Schedule B of Form 1040 asks if the filer maintained any foreign bank accounts or had signature authority over any foreign bank accounts and directs the taxpayer to the FBAR form.

evasion. The court noted that this “is an admission of violating [the FBAR reporting requirements].” The court concluded its analysis by stating “[t]hus, we are convinced that, at a minimum, Williams’ undisputed actions establish reckless conduct, which satisfies the proof requirement under section 5314.”⁶⁰

Shortly after *Williams* was decided, the government won another FBAR penalty case. In *United States v. McBride*,⁶¹ the federal district court upheld a willful FBAR penalty while similarly concluding that recklessness can be sufficient to support a finding that an FBAR violation is willful.⁶²

Mr. McBride had established four foreign accounts held in the name of shell foreign entities that he controlled. He then diverted taxable income into these accounts and did not report this income on his tax returns. In addition, Mr. McBride did not report the investment income earned on the accounts or report the existence of the accounts on an FBAR. The trial revealed the following evidence: Mr. McBride himself had once described the structure as tax evasion; written material from Mr. McBride’s foreign advisors stated that U.S. citizens are subject to specific reporting requirements regarding trusts, corporations, and foreign accounts; Mr. McBride funded his accounts with skimmed funds and set up loans so that he could access and enjoy his funds in the United States; he was evasive and lied during the audit; one of Mr. McBride’s accountant’s specifically warned him about the validity of the structure; and Schedule B of Mr. McBride’s 1040 had the “no” box checked in response to the foreign account question.

On these facts, the court concluded that McBride willfully failed to file FBARs to report his foreign accounts. The court first ruled that the proper evidentiary standard in a civil FBAR case was a preponderance of the evidence, not the higher clear and convincing standard. It then went on to conclude that because McBride signed his income tax returns, knowledge of the FBAR rules was imputed to him and his failure to file the FBAR

⁶⁰ *Williams*, 489 Fed. Appx. at 660.

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

⁶² *Id.* at 1204. It is worth noting, however, that both *McBride* and *Williams* involved egregious facts where the intent to evade tax was glaring. This factor may have influenced the courts’ decisions and their willingness to stretch the meaning of willfulness for purposes of the civil FBAR violation.

was either reckless or due to willful blindness. The court closed the circle by stating that recklessness is adequate to demonstrate willfulness in the context of the civil FBAR penalty.

The decisions in both *Williams* and *McBride* are troubling for several reasons. First, both courts applied a preponderance of the evidence standard for proving willfulness, as opposed to the clear and convincing standard that had always been used in prior tax cases involving willfulness. Second, both cases come dangerously close to deeming a person's signature on a tax return to mean that the person had full knowledge of every entry on the return. Perhaps most importantly, the decisions in *Williams* and *McBride* can be criticized for watering down the willfulness requirement so that it equates to mere recklessness. Prior to these decisions, willfulness had always been interpreted uniformly to require actual subjective knowledge that one's conduct was illegal or, at the most, willful blindness about whether one was breaking the law. Indeed, the IRS itself has recognized that willfulness for purposes of the civil FBAR penalty requires an intentional violation of a known legal duty.⁶³ Whether the statements regarding recklessness in *Williams* and *McBride* stand the test of time or are disregarded as dicta, the fact is that willful blindness, at least for purposes of the 50% civil FBAR penalty, is very close to a recklessness standard.

Given the decisions in *Williams* and *McBride*, lawyers advising clients with unreported foreign assets have to be very conservative when they evaluate whether their clients acted willfully. Of course, a taxpayer often will have some good arguments to counter any potential badges of fraud, but few people are eager to put their counter-arguments to a test in front of a court that is determining huge civil penalties, or worse, a criminal jury.

III. Options for Taxpayers Who Have Failed to Report Foreign Assets

What can a taxpayer who has failed to report foreign assets do to mitigate his or her risk? There are essentially four options available in these cases: do nothing; begin filing accurately for current and future years; file amended returns to clean up some

⁶³ IRS Chief Counsel Memorandum 2006603026.

of the past years; or make a formal voluntary disclosure of the prior years' failures to the IRS.

The option of doing nothing, while practically possible, is a bad idea. If the taxpayer does not start reporting correctly, then he or she will end up committing new tax crimes every April 15th when the tax return is due and every June 30th when the FBAR is due. Of course, it would be completely unethical, and possibly even criminal, for a professional to advise a taxpayer to continue to hide and file false returns that do not report the account. Further, the taxpayer is likely to get caught.

The IRS is in the midst of an unprecedented crackdown against unreported foreign assets. In the past, the FBAR and other foreign asset reporting requirements discussed above were scarcely enforced and penalties under the various penalty provisions were rarely imposed. However over the past decade, the IRS has increased its focus on unreported foreign assets and, since 2009, after the IRS reached a non-prosecution agreement with Swiss bank UBS, the IRS has begun to break through bank secrecy around the world. Since then, it has brought numerous civil and criminal enforcement actions against taxpayers with unreported foreign assets.

In addition, in 2010, Congress passed the Foreign Account Tax Compliance Act ("FATCA") which, among other things, requires foreign financial institutions to report foreign accounts held by their U.S. customers. FATCA requires a foreign financial institution to scrub its records to determine which accounts have U.S. indicia, such as a U.S. passport, or a U.S. address, or a U.S. telephone number, and then, starting in 2015, it must produce information similar to that found on a 1099, reflecting the income earned in the U.S.-related accounts. This means that it is becoming virtually certain that a U.S. taxpayer with unreported foreign assets eventually will be caught by the IRS. Thus, trying to stay off the grid is not a legal or viable option.

Another option is for a taxpayer to simply start reporting his or her foreign assets accurately going forward. On the next tax return or FBAR due date, the taxpayer can begin to accurately report all foreign assets. While this has the benefit of avoiding further criminal conduct, it does nothing to correct the past non-compliance and leaves the taxpayer at risk for criminal prosecution or huge civil penalties for that past non-compliance.

