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Investment Funds Alert

Internal Revenue Service Clarifies FBAR Filing Requirements for Investments in Offshore Funds

March 4, 2010

INTRODUCTION

Rules adopted under the Bank Secrecy Act generally require U.S. persons who own interests in certain foreign financial accounts to file an annual Report of Foreign Bank and Financial Accounts (the "FBAR form") (TD F 90-22.1). The purpose of these rules is to identify situations that present opportunities for money laundering.

Informal Internal Revenue Service (IRS) guidance in the summer of 2009, along with certain changes to the instructions of the FBAR form for the 2008 calendar filing year, had suggested that interests in foreign hedge funds and, perhaps, foreign private equity funds constituted "foreign financial accounts" for purposes of these rules—a conclusion that would have the effect of requiring U.S. persons, including U.S. tax-exempt entities, to file FBAR forms on an annual basis to report their ownership interest in such funds. As discussed in more detail below, updated IRS guidance issued on February 26, 2010, clarifies that the IRS will not take any adverse enforcement action for failure to file an FBAR form in the case of U.S. persons owning interests in foreign hedge funds and private equity funds in respect of the 2009 or prior calendar years. Proposed regulations issued by the Treasury Department on the same date ("Proposed Regulations") would reserve on the treatment of such funds for subsequent calendar years, although the preamble to the Proposed Regulations ("Preamble") indicates that the issue is still under study.

BACKGROUND

In general, each U.S. person who has a financial interest in, or signature or other authority over, any "foreign financial account" during a calendar year must file the FBAR form on or before June 30 of the following year if the aggregate value of these financial accounts exceeds $10,000 at any time during the year. Historically, the FBAR form instructions have defined "financial accounts" quite broadly, so that the term could be interpreted to apply to interests in a foreign hedge fund (feeder or master) or a foreign private equity fund. This concern was exacerbated last summer when representatives of the IRS stated informally that an interest in a foreign hedge fund generally would be considered a "foreign financial account" for purposes of the FBAR form. These statements also suggested that foreign private equity funds could be subject to the same treatment. (For further coverage of this development, see our June 19, 2009, client alert, "Interests in Foreign Hedge Funds and Private Equity Funds May be Reportable as Foreign Financial Accounts – Reports Due on June 30, 2009," http://www.akingump.com/communicationcenter/newsalertdetail.aspx?pub=2175.)

On August 7, 2009, the IRS issued Notice 2009-62, 2009-35 IRB 260, which provided partial temporary relief. This Notice provided that (i) persons with signature authority over, but no financial interest in, a foreign financial account and (ii) persons with a financial interest in, or signature authority over, a foreign commingled fund, would have until June 30, 2010, to file an FBAR for the 2008 and earlier calendar years with respect to these foreign financial accounts. The IRS also asked for comments regarding when persons in these circumstances should be subject to FBAR filing obligations.

THE FEBRUARY 26 GUIDANCE

Notice 2010-23. Notice 2010-23 states that, for 2009 and prior years, the IRS will not interpret the FBAR filing requirement to apply to persons with a financial interest in, or signature authority over, a foreign commingled fund (other than a mutual fund). The Notice specifically states that a financial interest in, or signature authority over, a foreign hedge fund or private equity fund is included in that relief. In addition, the Notice extended the temporary relief of Notice 2009-62 for persons with signature authority over, but no financial interest in, a foreign financial account, so that FBAR filings that would have been due from such filers on June 30, 2010, would now be due on June 30, 2011.

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The Proposed Regulations. Contemporaneously with the publication of Notice 2010-23, the Treasury Department published the Proposed Regulations. The Proposed Regulations would explicitly provide that the FBAR filing requirement would apply to shares in "a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions." The Preamble to the Proposed Regulations states that mutual funds are covered by the filing requirements, because their liquidity features present opportunities for money laundering. The Preamble goes on to observe that other types of pooled investment companies, such as "private equity funds, venture capital funds and hedge funds," vary in the extent to which they present the same opportunities. The Preamble also notes that, because these nonpublic funds are not regulated, it is difficult to distinguish the funds that present money laundering risk from those that do not. For this reason, the Proposed Regulations reserve on the treatment of funds other than "mutual funds or similar pooled funds." However, the Preamble does note that Treasury is concerned about possible abuses of private funds and indicates that the issue is still under study.

It should also be noted that the Senate-passed version of H.R. 2847 would, if enacted, require a type of reporting similar to the FBAR regime for certain U.S. persons owning interests in foreign investment funds. The prospects for the passage of the bill are uncertain, but persons who may be subject to this legislation should follow the progress of this bill, as well as that of the Proposed Regulations and other FBAR guidance.

Certain other taxpayer-friendly changes would be made by the Proposed Regulations. Participants and beneficiaries of individual retirement accounts (IRAs), certain other qualified plans or trusts would not be required to file an FBAR with respect to a foreign financial account held by, or on behalf of, the IRA, plan or trust. In addition, although not implemented in the Proposed Regulations, the Preamble indicates that U.S. persons who are employed in a foreign country and have signature or other authority over foreign financial accounts owned or maintained by their employer will be subject to a modified, likely simpler form of FBAR reporting.

The Proposed Regulations do not set forth a proposed effective date. However, as noted above, the exclusion from the filing requirement for interests in commingled funds other than mutual funds under Notice 2010-23 is effective for FBAR filings in respect of the 2009 calendar year and earlier years; thus, any possible taxpayer-adverse changes or additions to the Proposed Regulations with respect to this point should only apply for FBAR filings in respect of the 2010 calendar year or later.

Announcement 2010-16. Finally, the IRS, in Announcement 2010-16, suspends, for persons who are not U.S. citizens or residents or domestic entities, the requirement to file the FBAR form for 2009 and earlier taxable years. The Proposed Regulations would also limit FBAR filings to U.S. citizens or residents or domestic entities and, thus, would remove the change in the October 2008 revised FBAR form that would have required foreign persons who were "in and doing business in the United States" to make FBAR filings in respect of foreign financial accounts.

CONTACT INFORMATION

If you have any questions regarding this alert, please contact —

Tax

Patrick B. Fenn
pfenn@akingump.com
212.872.1040
New York

Stephen M. Jordan
sjordan@akingump.com
212.872.1099
New York

Christopher S. Harvey
charvey@akingump.com
212.872.8047
New York

Stuart E. Leblang
sleblang@akingump.com
212.872.1017
New York

Robert Rothman
rrothman@akingump.com
212.872.7411
New York

Investment Funds

Stephen M. Vine
svine@akingump.com
212.872.1030
New York