Handle With Care: Administering Endowment Funds in Tough Times

Charitable organizations have been struggling in today's difficult economic climate. Recently, a director on the board of a not-for-profit organization told us that not only had his endowment funds declined by more than 50 percent, but that funding for the charity's various projects had also precipitously declined. He then posed the question as to whether the organization's endowment fund could be invaded, should the need arise.

At a time of increasing need, the resources available to charitable organizations are decreasing. This article discusses some of the legal requirements and various considerations that governing boards must take into account in analyzing their legal responsibilities with respect to endowment funds.

Endowment Funds

The New York State Not-for-Profit Corporation Law, Section 102 (1)(13), defines an endowment fund as an institutional fund that may not be "wholly expendable" by the organization, due to the specific terms and restrictions imposed in the applicable gift instrument. A common example might be the scholarship fund of a local college. Questions often arise as to the various rights, entitlements, and obligations of the organization with respect to such accounts. The current economic crisis has brought these issues to the attention of the boards of directors of many institutions.

In the administration of endowment funds, the board must first analyze the gift instrument. It is essential to carefully review the document under which the property was transferred to the not-for-profit entity. Such instrument might be a will, trust, deed, gift or grant letter, trust, or other document. The transfer might have also been made pursuant to a court order or other judicial determination. Due to the passage of time or careless file maintenance, difficulties arise when organizations do not have the original grant instrument.

The express or implied terms of the grant may further complicate matters. Provisions granting board discretion in utilizing earnings and principal might not be clearly stated within the document. For example, use of funds for overhead or principal withdrawals may not be addressed. In general, the organization must adhere to donor restrictions regarding the use of contributed assets. As described later in this article, not-for-profit corporations may be able to obtain relief from such restrictions by 1) obtaining the donor's consent, if possible, 2) proceeding on the grounds of impracticability or 3) proceeding under the doctrine of cy pres.

The proper management of an endowment fund requires that the board first determine the historic dollar value of the account. This is the value of the endowment fund at the time of its creation and includes any additional subsequent donation to the fund and any accumulations made pursuant to the applicable gift instrument. The good-faith determination by the entity of this historic dollar value is generally conclusive. If properly invested, an endowment fund will ordinarily generate significant appreciation, both realized and unrealized. The entity is granted full ownership rights in such accounts, including the appreciation, and is not considered to be holding such accounts as a trustee. Although this vested ownership provides the organization with additional flexibility, the law imposes strict requirements upon the board of directors. The governing board must adhere to the purposes specified in the gift instrument and must make prudent determinations both as to the investments and the utilization of the fund, as may be required.

After determination of historic dollar value, the governing board may then consider the prudent utilization of the funds. The board may appropriate for expenditure "for the uses and purposes for which an endowment fund is established so much of the net appreciation...in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by section 717 [of the Not-for-Profit Corporation Law]." In determining the use of such appreciation, the statute specifically allows utilization of net realized appreciation with respect to all assets, plus the unrealized appreciation with respect to marketable securities only. If allowed pursuant to the terms of the applicable gift instrument, the governing board is also permitted to expend funds in addition to those computed under the above formula. The board may also make reasonable and proper payment of administration expenses of the fund.

However, the board is not always allowed to utilize the net appreciation over historic dollar value; they must review the gift instrument. A provision in the gift instrument indicating that the donor intends that net appreciation not be expended must be respected. However, the donor must clearly state this limitation. Such a restriction will not be implied merely from a designation that the gift is an endowment, nor from a direction or authorization that the board may use only income, interest, dividends, rents, issues, or profits, or must preserve the principal intact. The statute construes such statements as a general designation of an endowment fund and not as an express restriction upon expenditure of the net appreciation.

Utilization in Market Decline

Due to the current market decline, many not-for-profit corporations are confronted with unique problems. Not only have their endowments fallen below historic dollar value, but due to the severe economic downturn, they are experiencing drastic reductions in revenue and contributions. A question arises as to whether an organization may utilize any portion of the endowment, when its market value has dropped below historic dollar value.

