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Hedge Fund and Private Equity Fund Alert



FBAR UPDATE: IRS EXTENDS JUNE 30 DEADLINE FOR CERTAIN TAXPAYERS

JUNE 25, 2009

On the afternoon of June 24, the IRS announced that it is extending until September 23, 2009, the filing deadline for the Report of Foreign Bank and Financial Accounts ("FBAR"), but only for taxpayers who: (i) have reported and paid tax on all of their 2008 taxable income; (ii) have "only recently learned" of their FBAR filing obligation and have insufficient time to gather the necessary information to complete the FBAR; and (iii) attach a statement to their filing explaining why the FBAR is filed late. The IRS noted that it will not impose a penalty for the late filing in this situation. (See the Alert below concerning the FBAR filing requirements.) The IRS announcement was included as a revised answer to Frequently Asked Questions ("FAQs") that the IRS had previously published.¹ Presumably, almost anyone who is filing due to an interest in, or authority over, a private offshore fund would fit within the category of having "only recently learned" of their FBAR filing obligation.

The IRS did not provide any further guidance in the revised FAQs as to whether private offshore funds are "financial accounts" that must be reported. According to an article in today's Wall Street Journal, an IRS official on June 24 stated that the requirement that private offshore funds must file an FBAR was not a new requirement, but it was an issue that the IRS had not "emphasized in the past." Despite this remark, it is possible that the IRS will issue guidance in writing as to offshore private fund requirements before September 23, 2009. Accordingly, for taxpayers who meet the requirements for the filing extension, it may be worthwhile to delay filing their FBAR until September 2009, in the hope that the IRS will clarify whether an FBAR is required in relation to private offshore funds. The IRS FAQs (Q.45) noted that taxpayers can call or write to the IRS with questions as to whether an FBAR is required as to a particular foreign account, though it is unclear if the IRS will provide any definitive response as to questions concerning private offshore funds.

¹ The revised FAQs are available at http://www.irs.gov/pub/irs-utl/faqs-revised_6_24.pdf. (See Q.43)

PREVIOUS FBAR CLIENT ALERT (ISSUED ON JUNE 24, 2009): U.S. INVESTORS AND MANAGERS OF OFFSHORE HEDGE FUNDS AND PRIVATE EQUITY FUNDS SHOULD FILE FBARS BY JUNE 30 DEADLINE

Summary

The Report of Foreign Bank and Financial Accounts ("FBAR"), which requires reporting by a U.S. person of a financial interest in, or "signature or other authority" over, a foreign "financial account," must be received by the Department of Treasury by June 30, 2009, with respect to the 2008 calendar year. Recent statements by Internal Revenue Service ("IRS") personnel have suggested that an offshore hedge fund is a "foreign financial account." Accordingly, unless and until the IRS clarifies the requirements, it seems prudent for every U.S. investor in an offshore hedge fund, offshore private equity fund, or any other private offshore fund, to file an FBAR by June 30, 2009. (It is possible that the IRS might publish some clarification prior to June 30.) Owners of more than 50% of an entity that has a financial interest in a foreign financial account must also file an FBAR. U.S. investors in, and managers of, offshore funds who are subject to the rules would include: U.S. feeder funds that invest in offshore master funds; any U.S. investor that owns more than 50% of the U.S. feeder fund; investment managers and general partners (and their principals) that have an equity interest in an offshore fund (including an interest in the carry or profits) or have signature authority over an offshore fund; U.S. tax-exempt entities that invest in an offshore fund; and any other direct investor in an offshore fund. Penalties for failure to file the FBAR are substantial, even for unintentional failures, and can include criminal penalties for willful failures.

Background

FBAR (Form TD F 90-22.1) must be filed by any "United States person" who has a "financial interest" in, or "signature or other authority" over, any foreign "financial account," if the aggregate value of the financial accounts exceed \$10,000 at any time during the calendar year.² The FBAR is due on or before June 30 of the succeeding year. The Treasury Department must receive the FBAR on or before June 30; mailing the form by June 30 is insufficient, according to the IRS. There is no extension available for filing the FBAR and an extension of time to file federal income tax returns does not extend the due date for filing an FBAR.