A third option is for the taxpayer to simply file amended tax returns. If the taxpayer is not already under audit or investigation, and if the taxpayer did not *willfully* fail to report the foreign assets or income, the amended returns will be “Qualified Amended Returns” which means that the IRS will not assert any penalties.⁶⁴ While this is an attractive option for taxpayers who are certain that their failure to report was merely negligent, it can be very dangerous if there is any chance that the IRS can prove that the failure to report was willful. The Qualified Amended Return provisions do not apply when willful or fraudulent conduct is involved.⁶⁵ In such cases, the IRS can use the taxpayer’s amended returns against him in a criminal prosecution to prove that the original return was false. In addition, the Qualified Amended Return rules do not apply to the FBAR, which is not a tax return.

If there is any real chance that the IRS could prove that the failure to report was willful, the only way to safely mitigate past non-compliance is to make a voluntary disclosure. Since 1952, the IRS has had a voluntary disclosure “policy” under which, the IRS would not refer for prosecution taxpayers that voluntarily confessed their tax sins. Under that policy, contained within the IRS’s Internal Revenue Manual (“IRM”), a taxpayer must make a disclosure to the IRS prior to the IRS’s learning of the taxpayer’s liabilities. The disclosure must be complete and truthful, the taxpayer must cooperate with the IRS and pay any tax, interest, and penalties that are due, and the disclosure must not relate to illegal source funds.⁶⁶ Untaxed monies are not deemed illegal. This long standing policy is merely a criminal policy and has no impact on the IRS’s ability to seek civil penalties.

In 2009, the IRS announced, the 2009 Offshore Voluntary Disclosure Program (“OVDP”), which essentially combined the voluntary disclosure policy contained in the IRM with a civil penalty component that capped the civil penalties the IRS could assess against participating taxpayers. Thus, in addition to being assured that they would not be criminally prosecuted, taxpayers who came forward under the 2009 OVDP were subject to reduced civil penalties. While the initial OVDP expired on Octo-

⁶⁴ Treas. Reg. § 1.6662-2(c)(3).

⁶⁵ *Id.*

⁶⁶ See IRM § 9.5.3.3.1.2.1.

ber 15, 2009, the program has since been extensively revised and extended.⁶⁷ At present, there is no deadline to participate, but the IRS has reserved the right to make changes or end the program at any time.

In its current form, the program generally requires taxpayers to file eight years of accurate amended (or original) tax returns reflecting any omitted income from the offshore assets, and pay the tax due plus an accuracy-related penalty equal to 20% of the additional tax due.⁶⁸ In addition, in lieu of the FBAR and *all* other information return penalties discussed above, participating taxpayers must pay a miscellaneous penalty equal to 27.5%, or 50%, of the highest aggregate balance of the previously unreported foreign assets during the eight-year look-back period.⁶⁹ The program has thus far elicited more than 45,000 disclosures and has been regarded as a success by the IRS.⁷⁰

Under the OVDP, taxpayers can challenge the penalty structure of the program if they believe that they would be subject to lower penalties under the relevant statutes.⁷¹ However, where a taxpayer challenges the program penalties, the IRS will not be bound by the program's penalty framework and can impose the maximum statutory penalties.⁷²

The voluntary disclosure program described above, which requires the taxpayer's attorney to contact the IRS's criminal investigation division to begin the process, is often referred to as the "formal" method of making a voluntary disclosure. In certain very limited situations, an informal or "quiet" voluntary dis-

⁶⁷ 2014 Offshore Voluntary Disclosure Program ("OVDP") Frequently Asked Questions ("FAQs"), available at <http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised>. See, e.g., Edward Robbins, Jr. et al., *What's Your Client's Criminal Exposure on His Undeclared Bank Account?*, 60 Fed. Law. 38 (Dec. 2013).

⁶⁸ *Id.* at FAQ 7.

⁶⁹ The penalty is increased from 27.5% to 50% for taxpayers who held accounts at any foreign bank that has publicly been identified as being under investigation by the U.S. government. *Id.* at FAQ 7.2. Under certain circumstances, truly non-willful violations can be corrected for little or no penalties pursuant to the IRS' Streamlined Compliance Procedures.

⁷⁰ IRS Press Release, IR-2014-73, June 18, 2014.

⁷¹ 2014 OVDP, *supra* note 68, at FAQ 35.

⁷² *Id.*

closure may be appropriate. Such a voluntary disclosure, if done properly and timely, should shield a taxpayer from criminal prosecution, but offers no protection from the potentially huge civil penalties described above. A quiet voluntary disclosure is made by filing amended and or delinquent tax and information returns, along with a statement explaining the circumstances, with the appropriate IRS Service Center.

Most states also impose an income tax on foreign source income and require taxpayers to file a corresponding amended state income tax return when they file an amended federal tax return. Thus, for most taxpayers, the filing of an amended federal income tax return as part of a voluntary disclosure triggers an obligation to file an amended state income tax return. Many states offer voluntary disclosure or amnesty programs that may limit a taxpayer's civil and criminal exposure.

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. However, a voluntary disclosure does result in the payment of significant income taxes and penalties.

IV. Discovering an Unreported Foreign Account in a Matrimonial Case

When attorneys discover unreported foreign assets in a divorce case, the immediate questions are how severe is the problem and how will it affect each of the spouses. In the example above, the specific questions that come to mind when the attorneys discover Brian's unreported Channel Islands account have to do with criminal liability and the size of any civil liability. Is this a potential criminal case? Who is responsible, just Brian or both Brian and Helena? If it is just taxes and penalties, how much is due and who is liable? Ultimately, the parties have to decide how to approach the problem and whether they can do so cooperatively. Answering these questions requires consideration of the following issues: (1) whether the violation was willful; (2) if the violation was willful, is a voluntary disclosure possible; (3) which liabilities are joint and several; (4) with respect to the joint and several liabilities, is innocent spouse relief available; and (5) how will the liabilities be allocated by the divorce court.