Recent advice provided by the New York State Attorney General's Office states that although the historic dollar value of the endowment fund's principal may not be exceeded by the corporation, "the income—traditionally, interest, dividends, rents, and royalties—is available for expenditure even if the value of the principal drops below historic dollar value, whether because of specific investment losses or general decline in market values." The board of directors, however, must act with prudence in determining whether or not to expend this income until the historic dollar value is restored.

The actions and determinations by the board of directors of the not-for-profit corporation must be made in accordance with Section 717 of the Not-for-Profit

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Corporation Law, described below. In undertaking its analysis and activities with respect to investments and decisions to utilize fund income and/or appreciation, the board of directors is always required to utilize the prudent director standard of inquiry.

Several avenues are available to a board confronted with severe economic hardship. What if the organization requires additional funds from the endowment in excess of the income and appreciation over historic value? Section 522 of the Not-for-Profit Corporation Law provides some opportunities for release of restrictions. The simplest option available is obtaining the consent of the donor.

The statute requires a written acknowledgement by the donor allowing the governing board to release all or any part of the restrictions imposed by the original gift instrument.8 If such consent cannot be obtained, the corporation may apply to the New York State Supreme Court (or Surrogate's Court, if applicable) for a release of a restriction imposed by the gift instrument. Such application may be made where the restriction is "obsolete, inappropriate, or impracticable," in which event the court may allow a release of the restriction in whole or in part upon notification to the Attorney General.9 Any release may not allow the utilization of the endowment fund for any purpose other than that of the corporation.10

The only case the authors found regarding releasing a restriction on this basis is Alco Cranmer, Inc. v. Knapp Foundation. In that case, the Knapp Foundation had been established in New York to assist employees of its founder, Joseph P. Knapp, corporations and their families. Due to an eventual decline in applications by such employees, the foundation's trustees resolved to dissolve the New York Foundation and transfer its assets to the Knapp Foundation in North Carolina. The North Carolina Foundation's purposes were to make contributions to tax-exempt organizations, not individuals. Accordingly, the New York Foundation amended its certificate of incorporation, authorizing the trustees to apply principal and income of the Foundation to any other charitable organization founded by Joseph P. Knapp, to include the North Carolina Foundation. When the contemplated transfer was challenged, the New York State Court of Appeals stated that the attempted amendment, changing the purposes to which funds may be applied, was not within the trustees' authority, and required Supreme Court review and approval.12

Another interesting alternative provided under the statute involves the application of the cy pres doctrine. A combination of impracticability and the cy pres doctrine may provide an effective mechanism for the release of restrictions. Under this doctrine, the court may direct the administration of a charitable disposition in a manner which will effectively accomplish its general purposes. Such doctrine is used when, for example, the intended charity may no longer be in existence and the court must apply the charitable gift in accordance with the donor's general intent.

Application of cy pres requires, as a prerequisite, that the following three conditions are met: (1) the gift or trust be charitable in nature; (2) the donor must have demonstrated a general, rather than a specific, charitable intent; and (3) circumstances have changed subsequent to the gift that render literal compliance with the restriction impossible or impracticable.13

In Estate of Outhier, the Surrogate's Court allowed a not-for-profit hospital to invade the principal of a restricted endowment fund because literal compliance with the granting instrument's restrictive provisions was impracticable. The Outhier had established an endowment fund, the income of which was to be used by the hospital for general purposes. After their respective deaths, severe changes in the healthcare industry placed the hospital in dire financial straits. It petitioned the court, under the doctrine of cy pres, to release the fund, allowing its use to pay the hospital's accounts payable and to invest in capital projects. The court was persuaded that, due to their involvement with the hospital, the donors had a general charitable purpose and intent with respect to their substantial gift. As a result of the severe economic pressures being experienced by the hospital, the court, A question arises as to whether an organization may utilize any portion of the endowment, when its market value has dropped below historic dollar value.

with the support of the attorney general, applied the cy pres doctrine to permit the utilization of the endowment below its historic dollar value, allowing the hospital to avoid the substantial risk of bankruptcy.14

The Prudent Director

Our fact pattern presents another important inquiry. Have the directors administered the investment of the endowment fund in accordance with their legal duties? The failure of a board member to act in accordance with the required standards will result in personal surcharge and liability.

