Uncovering Offshore Assets

Using U.S. Tax Reporting Requirements as a Discovery Tool

By **MATTHEW D. LEE**

The U.S. tax laws require all citizens and residents of the United States to disclose offshore financial assets, like bank accounts, on their tax returns and pay tax on income generated by those assets. For decades, however, many individuals were able to skirt these laws by hiding assets in tax havens around the globe, where their accounts were protected by stringent bank secrecy laws and governments unwilling to cooperate with the United States. In 2009, the Internal Revenue Service launched an aggressive crackdown on these practices, by designating offshore tax evasion a key enforcement priority and by successfully lobbying Congress to pass new laws strengthening the IRS's powers to obtain information about the offshore activities of U.S. taxpayers. The result of these efforts is that the U.S. tax laws now require more disclosure than ever of the offshore activities of U.S. taxpayers, and that compliance by taxpayers is substantially better than in the past. This new era of tax transparency affords significant benefits to family law practitioners in search of offshore assets, and U.S. tax returns can now provide a useful road-map for uncovering assets outside of the United States.

The United States is one of the few countries in the world to tax its citizens on their worldwide income. This means that U.S. citizens must annually file a U.S. tax return reporting all their income, from whatever source and from whatever location, and pay tax on that income. As part of their tax filing obligation, U.S. citizens are also required to disclose to the IRS their offshore financial assets, such as bank accounts and mutual funds, as well as any interests in foreign entities such as trusts, corporations, and partnerships. Hefty financial penalties can be imposed on individuals who fail to make these disclosures.

The obligation to file U.S. tax returns and disclose assets located outside of the United States also applies to foreign nationals who are considered U.S. residents for tax purposes. Foreign nationals will be deemed U.S. residents if they hold a green card (even if they live outside of the United States) or if they are physically present on U.S. soil for a requisite number of days each year. In addition, foreign nationals who are married to U.S. citizens may be subject to the same tax and disclosure obligations as U.S. citizens.

Tax Returns

U.S. tax returns provide fertile ground for family law practitioners in search of offshore assets and should be carefully scrutinized in every matrimonial case. The Form 1040 individual tax return itself requires disclosure of helpful information, and the tax laws also require individuals with

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foreign assets and investments to file several additional information-reporting forms. All of these tax returns and supporting schedules should be requested in discovery by practitioners in search of offshore assets.

Schedule B to Form 1040

The starting point is Schedule B to Form 1040, which is one of the attachments to the Form 1040 individual income tax return and is used to report interest and dividend income. Part III of Schedule B asks a series of questions about whether the taxpayer filing the return had foreign bank accounts, and if so, the identity of the country (or countries) where such accounts are located. Another question asks whether the taxpayer received a distribution from a foreign trust or made transfers to a foreign trust during the year in question. The answers to these questions can provide leads to uncovering foreign assets. Tax returns for corporations, partnerships, trusts, estates, and even nonprofit entities contain similar questions about foreign assets, so those returns should be requested in discovery and reviewed, if applicable.

Foreign Tax Credit

Practitioners should also focus on whether the tax return claims a foreign tax credit. The U.S. tax system generally allows taxpayers to claim a credit against U.S. taxes for any taxes that are paid to a foreign government. An individual claiming a foreign tax credit has necessarily paid taxes to a foreign government, and in most instances such an individual will have assets or investments in that country that are generating income subject to tax. Note, however, that the presence of a foreign tax credit on a tax return does not necessarily mean that the taxpayer has an offshore bank account or investment. For example, investments in international mutual funds offered by U.S. financial institutions can generate foreign tax credits.

Foreign tax credits are currently claimed on line 1 of Schedule 3 to Form 1040. In prior years, foreign tax credits were claimed on line 47 of Form 1040. Depending on the size of the credit claimed, some taxpayers will also be required to file Form 1116, which is a form used to provide additional detail on the foreign tax credit computation. Form 1116 requires disclosure of the foreign country to which taxes were paid and the nature of the foreign income in question (such as interest, dividends, royalties, and the like).

FATCA, Tax Transparency, and Form 8938

In 2010, the U.S. government recognized that a large number of its citizens and residents were hiding assets outside of the United States and that these assets were not subject to U.S. taxation. Around this same time, other countries around the globe came to the same realization that their citizens were evading tax by hiding assets in other countries. In that year, Congress reacted by enacting an anti–tax evasion law providing the IRS with additional powers to uncover offshore assets. Called the Foreign Account Tax Compliance Act (FATCA), this legislation imposed sweeping disclosure obligations on foreign banks and U.S. taxpayers.

