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FinCEN and IRS Provide Timely FBAR Guidance Regarding Key Definitions

By Joseph Fletcher and Edward Froelich

Last week the Department of Treasury issued proposed regulations addressing key definitions related to the Report of Foreign Bank and Financial Accounts, commonly referred to as the “FBAR.” While this guidance has narrowed the definition of a “United States person” subject to the FBAR requirements and has confirmed that mutual funds are treated as a “commingled fund,” it continues to “reserve” on the crucial issue of whether an interest in a hedge fund or a private equity fund should be considered a “commingled fund” whose ownership must be reported by a U.S. Person.

The IRS followed with an Announcement and a Notice that provide relief for U.S. persons who have signatory authority over, but not financial interest in an account that would otherwise be a reportable financial account for FBAR purposes and U.S. persons who have an investment in a foreign hedge fund or a foreign private equity fund.

RECENT DEVELOPMENTS

Specifically, on February 23 the Financial Crimes Enforcement Network (FinCEN) issued proposed regulations regarding certain key definitions to the instructions of the Report of Foreign Bank and Financial Accounts commonly known as the FBAR. The IRS followed up shortly after on February 25 with a Notice and Announcement that provided important administrative relief and guidance in time for the income tax return filing deadlines. On February 26 the IRS issued Announcement 2010-16 and Notice 2010-23 providing significant relief for taxpayers, under certain circumstances.

In our prior updates regarding the 2009 FBAR filing requirements, we noted two important definitional issues facing taxpayers:

- What is the scope of the definition of U.S. person, which was significantly broadened as part of the revision of the FBAR form in October 2008?

and

- Are investments in foreign private equity and foreign hedge funds reportable accounts?

Prior to the latest flurry of activity, the most recent action by the IRS was on August 7, 2009, when the IRS issued Notice 2009-62. In Notice 2009-62 the IRS also extended the due date for the 2008 FBAR from June 30, 2009 to June 30, 2010 for U.S. persons with signatory authority over, but no financial interest in, foreign accounts and for U.S. persons with interest in a foreign financial account, in which assets are held in a commingled fund (including a hedge fund or a private equity fund) and also solicited comments with respect to the tax treatment of foreign commingled funds. The recent proposed regulations, as well as the IRS Announcement and Notice provide significant clarification and administrative relief.

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THE PROPOSED FinCEN REGULATIONS

The Bank Secrecy Act of 1970 (the BSA), codified in Titles 12 and 31 of the U.S.C., authorizes the Secretary of the Treasury to issue regulations requiring persons to keep records and file reports of foreign financial accounts. That authority has been delegated to FinCEN, an agency within the Department of Treasury. The proposed regulations issued by FinCEN address a number of important interpretational issues.

U.S. Person

Practitioners expressed concern that the new definition of U.S. person introduced with the revision of the FBAR form in October 2008 was too broad and vague. It included not only domestic persons, but also “persons in, and doing business in, the United States.” The authority for this dramatic expansion of the definition is found right in the language of the BSA. See 31 U.S.C. section 5314.

FinCEN decided that this definition was not appropriate and proposed a definition to “more clearly delineate . . . the scope of individuals and entities that would be required to file the FBAR[.]” Preamble, Part III of the Proposed Regulations. FinCEN proposed to return to a definition close to that in effect prior to the October 2008 change. Under the proposed regulations a U.S. person is either a citizen or resident of the United States or an entity created, organized or formed under the laws of the United States, any state, the District of Columbia, the Territories and Insular Possessions of the U.S. or the Indian Tribe. An entity includes, but is not limited to a corporation, partnership, trust or limited liability company. It is interesting to note that FinCEN elected not to cross-reference the broader definition of entity that is found in 31 C.F.R. 103.11(z) and includes also syndicates, joint ventures, associations and other unincorporated entities. This definition had been cross-referenced in the instructions to the FBAR as revised in October 2008.