A. *Was the Violation Willful?*

Whether the violation was willful is the most important determination. If the failure to report the foreign asset was willful, then there are potential criminal issues and the possibility of huge penalties that, in the case of an unreported foreign account, could be many times the value of the unreported account. In determining whether a violation was willful, due regard must be given to the badges of fraud discussed above as well as the concept of willful blindness, or conscious avoidance, and the recent case law on willfulness.

In the example, there is a real chance that the government could prove that Brian willfully failed to report the Channel Islands account and related income because it was held in a tax haven jurisdiction; it was held under a number, instead of Brian's real name; Brian saved a lot of taxes on the payment that originally went into the account as well as taxes on the interest and dividends earned in the account; Brian did not check the box "yes" on the couple's joint tax return; and Brian presumably did not tell his accountant about the account. Other bad evidence could come to light once someone speaks to the banker in the Channel Islands, such as incriminating e-mails or facsimiles, etc.

Given the dire consequences that can result from a willful violation, it may be appropriate to consult a criminal tax specialist if there is any real concern with respect to the willfulness issue. If there is a risk that an IRS agent, a prosecutor, or a court could determine the taxpayers acted willfully, then there is a risk of a criminal case or huge tax and FBAR penalties. In such cases, it is necessary to consider whether and how to make a voluntary disclosure, assuming it is possible to do so.

B. *Is a Voluntary Disclosure Possible?*

There are essentially four requirements for a voluntary disclosure: (1) it must be timely; (2) the income or assets being disclosed must come from legal sources; (3) the taxpayer must be completely truthful and cooperate with any requests for information; and (4) the taxpayer must pay, or make good faith arrangements to pay, any taxes, penalties and interest determined to be due.⁷³ The threshold determinations for any disclosure is

⁷³ *Id.* at FAQ 12, 14; IRS IRM § 9.5.11.9 (12-02-2009).

104 *Journal of the American Academy of Matrimonial Lawyers*

whether it is timely and whether the source of the assets and income is legal.

Timeliness means that the taxpayer, or a related entity, is not already under audit or investigation.⁷⁴ Once the IRS has initiated an audit or investigation of the taxpayer, for whatever reason, it is too late to make a voluntary disclosure and the only thing the taxpayer can do at that point is either disclose the unreported income or assets in the course of the on-going audit or wait until the audit is complete and then initiate a voluntary disclosure. Either of these options comes with huge risks. A taxpayer who discloses unreported income or assets during an on-going audit or investigation may get credit from the agent for being truthful or may just be providing information that the agent will use against the taxpayer to assess huge penalties or, even worse, refer the case for criminal prosecution. Similarly, waiting for the audit or investigation to close is risky because, if the IRS finds the income or assets during the audit or investigation, the taxpayer loses any chance to get credit for a voluntary disclosure and has a higher likelihood of huge civil penalties or criminal prosecution.

In most cases, taxpayers will know if they are under audit or investigation because the IRS will have communicated in some fashion with the taxpayer, a representative, or a witness. However, it is possible that the taxpayer has been selected for audit or investigation and the taxpayer does not yet know because the IRS has not had an opportunity to begin making contacts. There is a “pre-clearance” procedure that a taxpayer can use to determine whether there is an open audit or investigation before the taxpayer proceeds with a disclosure that will tell the IRS all the details of the unreported assets. A taxpayer can request pre-clearance by simply sending to the IRS Criminal Investigation Division a letter with information identifying the taxpayer as well as any financial institution where the unreported assets were kept. The IRS will run the taxpayer’s name against lists of taxpayers that the IRS or the Department of Justice has already identified and will respond to the taxpayer informing them that he is either pre-cleared to make a disclosure or is ineligible to proceed. While this pre-clearance procedure does require the taxpayer to

⁷⁴ *Id.* at FAQ 12, 14.

raise his hand and identify himself as someone with unreported foreign assets, in most cases the taxpayer is not losing any advantage because if the pre-clearance is declined, it is because the IRS already knows about the taxpayer and is planning to proceed with an audit or investigation anyway. Accordingly, in most cases, it is important to request pre-clearance to proceed with a voluntary disclosure to insure that the disclosure is timely.⁷⁵

Another preliminary hurdle that must be cleared before a voluntary disclosure can be advised is to determine whether the source of the assets or income is legal. An offshore voluntary disclosure, properly done, gives the taxpayer a significant benefit by essentially eliminating the risk of a criminal prosecution in return for fixed penalties that are lower than what could otherwise be imposed on the taxpayer. The IRS does not intend to extend such benefits to criminals or those who acquired their unreported assets through illegal means. A taxpayer who wishes to participate in the voluntary disclosure program must be prepared to explain the source of the unreported assets or income, and that source cannot involve illegal conduct. For purposes of this analysis, the fact that the taxpayer did not properly report or pay tax on the assets does not mean that they are from an illegal source. Taxpayers with illegal source assets or income cannot participate in the voluntary disclosure program and are left to work out their tax issues in other ways.⁷⁶

In the example, the source of the foreign assets is Brian's electronics business, which is a legal source. Assuming Brian and Helena are not already under audit or investigation, then they can be pre-cleared to enter the voluntary disclosure program. If they do so, the IRS will assess taxes, penalties and interest. Some

⁷⁵ Criminal tax cases are particularly complex and sensitive and there may be unique circumstances in which a pre-clearance request is not appropriate. Such issues are beyond the scope of this article. *See, e.g.,* Caroline D. Ciruolo, *Criminal Tax Cases: A Primer*, Aspatore, 2011 WL 6741945 (Dec. 2011).

⁷⁶ Taxpayers in this situation can consider filing amended tax returns outside the voluntary disclosure program but, in many cases, the taxpayer will find that the prior failure to report cannot be fixed and the taxpayer's only choice may be to file accurate returns going forward. *See* Michael S. Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle and Practice*, 16 Fla. Tax Rev. 117, 153-57 (2014).

of these liabilities are assessed against both Brian and Helena and some are just assessed against Brian.