Pursuant to FATCA, foreign banks across the globe are now required to automatically disclose to the IRS the identities of their U.S. customers every year, along with data about their holdings, including account balances. FATCA also requires foreign banks to disclose the existence of accounts held by foreign entities if a U.S. citizen owns more than 10 percent of the entity. By requiring disclosure of entity accounts owned, at least in part, by U.S. citizens, FATCA attempts to curb a common practice of disguising the identity of the true beneficial owner of a foreign bank account by placing the account in the name of a nominee (or, in some cases, layers of nominee entities). Following FATCA's lead, more than 100 countries have now agreed to the automatic exchange of tax information in a similar manner under the auspices of the Organisation for Economic Co-operation and Development.

The FATCA law also dramatically broadened the offshore asset disclosure rules for U.S. taxpayers. As a result of FATCA, the IRS created a new information reporting form that is required to be attached to the Form 1040 individual tax return. Form 8938, "Statement of Specified Foreign Financial Assets," requires disclosure of a wide variety of foreign financial assets, including bank accounts, foreign stock or securities, ownership interests in a foreign entity, and any financial instrument or contract that has an issuer or counterparty that is not a U.S. person.

Foreign Corporations and Partnerships—Forms 5471 and 8865

Another set of tax forms requires disclosure of interests in foreign companies and other entities. For example, Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations," is required to be filed by certain U.S. taxpayers who are owners, officers, and/or directors of foreign corporations. This form generally requires the filer to disclose information regarding the foreign corporation, including the identities of its shareholders and its balance sheet and income statement.

U.S. taxpayers who are partners in a foreign partnership are required to file Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships." The form requires disclosure of the identity of the partnership's partners and affiliates, the partnership's balance sheet, and any transactions between the partnership and its partners.

Foreign Trusts—Forms 3520 and 3520-A

Individuals with interests in foreign trusts are required to file Form 3520, "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts." This form requires disclosure of a wide variety of information regarding foreign trusts, including the location of the trust,

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any transfers of funds to the trust by a U.S. individual, and distributions of funds from the trust. Note that Form 3520 is filed separately from the individual income tax return.

Form 3520 is also used to report gifts received from non-U.S. citizens and entities. Under U.S. tax law, an individual receiving a gift in excess of $100,000 from a foreign national must disclose the fact of such gift on Form 3520. In addition, a U.S. citizen receiving more than $16,388 as a gift from a foreign corporation or a foreign partnership must report such gift on Form 3520.

Over the past decade, however, a wave of tax transparency has swept the globe, resulting in the eradication of most tax havens and the repeal of bank secrecy laws, providing access to previously unavailable information about offshore assets.

A related reporting form is required to be filed by the foreign trust itself annually. Form 3520-A, "Annual Information Return of Foreign Trust with a U.S. Owner," requires reporting of detailed financial information about the trust, including its balance sheet and income statement, and distributions from the trust. The trust is also required to disclose information regarding the U.S. owner of the trust, trust income attributable to the U.S. owner, and the value of the U.S. owner's interest in the trust.

Gift Tax Returns

Practitioners should not overlook gift tax returns as a potential source of information regarding offshore assets and the transfer of such assets to others. U.S. citizens and residents must report to the IRS any gifts made to another person (including foreign nationals) if the gift exceeds a specific dollar threshold. For 2019, the threshold was $15,000. Such gifts are reported on IRS Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return."

The federal gift tax generally applies to any transfer by gift of real or personal property, whether tangible or intangible, as well as to sales of property for less than fair market value. The gift tax can also apply to debt forgiveness and to loans that are interest-free, or below market rate.

Foreign Bank Account Reporting

Separate and apart from the obligation to file tax returns and pay taxes, U.S. law requires all U.S. citizens and residents to annually disclose to the IRS if they have foreign bank accounts with a balance of more than $10,000. While the obligation to disclose foreign bank accounts has been on the books since the 1970s, the IRS only started meaningfully enforcing this duty approximately a decade ago. The reporting form for this purpose is called FinCEN Form 114, "Report of Foreign Bank and Financial Accounts," and is commonly referred to as the FBAR. The FBAR form was previously known as Form TD F 90-22.1. Both form numbers should be used in discovery requests in order to capture prior versions.

The definition of "foreign bank account" for FBAR purposes is deliberately broad and intended to capture not only traditional bank accounts but also securities accounts, mutual funds, and even life insurance policies that have a cash surrender balance. The FBAR form is not filed with the tax return, although it is required to be filed by April 15 just like tax returns.

Penalties for noncompliance with FBAR obligations can be severe. Intentional failures to file the FBAR form can subject an individual to criminal prosecution and/or civil monetary penalties calculated at 50 percent of the balance of the unreported foreign bank account(s). For nonwillful (negligent) failures to file the FBAR form, the civil penalties can be as high as $10,000 per unreported offshore account.

