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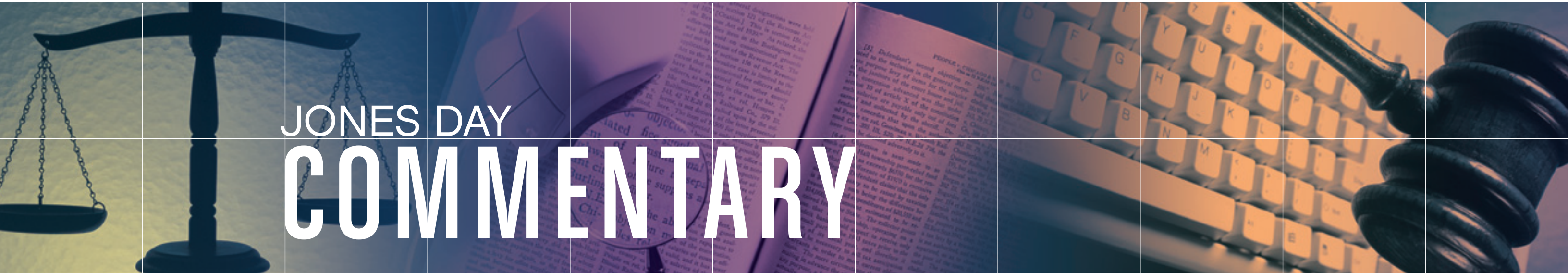

POTENTIAL IRS REPORTING REQUIREMENTS FOR INVESTORS IN OFFSHORE PRIVATE EQUITY AND HEDGE FUNDS

Recent informal comments by representatives of the U.S. Internal Revenue Service ("IRS") indicate that the IRS may expect U.S. investors in foreign hedge funds and foreign private equity funds to file an annual Report of Foreign Bank and Financial Accounts on Form TD F 90-22.1 (an "FBAR"). Most practitioners agree that the IRS's apparent new reporting position is at odds with established industry practice, and they have criticized the highly informal and unorthodox manner in which the new position was publicized. This new reporting position, along with numerous other uncertainties about the form, has caused the IRS to offer a one-time filing extension from the customary June 30 filing date to September 23, 2009, for investors who are otherwise compliant with their federal income 2008 tax obligations.

The IRS has yet to provide formal guidance confirming that interests in foreign hedge and private equity funds are subject to FBAR reporting. Given the severity of criminal and civil penalties for noncompliance, until formal guidance is provided, potentially affected persons who are eligible for the extended September 23, 2009, filing deadline should begin preparing their 2008 FBAR filing. This involves identifying investments that could be subject to FBAR reporting and gathering the information requested by the IRS's Form TD F 90-22.1.

As the scope of the FBAR and the definitions used in Form TD F 90-22.1 are in many respects unclear, potentially affected persons are well advised to consult their legal counsel about their FBAR reporting obligations.

BACKGROUND ON THE FBAR FORM

FBAR reports are required by regulations promulgated under the Bank Secrecy Act of 1970 and were introduced amid Congressional concern that foreign financial institutions located in jurisdictions with

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bank secrecy laws were being used to violate or evade U.S. criminal, tax, and regulatory requirements.

U.S. persons must file an FBAR for each calendar year in which they have a financial interest in, or signature or other authority over, a foreign financial account with an aggregate value of more than $10,000 at any time. The report must be filed with the IRS and is due on June 30 of the following year.

RECENT DEVELOPMENTS

Although the FBAR form has been around for some time, several developments over the past few years have raised the form's profile considerably. In 2003, the Financial Crimes Enforcement Network (or "FinCEN") delegated its enforcement authority for the FBAR to the IRS in an effort to improve compliance. Then, in 2008, the IRS changed two key definitions for FBAR purposes. First, it expanded the definition of "United States person" to include persons "in and doing business in the United States," potentially causing foreign persons to be subject to the FBAR reporting requirements. Second, it revised the definition of "financial account" to make clear that ownership of equity interests in commingled funds, including mutual funds, is subject to FBAR reporting. Finally, in a series of informal public statements in 2009, various IRS representatives expressed their view that ownership of equity interests in both foreign hedge and private equity funds is also subject to FBAR reporting.

This oral guidance was a departure from previous understandings addressing who is required to file an FBAR, and it has been a source of considerable confusion for investors in and sponsors of foreign investment funds. In partial response to the confusion, on June 25, 2009, the IRS announced that it would allow certain taxpayers who failed to file a 2008 FBAR report by the June 30, 2009, deadline to file a delinquent FBAR report without penalty by September 23, 2009, provided that certain conditions are met.

WHO IS A "U.S. PERSON"?

The FBAR filing requirement applies to "any person subject to the jurisdiction of the United States," which presently includes:

- citizens or residents of the U.S.;
- domestic partnerships (including domestic limited partnerships and limited liability companies);
- domestic corporations; and
- domestic estates and trusts.

Tax-exempt organizations like U.S. pension funds, private foundations, and public charities are not exempt from the FBAR filing requirement. Unless further guidance is issued, moreover, foreign persons "in and doing business in the United States" will be required to file FBAR reports commencing June 30, 2010.

WHAT IS A "FINANCIAL INTEREST"?