In the famous case of Vacco v. Diamandopoulos, the New York State Attorney General brought an action against the trustees and former president of Adelphi University. The action alleged, among other things, that the president failed to act in good faith and received excessive fees and reimbursement. The president also failed to disclose certain financial arrangements to the Board of Adelphi.15 Directors who act without prudent care face a similar risk with respect to investment responsibilities. For a breach or neglect of duty in such regard, directors and officers are similarly liable for any resulting losses.16

Section 717(a) of the Not-for-Profit Corporation Law describes the duty of directors and officers to set the standard of conduct required of governing boards with respect to investments. Directors and officers are required to meet the "ordinary prudent director" test in exercising their investment powers; i.e., they must discharge their duties with "that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."17

The statute also provides specific guidance, listing factors that boards should consider when making or retaining investments, including the long- and short-term needs of the corporation (in light of its purposes), present and anticipated financial requirements, expected total return on investments, price trends, and general economic conditions. Within those parameters, and subject to any specific limitations set forth in the applicable gift instrument, the board has rather broad investment powers, including the authority to invest in any property it deems advisable, whether or not such investment produces a current return.18 As long as they are acting in good faith and with ordinary prudence, directors and officers may rely on information, opinions, reports, statements, or other financial data presented by others as to matters believed to be within such persons' expertise.19 Directors and officers acting in this manner are exonerated from liability by reason of serving in such capacity for the organization.20

With respect to endowment funds, the statutes impose additional requirements upon the directors and officers. The governing board must keep accurate accounts of the fund assets, separate and apart from the accounts of the corporate assets. In addition, the treasurers must make an annual report to the organization's members, if there are any, or, if none, to the governing board, concerning the endowment assets and the uses made of such assets and of the fund's income.21 Endowment funds are generally reported as restricted fund balances on the financial statements.

Conclusion

The restrictions imposed upon endowment funds present governing boards with significant complexities in administering these assets. Today's dire economic circumstances only serve to exacerbate the difficulties involved, as many organizations are suffering from tremendous financial hardship. In light of these developments, governing boards of all not-for-profit organizations should strongly consider whether or not to pursue any of the alternatives available under New York State law in order to ameliorate the economic strain with which they are presented.

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1. N.P.C.L. Sec. 1021(a)(16).
2. Id.
3. N.P.C.L. Sec. 513(a).
4. N.P.C.L. Sec. 517.
5. N.P.C.L. Sec. 513(b).
6. Id.
7. N.P.C.L. Sec. 513(b).
8. N.P.C.L. Sec. 513(b).
9. N.P.C.L. Sec. 512(a).
10. N.P.C.L. Sec. 512(b).
11. N.P.C.L. Sec. 522(e).
17. N.P.C.L. Sec. 512.
18. N.P.C.L. Sec. 717(b).
19. Id.
20. N.P.C.L. Sec. 516(b).

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Taxing Income In Respect of a Decedent

Strategies can result in significant savings.

BY ROBERT S. BARNETT
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While we are familiar with the application of “income in respect of a decedent” (IRD) and its numerous drawbacks, we often overlook potential tax planning strategies. Understanding the IRD rules and utilizing them in an effective manner could result in significant income tax savings to an estate and its beneficiaries.

It is generally desirable for IRD assets to pass to charitable beneficiaries, thereby avoiding the tax double-sting, discussed below. This article focuses on estate and income tax planning opportunities relating to the strategic assignment of qualified plans and IRAs to charitable beneficiaries.

The IRD rules are enumerated in Internal Revenue Code (Code) §691. This section was enacted to ensure that income earned by a decedent, but not yet received, remains subject to income tax, either as part of the decedent’s estate or as income to another recipient entitled to receive such amount.

The term “income in respect of a decedent” is not defined in the Code. The Treasury Regulations, however, state that IRD “refers to those amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.”

A common example is a cash basis account receivable that is outstanding as of decedent’s date of death: The decedent was entitled to such income during his or her lifetime but did not live long enough to actually receive it.

IRD receivables are also considered part of a decedent’s estate and, as such, are also subject to estate tax. Under normal circumstances, assets includible in a decedent’s taxable estate receive a “step-up” in basis to the fair market value as of the date of death. This “step-up” is extremely valuable because it protects the estate and its beneficiaries from the tax double-sting.