IRS Programs to Remediate Undisclosed Offshore Assets

Since 2009, the IRS has offered a number of initiatives that afford taxpayers the opportunity to cure tax issues with offshore assets and avoid criminal prosecution and/or mitigate their civil penalty exposure. Tens of thousands of individuals have used these programs to remedy tax compliance problems, and family law practitioners should be certain to seek information about possible participation in these programs in their discovery requests.

The most popular program was the Offshore Voluntary Disclosure Program (OVDP), which was open from March 2009 through September 2018. The OVDP was essentially an

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amnesty program, allowing participants to avoid criminal prosecution if they filed amended tax returns for a period of eight years and paid all back taxes, interest, and a substantial civil penalty. The OVDP was hugely successful, with more than 56,000 taxpayers successfully completing the program, paying more than $11.1 billion in back taxes, penalties, and interest.

The IRS unveiled a related program, called the Streamlined Filing Compliance Procedures (SFCP), in 2014. This initiative was designed for taxpayers whose failure to disclose offshore assets was unintentional, and it required the filing of amended tax returns for a period of three years and the payment of a significantly lower penalty than required by the OVDP. The SFCP, which remains open today, has also been a highly successful remediation program, with more than 65,000 individuals participating to date.

Finally, some taxpayers with secret offshore assets have elected to simply file amended tax returns reporting the assets instead of using either of the formal disclosure regimes described above. The IRS refers to this approach as a "quiet disclosure" and generally discourages the practice.

Other Avenues to Obtain Tax Information

Federal law provides several other mechanisms by which tax returns and related information can be obtained from the IRS. Section 6103(e)(1)(B) of the Internal Revenue Code provides that in the case of a jointly filed return, either spouse may request a copy of such return. IRS Form 4506, available on the IRS website, is used for this purpose. Section 6103(e)(8) provides that separated or divorced spouses may request that the IRS provide details regarding collection activity undertaken with respect to jointly filed tax returns.

Under the federal Freedom of Information Act, taxpayers can request copies of their IRS tax file, which will include details regarding filed returns, audits, and collection activity with respect to unpaid taxes. Details on how to submit a FOIA request to the IRS can be found at www.irs.gov/foia. Individuals may also submit a FOIA request to obtain copies of any filed FBARs. Details on how to submit a FOIA request for FBARs may be found at www.irs.gov/irm/part4/irm_04-026-016#idm140512327807584.

Discovery Checklists

Family law practitioners in search of offshore assets should ensure that their discovery requests are crafted broadly in order to capture all tax returns and related forms that could provide details about, or leads to uncover, such assets. Every discovery request should certainly include a demand for production of Form 1040 (individual income tax return) and Form 1040-X (amended individual income tax return). If the spouse has an interest in any type of entity, the following tax returns could also be requested:

- Form 1120 (subchapter C corporate tax return),
- Form 1120-S (subchapter S corporate tax return),
- Form 1065 (partnership tax return),
- Form 1041 (income tax return for trusts and estates),
- Form 706 (estate tax return),
- Form 709 (gift tax return), and
- Form 990 (nonprofit tax return).

Practitioners should also be sure to request copies of any amended tax returns that may have been filed.

Discovery requests should also specifically demand production of the following tax forms, which, as described above, are used to report various types of offshore assets and activities:

- Form 1116 (foreign tax credit),
- Form 8938 (specified foreign financial assets),
- Form 5471 (foreign corporations),
- Form 8865 (foreign partnerships),
- Forms 3520 and 3520-A (foreign trusts),
- FinCEN Form 114 (FBAR prior to 2014), and
- Form TD F 90-22.1 (FBAR starting in 2014).

Finally, practitioners should request in discovery information regarding the spouse's potential participation in either the OVDP or SFCP, and whether the spouse may have made a "quiet disclosure" of offshore assets to the IRS.

Conclusion

Historically, family law practitioners in search of a spouse's offshore holdings faced a nearly insurmountable task, with such assets often stashed in tax haven jurisdictions and protected by stringent secrecy and confidentiality laws. Over the past decade, however, a wave of tax transparency has swept the globe, resulting in the eradication of most tax havens and the repeal of bank secrecy laws, providing access to previously unavailable information about offshore assets. At the same time, Congress has strengthened the disclosure obligations imposed on U.S. citizens and residents, and the IRS has ratcheted up its enforcement in this area. As a result, U.S. tax returns and related forms can be a critical tool for family law practitioners in search of offshore assets and must not be overlooked during the discovery process. FA

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