C. *Which Liabilities Are Joint and Several?*

Couples who file joint tax returns get certain advantages such as marginally lower tax rates and the ability to pool income and deductions. In connection with these advantages, Congress has deemed it appropriate to impose joint and several liability against both spouses who sign a joint return for most liabilities arising from such a return.⁷⁷

When foreign assets or income are not reported on a joint return, both spouses may have joint and several liability for the resulting underpayment of the taxes, certain penalties, and the interest on the joint taxes and penalties. To distinguish between the liabilities that are joint and several and the liabilities that are separate, it is necessary to separate the taxes, for which there always is joint liability, unless innocent spouse relief is available, from the penalties. With respect to the penalties, it is necessary to separate the tax penalties from the FBAR penalties and then determine which penalties are based on willfulness, as opposed to negligence or some other trigger.

In general, taxes, and the interest on the taxes, will be a joint and several liability. Similarly, any non-willful penalty, such as a negligence or substantial understatement penalty, and the interest on such penalties, also will be joint and several, unless innocent spouse relief is available. The taxes, non-willful penalties, and interest on the taxes and penalties will be joint and several regardless of whether the liabilities are assessed as part of a voluntary disclosure or outside of the voluntary disclosure program.

Willful tax penalties are treated differently. As described above, willful violations give rise to some of the most harsh penalties as well as potential criminal violations. In general, penalties associated with willful violations are imposed only against the person who acted willfully and, therefore, are separate liabilities. For example, a civil fraud penalty, which requires proof of willfulness, can be imposed only against the taxpayer or taxpayers who willfully failed to pay tax.⁷⁸ For the IRS to seek joint

⁷⁷ I.R.C. § 6103.

⁷⁸ I.R.C. § 6663(c).

and several liability with respect to a fraud penalty, the IRS must establish that both spouses were complicit in the fraud.⁷⁹

Similarly, criminal liability, which also requires proof of willfulness, always is determined on an individual basis. The criminal tax provisions apply only to the taxpayer with respect to whom each element of the criminal tax statute can be proven beyond a reasonable doubt. Of course, a husband and wife can be indicted together if each committed a crime, such as tax evasion, conspiracy to evade taxes, aiding or assisting in false return, or willful failure to file an FBAR. However, one spouse's criminal conduct cannot be attributed to the other without at least some criminal participation by the other spouse.⁸⁰

In addition to the tax penalties, a couple with unreported foreign assets or income must also consider the possible FBAR penalties. FBAR penalties are not tax penalties that arise from a joint return. Instead, they are imposed under the banking law where there is no concept of a joint return. Thus, FBAR penalties create separate liabilities that apply only to the person who had the reportable interest in the foreign account but failed to report it. If a husband has an interest in, or signatory authority over, a foreign account and fails to report it, he is subject to the FBAR penalty, not the wife. Of course, it is possible, and even common, for both a husband and wife to have a reportable interest in, or signatory authority over, a foreign account. In such cases, each spouse is potentially liable for their own separate FBAR penalties. However if both spouses come forward under the voluntary disclosure program, the IRS will assess only one penalty per unreported account, even if more than one person failed to report their interest in the account.⁸¹ This is another benefit to making a voluntary disclosure.

In the example, the taxes, tax penalties and interest due on the unreported foreign account will be joint and several against both Brian and Helena. However, the FBAR penalty can be imposed only against Brian because he is the only person who had an obligation to file an FBAR. With respect to criminal liability,

⁷⁹ *Id.*

⁸⁰ In the context of a conspiracy to evade tax, the conduct of one spouse can be used against the other provided that both spouses have entered into a conspiracy to break the law.

⁸¹ 2014 OVDP, *supra* note 67, at FAQ 39, 41.

it is likely that Brian would be the primary target of any criminal prosecution. However, if the IRS could prove that Helena knew about the Channel Islands account and participated in setting it up or benefited from it any significant way, it could take the position that Helena willfully filed a false tax return when she signed a joint return that did not disclose the account. Accordingly, it may be in both parties' interest to make a voluntary disclosure to avoid a criminal investigation.

D. Is Innocent Spouse Relief Available?

As discussed above, when spouses file joint tax returns, both spouses are jointly and severally liable for any tax and most penalties, other than tax fraud penalties, due in connection with the return. In certain circumstances, a spouse can seek to be excused from such liabilities. This is generally known as "innocent spouse relief."⁸² Innocent spouse relief is governed by I.R.C. section 6015, which contains three different grounds upon which a spouse can seek relief. The first ground provides full relief from joint and several liability if a series of specific requirements are met.⁸³ The second kind of relief allows one or both spouses to elect to have otherwise joint liabilities allocated as if they had filed separate returns provided that the spouses are divorced or legally separated.⁸⁴ The third kind of relief allows a spouse to seek equitable relief, but only if the spouse does not meet the standards of the other two provisions and can satisfy all the conditions required for equitable relief.⁸⁵

Not surprisingly, the most important themes that run through the federal innocent spouse provisions are whether the spouse requesting relief knew or, in some cases, had reason to know, of the tax liability and the extent to which the requesting spouse benefited from the failure to pay the proper amount of taxes. However, the innocent spouse provisions are relatively complex and the importance of a spouse's knowledge or benefit depends on the type of relief being requested. For example, even

⁸² See Daniel Gold-Kessler, *Assessing the Hazards to an "Innocent Spouse" of Civil and Criminal Liability for Tax Offenses in a Dissolution of Marriage Proceeding*, 25 J. Am. Acad. Matrim. Law. 103 (2012).

⁸³ I.R.C. § 6015(b).

⁸⁴ I.R.C. § 6015(c) & (d).

⁸⁵ I.R.C. § 6015(f).

a spouse who clearly benefited from a failure to pay tax may be able to elect separate return liability if the parties are divorced or separated, or a spouse that does not qualify for traditional innocent spouse relief or separate return liability, may still qualify for equitable relief. The three types of innocent spouse relief are discussed in more detail below.