Items of IRD, however, are denied this favorable tax treatment. Although the Code allows for certain limited “deductions in respect of a decedent,” IRD items do not receive a basis “step-up,” thereby resulting in both income and estate taxation.

As described below, by assigning IRD items to charitable beneficiaries, the negative effects of this unfavorable tax treatment are mitigated.

IRD Recipient Is Key

Once a receivable is determined to be IRD, the next issue is ascertaining its recipient. Code §691(a)(1) designates three categories of IRD recipients: generally, the income is taxable to whichever is entitled to receive the asset from the decedent, whether that is the estate or one of the beneficiaries. Strategic allocation to the ultimate IRD recipient is therefore imperative in order to minimize the tax burden.

Due to the fact that a decedent’s receivables are often collected by the estate, taxation of IRD frequently becomes locked at the estate level. Some IRD items, however, pass by operation of law directly to a designated beneficiary. A perfect example is a jointly held account with accrued and unpaid income that is passing to the surviving joint owner. In this instance, the person receiving the asset must include such IRD in his or her gross income.

Another category of recipients are those who have acquired the “right” to the IRD receivable. Examples include specific legatees of the IRD item and residuary beneficiaries of the estate.

Generally, if the right to receive an IRD asset is transferred by the estate or by the person who has the right to receive it, the IRD is taxed to the transferor. However, an exception exists for a transfer made by the estate to a person who has a right to receive such amount pursuant to a bequest, devise or inheritance. This category of IRD recipients allows for the potential to create an effective allocation strategy.

For example, as discussed below, if an estate were named as beneficiary of an IRD asset, the estate might avoid income taxation on such IRD by assigning the asset to the residuary beneficiaries entitled under the terms of the will.

Tax Strategies

The most straightforward method to avoid both estate taxation and income taxation of IRD is to designate a charity as a direct beneficiary of a pension, IRA or other IRD asset, such as savings bonds. By having such a beneficiary designation, the estate not only avoids all income taxes associated with the IRD but also benefits by receiving a charitable deduction. This is the most direct and effective method to properly allocate IRD.

Unfortunately, decedents do not always utilize the most effective estate planning techniques:
If no beneficiary designation is made, the lack of a specific designation is not always fatal to avoiding the IRD double tax sting. The Treasury Regulations provide that the estate may distribute a right to receive an IRD item to a particular residuary beneficiary. In this circumstance, only that recipient beneficiary will include the IRD in his or her gross income for the taxable year when received. Based on the Regulations, several Private Letter Rulings have held that an IRD receivable payable to a decedent’s estate may be assigned by the estate to a charitable residuary beneficiary in satisfaction of its share of the residue. As a result, only the charity includes the IRD in its gross income when the distribution is received. The executor is thus permitted to allocate items of IRD to charitable residuary beneficiaries, even to the exclusion of non-charitable beneficiaries.

The benefits of this allocation are obvious. The charity, as a tax-exempt entity, is not taxed on the income. In either case, the estate is the estate. Due to the fact that the non-charitable beneficiaries now receive non-IRD items in satisfaction of their respective bequests, they similarly avoid taxation on this income. As a result, this strategic allocation avoids double taxation.

Certain requirements must be met in order for the estate to avail itself of this benefit. Most imperative is that the executor must have sufficient authority to make non-pro rata distributions of property in kind. This is accomplished by including an authorizing provision in the will instrument. Such a provision may read as follows:

The fiduciary, in his or her sole discretion, may satisfy all bequests to charitable organizations with items of income in respect of a decedent or with amounts recognized as income in respect of a decedent. All is not lost, however, in the absence of such a provision. The executor’s authority may be established pursuant to local law.

For example, the New York Estates, Powers and Trusts Law bestows upon executors the power to make non pro rata distributions of property in kind. The IRS has held this provision to be a sufficient grant of such authority. Accordingly, as long as there is no provision in the will instrument limiting the executor’s enumerated powers under the EPTL, the absence of a specific authorizing provision is not fatal.