Reportable Accounts

The proposed regulations also address the scope of reportable accounts. FinCEN explains that it is focusing on “relations” versus “transactions” in an attempt to give clearer guidance regarding what types of accounts should be reported on the FBAR. “FinCEN believes that when a person maintains an account with a foreign financial institution, the person is maintaining a relation with a foreign financial agency. For this purpose, an account means a formal relationship with such person to provide regular services, dealings and other financial transactions.” Preamble, Part III, C. Thus, the length of time for which a service is being provided would not affect the fact of the existence of a formal account. *Id.* The effect of this new approach is to eliminate certain exceptions that are in the current FBAR instructions, including the exceptions for individual bonds, notes, or stock certificates held by a U.S. person or an unsecured loan to a foreign trade or business that is not a financial institution. However, given that the notion of an account requires a formal relationship with a foreign financial institution, it would appear that these exceptions are no longer needed to be explicitly stated because there is no relationship where the U.S. person holds the note, bond, or stock *outside* of any relationship with a foreign financial institution.

The proposed regulations break out the types of reportable accounts according to kinds of financial services being provided. “Bank accounts” are thus defined as savings deposit, demand deposit, checking or any other account maintained with a person engaged in the business of banking. *Id.* D. “Securities accounts” are accounts maintained with a person in the business of buying, selling, holding or trading stock or other securities. *Id.* E.

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The catch-all category of “other financial account” is also defined with respect to specific kinds of accounts: (i) an account with a person who is in the business of accepting deposits as a financial agency, (ii) an insurance policy with cash value, (iii) an annuity policy, (iv) a futures or options account in any commodity with a broker or dealer where the transactions are subject to the rules of a commodity exchange or association or (v) a mutual fund or similar pooled fund account which issues shares to the general public that have regular net asset value determinations or regular redemptions. *Id.* F.

Particularly important is the determination that non-mutual fund or similar pooled commingled accounts are not reportable accounts. The IRS had previously stated that foreign hedge funds and private equity funds would be treated as financial accounts and reportable on the FBAR. FinCEN decided to reserve on this question. “Accordingly, FinCEN has determined that, at this time, the proposal should reserve the treatment of investment companies other than mutual funds or similar pooled funds.” *Id.* FinCEN expressed its concern that such investment companies could be used to effect tax avoidance, which suggests that it will consider additional guidance in the future.

The proposed regulations do set forth specific exceptions to the reportable accounts similar to the prior exceptions of correspondent or nosotro accounts and military banking facilities. It includes further exceptions including accounts of international financial institutions of which the U.S. is a member, accounts of departments or agencies of the U.S., Indian Tribes or any State or political subdivision of a State or a wholly-owned entity, agency or instrumentality of any of the foregoing.

IRS GUIDANCE

IRS guidance goes well beyond the FinCEN regulations.

IRS Notice 2010-23 provides:

- The IRS will not interpret the term “commingled fund” as applying to funds other than mutual funds with respect to 2009 and prior years. The Notice expressly provides, that a U.S. person with a financial interest in, or signatory authority over, a foreign hedge fund or private equity fund will not be treated as having a reportable foreign account for 2009 and prior years.
- Taxpayers with signatory authority, but no financial interest in a financial account for which an FBAR would have been due on June 30, 2010 now have until June 30, 2011 to file the FBAR. Taxpayers with signatory authority in a financial account, but no financial interest in a financial account for years prior to 2010 now have until June 30, 2011 to file the FBAR.
- A taxpayer who has no other reportable foreign account for the year in question other than an account covered in Notice 2010-23 can check “no” with respect to the questions on the federal tax forms that ask about the existence of a financial interest in, or signatory authority over, a foreign account for 2009 or earlier years.

Further, IRS Announcement 2010-16 temporarily suspends the FBAR filing obligation for 2009 and prior calendar years for persons who are not U.S. citizens, residents, or domestic entities (corporations, partnerships, estates and trusts). The IRS determined that in view of the large number of public comments it received regarding the definition of U.S. person it was appropriate to provide the aforementioned administrative relief. The action effectively reverts to the definition of U.S. person in the July 2000 version of the FBAR for the 2009 and prior calendar year filing obligations. Clearly, the FinCEN

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proposed regulations on the definition of U.S. person are the likely position the Government will take in finalized regulations, and the IRS believed it was appropriate to postpone application of the October 2008 definition of U.S. person in light of FinCEN's action.

The full texts of IRS Announcement 2010-16 and IRS Notice 2010-23 are available at:
<http://www.irs.gov/taxpros/article/0,,id=219707,00.html>.

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