1. *Traditional Relief from Joint and Several Liability*

Under I.R.C. section 6015(b), when a joint return has been filed and there is an understatement of tax attributable to the erroneous items of one spouse, the other spouse requesting innocent spouse relief can be relieved from liability for tax attributable to the understatement if the requesting spouse can establish that, in signing the return, she did not know and had no reason to know of the understatement; and taking all the facts and circumstances into account, it is inequitable to hold her liable for the deficiency in tax attributable to the understatement.

a. *The knowledge requirement*

The knowledge requirement in I.R.C. section 6015 refers to knowledge of a tax understatement. A tax understatement is defined as the difference between the correct amount of tax and the amount of tax reported on the return.⁸⁶ To really know whether there was an understatement on a return, a spouse would have to know whether an item was legally deductible or legally reportable. This would require the spouse to have some knowledge of the tax law.

To avoid arguments about whether a spouse understood the law and knew an item was legally deductible or legally reportable, courts have held that a spouse has knowledge of an understatement if the spouse knew of the underlying facts giving rise to a deduction or omission of income, regardless of whether the spouse knew that the deduction or omission was improper under the tax law. Stated differently, a spouse will qualify for innocent spouse relief under I.R.C. section 6015(b) only if the spouse can prove that he or she did not know, or have reason to know, of the underlying facts surrounding the income or deduction, not

⁸⁶ I.R.C. 6664(a).

merely that the spouse did not understand the tax law consequence of the transaction.

The question of how much knowledge of the underlying facts will disqualify a spouse from receiving innocent spouse relief can depend on whether the tax understatement at issue arises from an erroneous deduction or omitted income. With respect to erroneous deduction cases, many courts require only some knowledge of the transaction that generated the deduction whereas other courts require more extensive knowledge of the details giving rise to the erroneous deduction.

For example, in *Bokum v. Commissioner*,⁸⁷ the Tax Court held that Mrs. Bokum knew enough about the item of income at issue and the tax return to disqualify her from innocent spouse relief. The Bokums' joint tax return improperly took a deduction against a dividend distribution in order to eliminate any tax on the dividend. Mrs. Bokum was aware of the dividend distribution and knew that it had been offset by a deduction on the tax return. The Tax Court held that Mrs. Bokum's knowledge of the dividend and the offsetting deduction on the tax return equated to knowledge of the understatement and precluded her from receiving innocent spouse relief. Mrs. Bokum's ignorance regarding whether the offsetting deduction was proper under the tax law did not matter.

In contrast, the Ninth Circuit Court of Appeals in *Price v. Commissioner*⁸⁸ held that a spouse who knew about her husband's gold mine investment and a related deduction for mining expenses, which later turned out to be improper, did not know of the understatement. The court ruled that Mrs. Price did not know of the understatement because she did not have sufficiently detailed information regarding the underlying mining activity and the resulting mining expense deductions. The court also relied, in part, on the fact that Mrs. Price questioned her husband about the deduction and he assured her that the accountant would not have taken the deduction if it was not proper.

In omitted income cases, courts generally find that some knowledge of the underlying transaction that generated the income that was omitted from the return is sufficient to put the

⁸⁷ 94 T.C. 126 (1990), *aff'd on other grounds*, 992 F.2d 1132 (11th Cir. 1993).

⁸⁸ 887 F.2d 959 (9th Cir. 1989).

spouse on notice of a possible underpayment. For example, in *Cheshire v. Commissioner*,⁸⁹ the wife knew about a distribution from her husband's retirement account that the couple used to pay off their mortgage. The Fifth Circuit Court of Appeals reasoned that mere knowledge of the distribution equated to knowledge of the understatement and it did not matter that Mrs. Cheshire had no idea whether a distribution from a retirement plan had to be reported on a tax return. Most cases involving a foreign bank account will be omitted income cases and, therefore the relevant inquiry will be whether the spouse knew or should have known of the foreign account.

The next question is what kinds of evidence will satisfy the "actual knowledge" requirement or the "should have known" requirement. Evidence of actual knowledge is relatively straightforward and would include things like an admission by the spouse or testimony by a witness, such as the other spouse or an accountant or business partner, proving that the spouse knew about the transaction giving rise to the understatement. For example, if there was evidence that Brian told Helena about the foreign account, or that Helena helped set up the foreign account, the IRS would be able to argue that Helena had actual knowledge.

However, most cases are not so straight forward and do not involve a question of actual knowledge. The real issue in most innocent spouse cases is whether spouse "had reason to know" of the understatement. When determining whether a spouse had reason to know of an understatement or, more accurately, the transaction underlying the understatement, the law looks at whether a hypothetical reasonable person in similar circumstances would have known of the understatement.⁹⁰

The Treasury Regulations enumerate the kind of evidence considered in determining whether a spouse had reason to know of an understatement, including: the nature of the erroneous item and the amount of the erroneous item relative to other items; the couple's financial situation; the requesting spouse's educational background and business experience; the extent of the requesting spouse's participation in the activity resulting in the

⁸⁹ 282 F.3d 326 (5th Cir. 2002), *aff'g*, 115 T.C. 183 (2000).

⁹⁰ Treas. Reg. § 1.6015-2(c).

