

June 16, 2009

Reporting Requirements for Foreign Financial Accounts Including Foreign Hedge Funds and Private Equity Funds

IRS Representatives Discuss FBAR Filing Requirements in Teleconference in Anticipation of June 30 Deadline

SUMMARY

The Report of Foreign Bank and Financial Accounts (the “FBAR”), generally required to be filed with respect to foreign financial accounts, is due June 30, 2009 with respect to the 2008 calendar year.¹ It remains unclear, however, whether an interest in a foreign hedge fund or a foreign private equity fund would constitute a “financial account” under the FBAR rules, which carry significant penalties for noncompliance. The IRS has issued only limited, conflicting guidance on the subject. Investors in these funds will wish to consider whether the FBAR filing requirements may apply in their particular cases.

BACKGROUND

The FBAR is used to report a financial interest in, signature authority, or other authority over one or more financial accounts in foreign countries, as described in the FBAR Instructions (the “FBAR Instructions”). The FBAR must be filed with respect to each calendar year for any “financial accounts” covered under the FBAR Instructions, and must be received by the Department of the Treasury on or before June 30th of the succeeding year.

A revised FBAR was issued by the IRS for the 2008 calendar year filings, making certain changes to and clarifying the FBAR Instructions. However, many uncertainties remain, including the scope of the filing requirements as they may apply to foreign hedge funds and foreign private equity funds.

TREATMENT OF INVESTMENTS IN FOREIGN FUNDS AS “FINANCIAL ACCOUNTS”

The FBAR Instructions define a “financial account” as:

. . .any bank, securities, securities derivatives or other financial instruments accounts. Such accounts generally also encompass any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund (including mutual funds). . . . Individual bonds, notes, or stock certificates held by the filer are not a financial account nor is an unsecured loan to a foreign trade or business that is not a financial institution.²

Although the IRS has made clear in the FBAR Instructions that shares in a foreign mutual fund are considered a financial account for purposes of filing the FBAR, it remains uncertain whether an interest in a foreign hedge fund or private equity fund would be subject to similar filing requirements. The IRS has offered only limited guidance in this area.

In 2007, the IRS held a National Phone Forum on FBARs, after which the IRS disseminated the questions and answers from the teleconference. The published answers state that where an IRA owns an interest in a foreign hedge fund, the custodian does not have to file an FBAR if the custodian of the IRA does not have signature authority over the hedge fund account, and does not control the hedge fund, but holds units of the hedge fund as an investment in the IRA.³

However, in a teleconference hosted on June 12, 2009 by the American Bar Association and the American Institute of Certified Public Accountants, IRS panelists suggested that the definition of financial account would include an interest in a foreign hedge fund, and, in particular, would require filing if the hedge fund were serving a function similar to a mutual fund.⁴ In addition, the teleconference panelists advised one tax-exempt questioner who had not filed with respect to hedge fund investments in previous years to file FBAR forms for such investments both for 2008 and for the preceding five years.⁵ In a “Frequently Asked Questions” release issued May 6, 2009, the IRS stated that penalties for failure to file prior year FBARs will not be imposed in cases where taxpayers reported and paid tax on all their taxable income for those prior years. The IRS instructed taxpayers in this situation to file delinquent FBARs by September 23, 2009 with a statement explaining why the reports are filed late, along with copies of tax returns for the relevant years.⁶

Since the teleconference on Friday, we have reached out to personnel at the IRS for the purpose of pointing out to them that this reporting requirement will be viewed, whether rightly or wrongly, by many in the industry as a change in position by the IRS. However, notwithstanding these conversations, at the present time we understand that the IRS personnel responsible for the technical guidance on this issue still believe that an FBAR filing is required.

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No specific statements have been published with respect to foreign private equity funds, and it is unclear whether the IRS would take the position that FBAR filing is required for investments in these entities. However, in the absence of any guidance on the topic, investors will want to consider whether to make an FBAR filing for foreign hedge funds and private equity funds.

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ENDNOTES

- ¹ IRS Form TD F 90-22.1.
- ² IRS Form TD F 90-22.1, at 6.
- ³ Steven Tosher and Michel R. Stein, *FBAR Enforcement—Five Years Later*, J. Tax Practice & Procedure (June-July 2008) (Q&A materials released by the IRS following the 2007 National Phone Forum are published as Exhibit 1 to the article).
- ⁴ The IRS panelists were Samuel Berman, Special Counsel, IRS SB/SE Division Counsel; Rod Lundquist, IRS SB/SE BSA Policy Liaison to FinCEN; and John C. McDougal, IRS Counsel (SB/SE).
- ⁵ The panelists noted generally that if FBAR forms had not been filed with respect to prior years in which they had been required, these delinquent forms should be filed for the past six years.
- ⁶ Internal Revenue Service, “Frequently Asked Questions” (May 6, 2009), available at <http://www.irs.gov/pub/irs-news/faqs.pdf>.

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