June 19, 2009

INVESTMENT FUNDS ALERT

INTERESTS IN FOREIGN HEDGE FUNDS AND PRIVATE EQUITY FUNDS MAY BE REPORTABLE AS FOREIGN FINANCIAL ACCOUNTS – REPORTS DUE ON JUNE 30, 2009

INTRODUCTION

The Report of Foreign Bank and Financial Accounts (the FBAR form) (TD F 90-22.1), which is due on or before June 30, 2009, in respect of the 2008 calendar year, was revised in October of 2008 to apply to a wider set of accounts than in prior years. In addition, representatives of the Internal Revenue Service (IRS) have informally stated that interests in foreign hedge funds generally constitute "foreign financial accounts" for purposes of these rules. It is possible that foreign private equity funds may also constitute "foreign financial accounts"; thus, United States investors (including U.S. tax-exempt investors) in foreign hedge funds and private equity funds may be required to file the FBAR form with respect to such investments. Managers of foreign investment funds and domestic investment funds with foreign accounts should consider whether they and/or the funds and management companies, are obligated to file the FBAR form. Significant penalties, including possible criminal sanctions, may apply in the case of noncompliance. For your reference, the FBAR report can be obtained at http://www.irs.gov/pub/irs-pdf/f90221.pdf

DISCUSSION

In general, each United States person who has a financial interest in, or a signature or other authority over, any foreign financial accounts must prepare and file the FBAR form on or before June 30, 2009, in respect of accounts relating to the 2008 calendar year, if the aggregate value of these financial accounts exceeds $10,000 at

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any time during the year. Note that multiple persons may be responsible for filing an FBAR report to provide details of the existence of the same foreign financial account. Extensions to file this form are not available. A "United States person" means (1) a citizen or resident of the United States, (2) a domestic partnership, (3) a domestic corporation or (4) a domestic estate or trust. Although the instructions to the revised FBAR form prepared by the IRS in October 2008 contain a broader definition of "United States person" that could apply to some foreign persons with contacts in the United States, the IRS by announcement has limited the definition to the categories stated above for FBAR forms due on or before June 30, 2009, in respect of the 2008 calendar year.

The FBAR filing requirement relates to financial accounts in a geographical location outside the United States. The FBAR form instructions define "financial accounts" broadly, so that they include: "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). The term also means any savings, demand, checking, deposit, time deposit, or any other account (including debit card and prepaid credit card accounts) maintained with a financial institution or other person engaged in the business of a financial institution."

It is not clear whether this definition as written includes an interest in a foreign hedge fund (feeder or master) or a foreign private equity fund. However, in a telephone conference on June 12, 2009, sponsored by the American Bar Association (ABA) and American Institute of Certified Public Accountants (AICPA), IRS representatives stated that an interest in a foreign hedge fund generally would be considered a "foreign financial account" for purposes of the FBAR form. Moreover, they asserted that any foreign partnership or foreign corporation that was used by investors to commingle funds for investment would be a "foreign financial account." This rationale would apply to foreign private equity funds as well.

A United States person has a "financial interest" in each account for which he or she is the owner of record or has legal title, whether or not such account is maintained for his or her own benefit. Further, a United States person has a financial interest in each account in a foreign country for which the owner of record or holder of legal title is (i) a person acting as an agent, nominee, attorney, or in some other capacity on his or her behalf; (ii) a corporation in which he or she owns more than 50 percent of the

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total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (iii) a partnership in which he or she owns an interest of more than 50 percent of the profits or capital of the partnership or (iv) a trust in which he or she has a present beneficial interest of more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.

If a hedge fund is a "foreign financial account" for purposes of the FBAR form, any U.S. investors invested in a hedge fund through a foreign vehicle, such as a foreign feeder, during 2008 would be required to file the FBAR form with respect to that investment by June 30, 2009. The domestic feeder in a typical master-feeder structure would be required to file in respect of its investment in the offshore master fund, and if the domestic feeder owned more than 50 percent of the master fund, it would also have to file in respect of all foreign financial accounts of the master fund itself. Similarly, under this reading of the definition of foreign financial account, investments in foreign private equity funds would give rise to the requirement to file the FBAR form.

As another example, an employee or principal of an entity that manages an investment fund would have to file the FBAR form with respect to foreign financial accounts of that fund if such employee or principal has "signature or other authority" with respect to that account. A person has "signature authority" over an account if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other person) to the person with whom the account is maintained. A person has "other authority" if such person can exercise comparable power over an account by communication with the person with whom the account is maintained, either directly or through an agent or nominee, orally or through some other means. However, a person who only has investment authority with respect to an account, without the authority to instruct the free delivery of securities or free payment of cash, does not have "signature or other authority" with respect to that account, according to an IRS FAQ release. The existence of "signature or other authority" will in many cases be a factual question to be reviewed with counsel.

The FBAR form must be received by the Treasury Department on or before June 30. The timely filing rule (i.e., only requiring mailing of a tax form by the due date) does NOT apply to the FBAR form, according to the IRS.

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Penalties for failure to file an FBAR form are substantial. An unintentional failure to fail results in a penalty of $10,000, subject to a reasonable cause defense. A willful failure incurs a penalty of the greater of $100,000 or 50 percent of the value of the account. Criminal prosecution for a willful failure may result in the imposition of fines of up to $250,000 (increased to $500,000 if the willful failure is part of a pattern of illegal activity) and a prison term.

Persons who determine they did not properly report income from foreign accounts should consult their counsel to discuss participation in the IRS offshore voluntary disclosure program, effective from March 23, 2009, to September 23, 2009. If a taxpayer has paid tax on all income from foreign accounts but has failed to file FBAR forms, under an IRS publication, the taxpayer may file delinquent FBAR reports with an explanation of the reason for late filing by September 23, 2009, to avoid penalties, instead of participating in the voluntary disclosure program.

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