112 *Journal of the American Academy of Matrimonial Lawyers*

erroneous item; whether the requesting spouse failed to inquire, at or before signing the return, about items on the return or omitted from the return that a reasonable person would question; and whether the erroneous item represented a departure from a recurring pattern reflected in prior years' returns.⁹¹

In *Alt v. Commissioner*,⁹² the court discussed whether the wife knew or had reason to know of an understatement. The court found it relevant that the wife had a bachelor's and a master's degree in education. Although she knew nothing about taxes, the "lack of knowledge of the tax consequences of the income received, or of its proper treatment on the return, constitutes mere ignorance of the law that, without more, cannot establish that the taxpayer lacked reason to know of the tax underpayment."⁹³ The court concluded that

Based on the information in the record, we believe that a reasonable person in [the wife's] situation would have known of the tax deficiencies. Not only was [the wife] involved to some extent in the business activities of her daughter's corporations [set up by the daughter to help evade her parents' taxes], but she was aware of the ongoing tax problems of the family, both prior to and during the years at issue. Furthermore, there is no evidence of concealment [by the husband] and [the wife] had witnessed the unusual expenditures of the family during the years at issue. A reasonable person with [the wife's] intelligence and education alone might not have been expected to know of the omissions, but suspicious situations in the instant case should have led to further inquiry and discovery of the omissions.⁹⁴

Similarly, in *McGee v. Commissioner*,⁹⁵ the court denied innocent spouse relief, holding that "[the wife] did not act as a reasonably prudent person with an equal level of knowledge would under the surrounding circumstances with regard to determining the amount of [her husband's] income for the years in question."⁹⁶The court reasoned that

Taxpayer was aware that her husband earned income from his dental practice, although she did not know the exact amount. She was aware of [her husband's] irresponsible behavior in financial matters, yet never questioned him regarding the amounts he earned from his den-

⁹¹ *Id.*

⁹² 93 AFTR 2d 2004-2561, 101 Fed. Appx. 638 (6th Cir. 2004).

⁹³ 101 Fed. Appx. 638 at 640.

⁹⁴ *Id.* at 45.

⁹⁵ 979 F.2d 66 (5th Cir. 1992).

⁹⁶ *Id.* at 72

tal practice or whether tax returns were being timely filed. She made no effort to review tax documents before signing them. Furthermore, taxpayer testified at trial that she could have determined [her husband's] income for the years at issue by asking [her accountant].⁹⁷

Some courts put great weight on whether the spouse acted reasonably in attempting to investigate the accuracy of the return in determining whether a spouse should have known of an understatement. Blindly signing a joint return without further inquiry can result in a finding that the spouse should have known of an understatement. In *Park v. Commissioner*,⁹⁸ the court held that constructive knowledge could be imputed to a spouse who signed a joint return without reviewing it because she had failed to satisfy a duty to take reasonable steps to determine the accuracy of the return.

In contrast, the wife in *Jones v. Commissioner*,⁹⁹ knew that her husband had received a distribution from a partnership but still qualified for relief. With respect to whether the wife knew or had reason to know of the understatement of tax, the Court held, “[w]here, as here, a taxpayer on notice that her spouse had unreported income does not know the exact amount of income, she must fulfill a duty of inquiry or risk being charged with constructive knowledge of the understatement of tax on the return.” Because the wife testified credibly as to her extensive efforts to obtain the K-1s for both entities, the court found that she acted as a reasonable person would in the circumstances, and did not have actual or constructive knowledge of remaining distributions and, therefore, qualified as an innocent spouse.

b. *The inequitable requirement*

In addition to proving that he or she did not know or have reason to know of the understatement, the innocent spouse must also prove that it would be inequitable to hold him or her responsible for the tax. The IRS has published guidance listing the following factors to be considered in determining the equities: whether there was a significant benefit, beyond normal support, to the spouse claiming relief; whether the non-requesting spouse deceived the requesting spouse or concealed information about

⁹⁷ *Id.* at 70

⁹⁸ 25 F.3d 1289, 1299 (5th Cir. 1994).

⁹⁹ T.C. Memo. 2010-112, 2010 WL 2011013 (U.S. Tax Ct. May 20, 2010).

114 *Journal of the American Academy of Matrimonial Lawyers*

their financial affairs or tax returns; whether there is probable hardship to the requesting spouse; whether the couple is still married or living together; whether the requesting spouse received benefit on the return from the understatement; and whether the requesting spouse was in poor mental or physical health on the date that she signed the return or at the time of request for relief.¹⁰⁰

In *Alt v. Commissioner*, the court held that the wife was not entitled to innocent spouse relief.¹⁰¹ In so holding, the Court evaluated the husband's alleged wrongdoing and concluded that there was no evidence that the husband had deceived the wife or concealed information about their financial affairs or tax returns. In reaching this conclusion, the court noted that the wife had withdrawn funds from the bank accounts of corporate entities that gave rise to the deficiency. The court also relied on the fact that the couple's lifestyle during the years at issue was "unusually lavish when compared with the past."

Courts weighing the equities also look at whether there was a significant benefit to the spouse claiming relief.¹⁰² Normal support is not considered a significant benefit, but amounts received by a spouse in excess of normal support can constitute a significant benefit. If the family's expenditures demonstrate a substantially enhanced living standard, courts are likely to find that the requesting spouse has benefited from the underpayment of tax.¹⁰³

Another equitable factor is whether the requesting spouse is likely to suffer economic hardship if relief is not granted.¹⁰⁴ Although the wife in *Alt* testified that the couple had moved into a dilapidated house and that she was sick and without health insurance, the court held that the Tax Court did not err in finding that the family could pay basic expenses based on the husband's current income and, therefore, would not suffer economic hardship.¹⁰⁵

¹⁰⁰ See Rev. Proc. 2013-34

¹⁰¹ 101 Fed. Appx. 638

¹⁰² *Alt*, 101 Fed. Appx. 638.

¹⁰³ See *Resser v. Comm'r*, 74 F.3d 1528, 1543 (7th Cir. 1996).

¹⁰⁴ *Alt*, 101 Fed. Appx. 638

¹⁰⁵ *Id.*

2. Allocation of Liability Between Divorced or Separated Spouses

Under I.R.C. sections 6015(c) and (d), a divorced or legally separated spouse may elect to limit her liability for a deficiency on a joint return to the portion of the deficiency allocable to her. The allocation of liability provisions can be very advantageous because they allow a spouse to avoid joint liability even in cases where that spouse may not qualify for traditional innocent spouse relief. However, the threshold requirement is that the spouses must be divorced or legally separated and other conditions may apply as well.