We have recently obtained a Private Letter Ruling for one of our clients, resulting in favorable tax treatment to the estate. In Private Letter Ruling 200845029, a pension benefit was payable to the decedent’s estate due to his failure to designate a beneficiary. The Ruling held that the estate could assign such benefit to the charitable residuary beneficiary in partial satisfaction of its share of the residue, and that only the charity would include the associated IRD in its gross income when received.

If the estate could direct the pension administrator to pay the benefit directly to the charity. The 1099R reporting the income is then directed to the charity and not to the estate. As an exempt entity, the charity would not pay tax on this receipt.

Conclusion

In summary, as a best course of conduct, IRD items should be properly allocated to charities. This is usually accomplished by careful beneficiary designation.

In addition, wills with charitable beneficiaries should include a provision authorizing the executor to allocate the IRD items to such beneficiaries, as well as allowing for non-pro-rata distributions. Even estates without charitable beneficiaries may benefit from similar provisions; such authority allows the executor to effectuate the most favorable allocation of IRD items at the time of distribution, taking into consideration all potential tax implications.

At the very least, the will should not limit the executor’s powers under local law. The authority to make non pro rata distributions of property in kind, as provided under New York state law, is currently sufficient to permit strategic allocation of IRD items in order to mitigate the negative tax consequences. The better procedure would be to also expressly include such authority in the will.

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Pressure Builds on U.S. Taxpayers with Foreign Accounts
By Robert Barnett, CPA, JD, MS (taxation) and Renato Matos, JD, LLM (taxation)

The Foreign Account Tax Compliance Act of 2010 (FATCA) has manifested outside the United States in recent months, as a result of an agreement announced on Aug. 29, 2013, between the U.S. Department of Justice and the Swiss Federal Department of Finance. Recently, numerous Swiss banks have notified U.S. account holders to either provide evidence that their accounts have been properly disclosed to the IRS or to confirm participation in the Offshore Voluntary Disclosure Program (OVDP). Failure to comply will likely result in the bank releasing information about the account and account holder to the U.S. Department of Justice, which will then determine whether to pursue a criminal investigation and prosecution.

In addition to prompting international agreements, FATCA seeks to enforce U.S. tax and banking laws by requiring U.S. banks to withhold 30 percent of international fund transfers and by requesting foreign financial institutions to disclose account holders who might have failed to comply with U.S. tax obligations.

Under the Internal Revenue Code (IRC) and banking laws (i.e., the Bank Secrecy Act), U.S. residents and citizens—including those living outside the United States—have two primary reporting obligations to the Treasury Department. First, they must report all of their worldwide income (including income from wages and investments) and their interests in certain entities. Generally, such entities include corporations, partnerships, and trusts organized outside the United States and not publicly traded. Second, pursuant to the Bank Secrecy Act, all U.S. taxpayers must file Form 114, Report of Foreign Bank and Financial Account (FBAR), reporting their financial interest in financial accounts outside the United States when the aggregate value of such accounts exceeds $10,000.

Under U.S. law, noncompliant taxpayers face criminal prosecution and penalties that could exceed the undisclosed account’s balance; however, taxpayers may become compliant and avoid criminal prosecution by entering agreements with the IRS through the OVDP or related procedures, such as opting out or the Streamlined Filing Compliance Program.

Offshore Voluntary Disclosure Program

Under the OVDP, a U.S. taxpayer discloses foreign bank accounts and amends returns for an eight-year voluntary disclosure period. Taxpayers must then pay taxes on all previously unreported income, along with a 20 percent accuracy-related penalty on such taxes. In addition, the taxpayer pays one of three nonnegotiable penalties based on the highest annual aggregate account balance that the taxpayer has previously failed to disclose. These OVDP penalties are applied in lieu of the FBAR penalty under the banking law, penalties under the tax code, and potential liabilities for years prior to the voluntary disclosure period:

27.5 percent OVDP penalty. The standard penalty equals 27.5 percent of the highest annual aggregate account balance during the voluntary disclosure period. This penalty applies in the majority of OVDP cases and, while substantial, it provides amnesty from criminal prosecution for noncompliance.
12.5 percent OVDP penalty. A taxpayer will qualify for a 12.5 percent penalty if the taxpayer’s highest aggregate account balance, in each of the years within the voluntary disclosure period, is less than $75,000.