Having a "financial interest" generally means being the owner of record or having legal title to a foreign account. It also applies to a U.S. person who has an agent, nominee, or attorney (or in certain situations, a trust) act as the owner of record or holder of legal title on the U.S. person's behalf. The IRS will also "look through" corporations or partnerships (including limited partnerships and limited liability companies) to impute a "financial interest" to an owner of 50 percent or more of the interests in the entity that is the owner of record or holder of legal title of a foreign account.

WHAT IS "SIGNATURE" OR "OTHER AUTHORITY"?

Possessing "signature authority" over a foreign account means having the power to control the disposition of money or other property in the account by delivery of a document containing one's signature to the bank or other person with whom the account is maintained. "Other authority" is described as power that is comparable to signature authority over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means.

WHAT IS A "FINANCIAL ACCOUNT"?

Previously, the FBAR instructions defined the term "financial account" to include "any bank, securities, securities

derivatives, or other financial instrument accounts." In October 2008, the IRS expanded this definition to include "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)." At a June 12, 2009, teleconference panel discussion hosted by the American Bar Association and the American Institute of Certified Public Accountants, an IRS representative stated that this definition includes an offshore hedge fund regardless of whether the fund itself holds any foreign bank or securities accounts. It would seem this position is based on the view that holding an interest in a foreign hedge fund is akin to holding shares in a foreign mutual fund, and thus requires filing of an FBAR if all other conditions are met. It was not clear from the June 12, 2009, panel, however, whether an interest in a foreign private equity fund would also be considered a "financial account." While mutual funds and many hedge funds can be characterized by short-term buying and selling of public equities, private equity funds generally have long-term investment horizons and rarely hold significant amounts of public equities. Despite this apparent distinction, on June 26, 2009, an IRS spokesperson providing an informal response to a query from a tax publication confirmed that interests in foreign private equity funds would also be considered "financial accounts."

WHAT MAKES A FINANCIAL ACCOUNT "FOREIGN"?

Bank, securities, or other financial accounts "in a foreign country" are potentially subject to FBAR reporting. An account is in a foreign country if the geographic location of the account (and not the site of formation or management of the financial institution) is outside the United States, which for this purpose is defined to include U.S. territories and insular possessions. Thus, accounts held abroad through branches of U.S. banking or other financial institutions are treated as foreign accounts for purposes of the FBAR form. By contrast, accounts held with U.S. branches of foreign banking or other financial institutions are not subject to FBAR reporting.

When initially promulgated, the FBAR report was directed toward traditional financial accounts such as bank or brokerage accounts. The concept of an account "in a foreign country" fits more neatly within this traditional framework. However, the IRS's recent informal interpretation that any "foreign" investment fund is a "foreign financial account" appears to suggest a broader interpretation than originally intended, with the jurisdiction of the fund's organization itself determining whether a financial account is "foreign."

WHO IS REQUIRED TO FILE BASED ON THIS NEW IRS POSITION?

The IRS's new position could require filings from the following persons:

- U.S. investors (often limited partners, and including U.S. tax exempt investors) with interests in offshore funds, including offshore private equity and hedge funds.
- U.S. investors with interests in domestic funds that hold foreign accounts, where the U.S. investor holds more than a 50 percent interest (*e.g.*, profit or capital interest, stock or voting power, or beneficial interest) in that fund.
- U.S. fund sponsors (such as the general partner) owning interests in their managed offshore funds.
- U.S. persons with more than a 50 percent interest in a fund of funds that invests in offshore funds would be required to report the interests in the underlying offshore funds, as well as any other foreign financial accounts held by the top tier fund.
- U.S. persons with more than a 50 percent interest in a domestic or foreign entity that invests in offshore financial accounts (including funds).
- U.S. persons in a foreign blocker or other foreign corporation that may be considered a commingled fund.
- U.S. persons who have signature or other authority over a foreign account held by a fund, such as general partners, managing members, advisors, and their employees or other agents.
- U.S. persons who have signature or other authority over an offshore hedge or private equity fund, such as general partners, managing members, advisors, or their employees or other agents. Individuals with the authority to bind the general partner, managing member, or advisor may be required to file their own FBAR, in addition to any FBAR filed by the general partner, managing member, or advisor itself.

WHO IS ELIGIBLE AND WHAT MUST BE FILED FOR THE EXTENDED DEADLINE?

The IRS has stated that taxpayers who reported and paid tax on all their 2008 taxable income, but only recently learned of their FBAR filing obligation and have insufficient time to gather the necessary information to complete the FBAR by the June 30 filing date, will not be penalized if the FBAR filing is made by September 23, 2009. Eligible taxpayers must file Form TD F 90-22.1 together with both a copy of their 2008 tax return and an explanation of why the FBAR has been filed late, with the IRS's Philadelphia Offshore Identification Unit by the extended deadline.

At the June 12, 2009, teleconference, the IRS representative noted further that an investor who failed to file previous year FBARs must file them for the preceding six years, along with an explanation for the delinquent prior year filings, by September 23, 2009. The IRS has yet to issue any official written guidance confirming this position. However, it may be prudent for an affected taxpayer to prepare to make any prior year filings as well.

POTENTIAL PENALTIES FOR NONCOMPLIANCE

The IRS may impose criminal penalties for a willful failure to file a required FBAR, including monetary penalties of up to $500,000 and imprisonment for up to 10 years. Civil penalties of up to $10,000 for each violation or, for willful violations, the greater of $100,000 and 50 percent of the account balance, may also be imposed. The IRS has discretion, however, to lessen penalties for reasonable cause.

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