Under I.R.C. section 6015(d), the portion of a deficiency on a joint return that will be allocated to the requesting spouse is the amount that bears the same ratio to the deficiency as the net amount of items allocable to the requesting spouse bears to the net amount of all items taken into account in computing the deficiency.¹⁰⁶ In effect, the election permits the electing spouse to compute his or her tax liability as if the couple had filed on a married filing separately basis, subject to certain rules.¹⁰⁷

The first rule is that the spouses have to be divorced or legally separated. The second rule is that the allocation rules do not apply to any portion of an understatement about which the requesting spouse had actual knowledge.¹⁰⁸ It is important to understand that, under the allocation of liability provisions, the IRS must prove actual knowledge, not just reason to know.¹⁰⁹ Further, unlike under section 6015(b), the IRS bears the burden of

¹⁰⁶ Treas. Reg. 1.6015-3(d). The primary allocation method is called the “proportionate allocation method.” Proportionate allocation of a deficiency is determined as follows, where X = the portion of the deficiency allocated to the requesting spouse:

$$X = \text{deficiency} \times \frac{\text{net amount of all erroneous items allocable to spouse}}{\text{net amount of all erroneous items}}$$

¹⁰⁷ If the non-requesting spouse does not also elect relief under I.R.C. § 6015(c), and thereby himself become a requesting spouse, he remains liable for the entire deficiency. If both spouses elect to allocate the deficiency, any portion of the deficiency not allocable under the rules of I.R.C. § 6015(d) remains the joint and several liability of both.

¹⁰⁸ Treas. Reg. § 1.6015-3(d)(4)(i)(B)(1).

¹⁰⁹ I.R.C. § 6015(c)(3)(C).

proving actual knowledge when a spouse elects to allocate liability.¹¹⁰ Of course, the IRS may rely on all the facts and circumstances to support an inference that a requesting spouse had actual knowledge of an understatement.¹¹¹ Some of these facts and circumstances include whether the requesting spouses deliberately avoided learning about an item on the tax return, or whether the requesting spouse had an ownership interest in the property that resulted in an erroneous item on a tax return.¹¹²

In an omitted income case, the key in determining actual knowledge is whether the electing spouse had knowledge of the receipt of the income, as opposed to knowledge of the source of the income. For example, if a wife knows that the husband owns corporate stock, but does not know that a dividend has been paid, she does not have actual knowledge of receipt of the dividend.¹¹³ On the other hand the IRS need not establish that a spouse knew of the source of an item to establish knowledge. For example, if the spouse knows about the receipt of a sum of money, but does not know the source, the spouse nevertheless has actual knowledge of that item.¹¹⁴

This part of the innocent spouse statute has a special rule to insure that spouses do not conspire to transfer property away from one spouse and then allocate tax liability to that spouse, thereby leaving him or her with insufficient assets to pay while shielding the “innocent” spouse from liability. Under I.R.C. section 6015(c)(4)(B), if an electing spouse receives a transfer of property and if the principal purpose of transfer was to avoid tax or the payment of tax, then the electing spouse will not be relieved by that portion of the tax understatement equal to the value of the property. There is a presumption that any transfer made within the year before a letter of proposed deficiency that allows IRS appellate review is sent has as its principal purpose the avoidance of tax or payment of tax, unless the transfer was made pursuant to a decree of divorce.

There are four other exceptions to the rule that erroneous items are allocable to the spouses as if they had filed separate

¹¹⁰ *Id.*

¹¹¹ Treas. 1.6015-3(c)(2)(iv).

¹¹² *Id.*

¹¹³ Treas. Reg. § 1.6015-3(c)(2)(iii).

¹¹⁴ *Id.*

returns: (1) erroneous items are allocated to the requesting spouse to the extent that spouse received a tax benefit on the joint return, even if the items would otherwise be allocated to the non-requesting spouse; (2) if an item is due to fraud by one or both spouses, the IRS may allocate the item between spouses; (3) items of income are allocated to the spouse who was the source of the income; and (4) deductions related to a business or investment are allocated to the spouse owning the business or investment.¹¹⁵

3. *General Equitable Relief*

In cases where a spouse cannot qualify for relief under I.R.C. section 6015(b) or elect separate return liability under I.R.C. section 6015(c), the spouse may still be able to get equitable relief from joint liability under I.R.C. section 6015(f). The threshold criteria for a spouse to obtain equitable relief under section 6015(f) are set forth in Rev. Proc. 2013-34 § 7.

Those criteria include: a joint return; relief is not be available under sections 6015(b) or 6015(c); no assets were transferred between the individuals filing the joint return as part of a fraudulent scheme; the liability must exceed any disqualified assets; the requesting spouse did not knowingly participate in filing a fraudulent return; and the income tax liability from which the requesting spouse seeks relief is attributable to an item of the non-requesting spouse. In addition, the requesting spouse must also establish that she is no longer married to the non-requesting spouse; failure to grant relief would result in economic hardship; and she did not know or have reason to know that there was an understatement on the return.¹¹⁶

The knowledge test under I.R.C. section 6015(f) is similar to the knowledge test under I.R.C. section 6015(b) but is applied with a view toward the overall equities of the situation. For example, if the non-requesting spouse maintained control over the household finances by restricting the requesting spouse's access to financial information, and the requesting spouse feared questioning items on the return for fear of retaliation, then the requesting spouse will not be deemed to have had reason to know

¹¹⁵ Treas. Reg. § 1.6015-3(c)(2)(iii).

¹¹⁶ Rev. Proc. 2013-34, 4.03(2).

of the understatement.¹¹⁷ Equitable relief also may be appropriate in cases where a spouse failed to timely request relief under the other innocent spouse provisions.

In the example, Helena will not be responsible to the IRS for any civil tax fraud penalties or FBAR penalties assessed against Brian. However, at least initially, she will be jointly and severally liable for any taxes and non-willful tax penalties and interest. If Helena did not know about the foreign account, she could argue that it was hidden from her, she did not benefit from it and it would be inequitable for her to be liable for any taxes, penalties and interest arising from the account. However, regardless of how strong her claim for innocent spouse relief may be, Helena still must consider how the divorce court will allocate the various liabilities arising from the foreign account.