5 percent OVDP penalty. A taxpayer will qualify for a 5 percent penalty if the taxpayer falls within one of the following three categories, two of which apply to U.S. taxpayers living outside the United States (foreign resident):

- De minimis. To qualify, the taxpayer 1) must not have opened or caused the account to be opened; 2) exercised minimal, infrequent contact with the account; 3) must not have withdrawn more than $1,000 from the account in any year the taxpayer was noncompliant; and 4) must establish that all applicable U.S. taxes were paid on funds initially deposited to the account.
- Unaware foreign resident. The taxpayer must be a foreign resident who was unaware of being a U.S. citizen.
- Compliant foreign resident. The taxpayer must 1) reside in a foreign country, 2) have made a good faith showing that he timely complied with all tax reporting and payment requirements in the country of residence, and 3) have less than $10,000 of U.S. source income each year.

Opting Out

Before or after entering the OVDP, a taxpayer may irrevocably elect to opt out of the OVDP’s rigid penalty structure. In such case, the IRS will examine the taxpayer’s former noncompliance under the IRC, the Bank Secrecy Act, and their accompanying regulations. Generally, a six-year statute of limitations applies, as opposed to the OVDP’s eight-year disclosure period. Protection from criminal prosecution is generally provided to the taxpayer if the opt out occurs after entering the OVDP.

Generally, under the Bank Secrecy Act, there are three levels of penalties for the failure to file FBARs:

- Willful penalty. The penalty equals the greater of 50% of the highest account balance or $100,000 per account annually. The burden is on the IRS to prove that the taxpayer was willful (i.e., knew of or was willfully blind toward) the FBAR filing requirement. Evidence of willfulness includes letters from the IRS (or other entities) to the taxpayer informing of the FBAR filing responsibility or the taxpayer’s previous FBAR filings.
- Nonwillful penalty. Where the IRS cannot prove that the taxpayer was willful in failing to file, the penalty is $10,000 per account annually.
- Nonwillful penalty with reasonable cause. Where the taxpayer had reasonable cause for failure to file, the IRS will not impose penalties. The taxpayer must show proof of reasonable cause, which includes reliance on a tax professional.

At all three penalty levels, taxpayers can negotiate based on facts and circumstances in their particular case. The willful and nonwillful penalties can be mitigated or lowered based upon certain criteria, including the size of the undisclosed account.

Streamlined Filing Compliance Procedure

The Streamlined Filing Compliance Procedure is designed for U.S. citizens living abroad. It requires tax returns for a three-year period, as well as filing delinquent FBARs for a six-year period. Eligible taxpayers are only responsible for any U.S. back-taxes and do not pay any FBAR penalties.

To be eligible, a taxpayer must 1) have resided outside the United States since Jan. 1, 2009, 2) have not filed a U.S. tax return during the same period, and 3)
present a low compliance risk. A variety of factors apply in determining the existence of low compliance risk, including whether the taxpayer owes less than $1,500 in taxes for each year being disclosed, has declared all income in the country of residence, and has a financial interest in an account located outside the resident country. Although seemingly "streamlined," this option is limited in scope. Minimal IRS guidance for its use exists.

Implications

As FATCA and the U.S. Department of Justice break down international legal barriers, it is important for noncompliant U.S. taxpayers living in the United States or abroad to consider the options discussed above.

There are many complexities associated in becoming compliant with U.S. tax laws and banking laws. Each taxpayer’s situation is different and requires a thorough individual analysis. For this reason, noncompliant individuals are urged to seek legal advice from U.S. counsel knowledgeable regarding the relevant U.S. laws and IRS procedures.

Robert Barnett, JD, MS (taxation), and Renato Matos, JD, LLM (taxation), are partners at Capell Barnett Malaloni & Schoenfeld LLP, where they focus primarily on taxation matters, both domestic and international. Mr. Barnett and Mr. Matos have extensive experience representing clients with unreported foreign assets, including failure to file FBAR forms, and have advised clients in all facets of the Offshore Voluntary Disclosure Program, including penalty minimization strategies and options. The authors would like to thank Mikhail Lezhnev, JD, an associate at their firm, for his assistance in preparing this article.