The FBAR form and instructions were revised in 2008. The revised definition of "financial account" includes 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)." Although the revised definition mentions a "commingled fund" and mutual funds, the Managed Funds Association ("MFA") has noted that the definition had not generally been interpreted as including hedge funds and private equity funds, which, unlike mutual funds and bank accounts, do not allow daily redemptions. During a recent teleconference, however, IRS personnel took the position that an offshore hedge fund is a foreign "financial account" for FBAR purposes, and that therefore every U.S. investor in an offshore hedge fund should file an FBAR.³ The MFA has written to the IRS requesting clarification of the definition of "financial account," but in light of the severe penalties for failing to file an FBAR, it seems prudent to file an FBAR on the assumption that an offshore

² The FBAR can be obtained at <http://www.irs.gov/pub/irs-pdf/f90221.pdf>. The IRS has issued FAQs concerning FBARs, available at <http://www.irs.gov/businesses/small/article/0,,id=148845,00.html>. The IRS has issued a separate set of FAQs concerning delinquent filing of FBARs and its voluntary disclosure program. See footnote 4 infra.

³ The IRS personnel 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).

private fund is a foreign financial account, unless the IRS formally issues guidance prior to the June 30 deadline.

Who Needs to File the FBAR

The definition of "financial interest" is broad and a U.S. person is deemed to have a financial interest in a foreign financial account for which the owner is: (i) a partnership in which the U.S. person owns directly or indirectly more than 50% of the profits or of the capital of the partnership; or (ii) a corporation in which the U.S. person owns directly or indirectly more than 50% of the voting power or of the total value of the stock of the corporation. "Signature authority" over an account includes the ability to control the disposition of the assets of an account by delivery of a document containing his or her signature (or with co-signing authority) to the bank or other person with whom the account is maintained. "Other authority" over an account is comparable power to signature authority over the account, either directly or through an agent, nominee or attorney. The IRS has explained that "other authority" does not include a person who has power to direct how an account is invested but who cannot make disbursements to the account.

Due to these expansive definitions, all of the following entities and individuals would need to file an FBAR (assuming that a private offshore fund is a foreign financial account):

- U.S. feeder funds that invest in offshore master funds
(Note that U.S. feeders that own more than 50% of an offshore master would have to file in respect of all foreign financial accounts of the offshore master.)
- U.S. investors who own more than 50% of a U.S. feeder fund that invests in an offshore master fund
- Investment managers (and their principals and employees) that have an equity interest in any offshore fund (including an interest in the carry or profits) or have signature or comparable authority over an offshore fund
- General partners (and their principals and employees) that have an equity interest in any offshore fund (including an interest in the carry or profits) or have signature or comparable authority over an offshore fund
- U.S. tax-exempt entities that invest in any offshore fund (whether in an offshore feeder or directly into an offshore master fund)
- Any direct U.S. investor in an offshore fund

Change in Definition of U.S. Person

Prior to the 2008 revision of the FBAR instructions, U.S. person was defined as: (1) a citizen or resident of the U.S.; (2) a domestic partnership; (3) a domestic corporation; or (4) a domestic estate or trust. The revised instructions replace (2) – (4) with "a person in and doing business in the U.S." but do not provide any further explanation of that phrase. Accordingly, the IRS potentially could interpret the revised definition of U.S. person to include offshore funds that trade in securities or commodities within the U.S. The IRS, however, issued an announcement suspending the FBAR filing due on June 30, 2009 for persons who are not U.S. citizens, residents or domestic entities, and allowing the use of the prior definition of U.S. person to determine filing obligations for FBARs due June 30, 2009. All other requirements in the revised FBAR form and instructions remain in effect. The IRS noted that it will issue additional guidance for FBARs due in subsequent years.

Filing FBAR for Years Prior to 2008

The IRS personnel at the recent teleconference suggested that an FBAR relating to offshore hedge fund interests be filed not only for 2008, but for the preceding six years. The IRS has stated that taxpayers who reported and paid tax on all their taxable income for prior years but did not file FBARs should file the delinquent FBARs by September 23, 2009, and attach a statement explaining why the reports are filed late, along with copies of tax returns for all of the relevant years. The IRS noted that it will not impose any penalty in this situation, and that such taxpayers would not need to participate in the IRS's voluntary disclosure program.⁴ Persons who did not properly report income from foreign accounts should consider, with the assistance of counsel, participating in the IRS offshore voluntary disclosure program, which is available until September 23, 2009.

Penalties for Failing to File FBARs

A non-willful violation of the FBAR reporting requirements can result in a \$10,000 penalty, subject to a reasonable cause defense. A willful violation can result in a penalty of the greater of \$100,000 or 50% of the balance of the account at the time of the violation. Criminal penalties for willful violations can result in a fine of \$250,000 and five years imprisonment, and if the violations are part of a pattern of illegal activity, a fine of \$500,000 and ten years imprisonment.

Contact

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⁴ IRS, Frequently Asked Questions, May 6, 2009, FAQ #9, available at <http://www.irs.gov/pub/irs-news/faqs.pdf>.