E. How Will the Divorce Court Allocate the Liabilities?

As discussed above, a couple's filing status will initially determine who is liable to the IRS for tax-related liabilities. Spouses who file separate returns will each be responsible only for the tax liabilities stemming from their separate filings, while taxpayers who file joint returns are jointly and severally liable, except with respect to willful penalties. Superimposed on this basic structure is the concept of "innocent spouse relief" which can provide relief from a tax liability for an "innocent spouse" even if he or she filed a joint return and would otherwise be jointly liable. In the context of a divorce, however, these basic rules may not be conclusive and are only the first step towards resolution of the issue.

Joint and several liability under the tax code does not necessarily translate into joint and several liability for purposes of divorce proceedings. State courts have the authority to allocate assets and liabilities in a divorce case and an IRS determination of whether a spouse is jointly liable or is entitled to innocent spouse relief is not binding on a state court. As the Ninth Circuit has stated "[t]he question whether, under federal law, [a wife] escapes taxes which [her husband] must pay to the IRS, does not control the state law determination of whether, as an equitable

¹¹⁷ Rev. Proc. 2013-34, 4.03(2)(c).

matter, [the wife] should have to contribute anything to [her husband].”¹¹⁸

Similarly, a state court’s determination that a particular spouse is innocent is not binding on the IRS. A state court may apportion responsibility for paying taxes in making an equitable distribution of property in a divorce case.¹¹⁹ For example, in *Capasso v. Capasso*,¹²⁰ a New York court held that tax liabilities stemming from illegal activities were to be apportioned equally between the spouses even though the wife was “innocent.” According to the court, both spouses should share in the tax liability where the benefits of the illegal activity were used to fund marital assets whose benefit inured to both spouses. Conversely, when spouses file separate returns and are thus not liable to the IRS for each other’s tax debts, matrimonial courts have found that an underlying tax liability can be treated as a matrimonial debt.¹²¹

While the IRS’s innocent spouse provisions contain a lot of technical rules, matrimonial courts take a somewhat more equitable approach and look to who benefited from the tax savings and who caused the tax liability. Where both spouses benefited and where the activity causing the tax problems helped add to the couple’s wealth, a matrimonial court may very well hold both parties responsible, even if one spouse already has received innocent spouse treatment from the IRS, or even if separate tax returns were filed.¹²² On the other hand, when the financial benefit does not accrue to both spouses, such as where one spouse diverts the funds for a personal non-marital activity, a

¹¹⁸ Estate of Ravetti v. United States, 37 F3d 1393, 1395 (9th Cir. 1994). See generally Daniel Gold-Kessler, *Assessing the Hazards to an “Innocent Spouse” of Civil and Criminal Liability for Tax Offenses in a Dissolution of Marriage Proceeding*, 25 J. AM. ACAD. MATRIM. LAW. 103 (2012).

¹¹⁹ See Melvin B. Frumkes, *Equitable Distribution of Tax Liabilities*, 20 J. AM. ACAD. MATRIM. LAW. 179 (2006).

¹²⁰ 517 N.Y.S.2d 952 (N.Y. App. Div. 1987),

¹²¹ E.g., *Barner v. Barner*, 716 So.2d 795 (Fla. Dist. Ct. App. 1998); *Meints v. Meints*, 608 N.W.2d 564 (Neb. 2000).

¹²² On the issue of penalties, however, even matrimonial courts will look to assign blame to the delinquent spouse. In *Meints v. Meints*, 608 N.W.2d at 570, the court noted that the non-delinquent spouse should not be required to share the burden of satisfying penalties arising from the actions of the delinquent spouse.

120 *Journal of the American Academy of Matrimonial Lawyers*

matrimonial court will likely hold that only that spouse is responsible for the tax liability.¹²³

The distinction between an IRS determination and a matrimonial court's decision on issues of tax liability is best summarized by the court's opinion in *Dobson v. Dobson*:

[t]he IRS's determination for innocent spouse relief is not entitled to preemption or res judicata because it involves only an administrative process rather than an adjudication, and the only rights adjudged go to which party the IRS pursues for payment. . . . Thus . . . a determination by the IRS or the Federal Tax Court is not dispositive in a division of a marital debt that includes tax liability.¹²⁴

Spouses with undeclared foreign assets must keep these principles of marital liability in mind in addition to the concepts of innocent spouse and federal tax liability rules. The answer to the question of who is at fault and who must pay may very well be different depending on whether the IRS or a divorce court is answering the question.

In the example above, even if Helena receives innocent spouse relief from the IRS, the divorce court may take Brian's tax and FBAR penalties into account in determining how to equitably distribute the marital estate. The court may want to know what Helena knew about the Channel Islands account, how involved she was with the account and the extent to which she benefited from the account. If there is a chance that the court will charge some of the liabilities against Helena's share of the marital estate, the best course of conduct may be for both spouses to cooperate in whatever approach is most likely to minimize the financial impact on the overall marital estate.

V. Conclusion

A surprising number of people have unreported foreign assets or income. When foreign assets or income surface in a divorce, the consequences can be minimal or catastrophic. The following five-step analysis should be used to evaluate the potential consequences and chart a course forward. First, compute the size of the potential liability, including taxes, penalties and interest. Second, consider whether the failure to report was willful

¹²³ Carter v. Carter, 626 N.W.2d 576 (Neb. 2001).

¹²⁴ 159 S.W.3d 335, 337 (Ky. Ct. App. 2004).

and whether criminal liability for either or both spouses is a concern. Third, discuss the possibility of making a voluntary disclosure. Forth, determine which liabilities are joint and several. Fifth, assess how the divorce court will allocate the liabilities.

This analysis works best if the parties can set aside the other matrimonial issues, at least temporarily, to focus on their common adversary, the IRS. It is rarely in either party's interest to risk crushing civil penalties or an expensive and ruinous criminal investigation. In many cases, the analysis outlined above will help the parties develop a joint approach to the problem that will avoid unnecessary depletion of the marital estate.

