

Revised foreign bank account reporting causes additional burdens for investment funds and advisors

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Investment fund managers should be aware of major changes to the foreign bank account reporting rules that impact filings due on June 30, 2009. Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," has been revised and now requires significantly more information to be provided to the Internal Revenue Service ("IRS") regarding foreign financial accounts and non-U.S. owners of such accounts. This reporting impacts U.S. individuals and entities that have ownership or control over foreign financial accounts. Failure to file properly could bring significant monetary and criminal penalties. Given the expanded scope of these reporting requirements, investment managers should begin to assess the impact of these new reporting rules on their filing obligations and determine the best course of action.

The most relevant changes for the investment fund industry include:

- Filings will be required by "persons in and doing business in the United States."
- A "financial account" now specifically includes "mutual funds."
- The scope of signature authority over a foreign financial account has been expanded.
- The maximum value of each foreign account must be reported.
- Consolidated reporting for filers with signature authority over 25 or more foreign accounts is available.
- Persons with only signature authority over a foreign account must now also report the primary owner that has a financial interest in such account.

- The concept of "financial interest" via indirect ownership through corporations and partnerships has been expanded.
- Instructions clarify what identifying information must be provided by a non-U.S. individual or by a non-U.S. entity that does not have a U.S. identification number.

U.S. Persons

The term "U.S. Person" has been expanded for foreign bank account reporting ("FBAR") purposes from citizens and residents of the U.S. to also include "persons in and doing business in the United States."¹ While the broader scope will increase the number of persons required to file, little guidance has been provided as to its desired reach and with the vague instructions, it is not clear whether individuals must be physically present in the U.S. or if being engaged in a U.S. trade or business is sufficient to rise to the level of "in and doing business in the U.S."

Earlier this year, the IRS issued several FAQs on FBAR in order to clarify certain new concepts including the addition of a filing requirement for "persons in and doing business in the United States." The FAQs seem to indicate that a physical presence is required, stating that generally a person is not considered "in and doing business in the U.S. unless that person is conducting business within the U.S. on a regular and continuous basis."² The examples within the FAQs provide that persons who are not citizens or residents are not required to file if they "occasionally visit the U.S. to meet customers or business associates," if they "occasionally come to the U.S. to participate in exhibits, sporting events, or performances" in the case of performers and athletes, or visit "the U.S. to manage . . . personal

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¹ The definition of "person" for FBAR purposes includes an individual, corporation, partnership, trust or estate, joint stock company, association, syndicate, joint venture, unincorporated organization or group. See 31 C.F.R. 103.11(z).

² For IRS FAQs on FBAR see <http://www.irs.gov/businesses/small/article/0,,id=148845,00.html>. Page last updated March 13, 2009.

investments, such as rental property, and conduct no other business."³ Ultimately, the IRS has indicated that the determination should be made based on the facts and circumstances of each case.

Financial accounts

A "financial account" generally includes any bank, securities, securities derivatives or other financial instruments account. Where assets are held in a commingled fund and the owner holds an equity interest in the fund (such as a mutual fund), such interests are also considered financial accounts. The inclusion of a reference to an equity interest in a foreign mutual fund has been specifically added in the revised instructions. A mutual fund can be thought of as company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, or other securities.⁴ Unfortunately, the term "mutual fund" is not presently defined for FBAR purposes and thus it is unclear how to apply this term in a hedge fund or investment fund context; presumably an interest in a foreign partnership that holds stocks and securities could be viewed as a comingled fund even if it is not registered as a "registered investment company." Similarly, a foreign corporation whose only asset is a partnership interest in an investment partnership (i.e., a foreign feeder in a master-feeder structure) may also be characterized as a "financial account" for this purpose. Many mutual funds use master-feeder structures to invest through. Alternative investment fund managers and investors may choose to file with respect to foreign fund entities given the lack of clear guidance in this area and the risk of monetary and criminal penalties.

The definition of an account now also includes debit cards and prepaid credit card accounts. Individual bonds, notes, and stocks certificates are not considered financial accounts, nor are unsecured loans to a foreign trade or business that is not a financial institution. Generally, a line of credit, or a promise to provide a loan by itself would not be considered an account, however, caution must be exercised because if combined with the deposit of assets to secure the line of credit, the financial arrangement may be considered an account.

³ For additional guidance on "in and doing business in" see the IRS Headliner, Volume 262, dated February 26, 2009. See <http://www.irs.gov/businesses/small/article/0,,id=204798,00.html>

⁴ As defined by the Securities and Exchange Commission, <http://www.sec.gov/answers/mutfund.htm>

In determining if a financial account will be considered "foreign," the new FBAR instructions place emphasis on the geographical location of the account (i.e., outside the U.S. and its territories) and not the nationality of the financial institution where the account is held. For example, any financial account located outside of the U.S., even if it is held at an affiliate of a U.S. financial institution, is required to be reported. Accounts located in the U.S. with a branch, agency or other office of a foreign financial institution, are specifically not required to be reported under the revised guidelines.⁵

Financial interest

While the definition of a "financial interest" has remained generally the same under the revised FBAR guidelines, the concept of financial interest via indirect ownership through corporations and partnerships has been expanded. In addition to the greater than 50% total share value threshold, a U.S. Person is now considered to have a financial interest in a foreign corporation where the person owns directly or indirectly more than 50% of the voting power of all shares of stock. Financial interest in a partnership now includes instances where a U.S. Person owns more than 50% of the partnership's capital; the previous requirement looked solely to ownership of greater than 50% of the profits, i.e., the distributive share of income.

Signature and other authority

A person is considered to have signature authority over an account if the person can control disposition of the account's assets through delivery of a document containing his signature to the bank or other person with whom the account is maintained. The updated FBAR guidance also clarifies the concept of "other authority over an account" to include U.S. Persons who can exercise power comparable to that of the account's signatory through representatives such as agents, nominees, or attorneys. Where U.S. Persons have only signature authority over an account, the Form must also include the identification of any primary owner that has a financial interest in the account. This could result in the reporting of a foreign corporation or fund that does not otherwise file

⁵ Note that if a bank account is held electronically through the internet, it may be difficult to determine the location of such account; ultimately the location of the bank's records should be determinative regarding location.

in the U.S. and could possibly lead to more scrutiny for such entity.

Filing

Form TD F 90-22.1 is due on or before June 30 of each year for the preceding calendar year, and no extensions are available. The filing is necessary if the aggregate value of all of the U.S. Person's foreign financial accounts exceeds \$10,000 at any time during the calendar year. Once the \$10,000 threshold is met, all of the U.S. Person's foreign financial account relationships during that year are subject to reporting on Form TD F 90-22.1.

A significant change is that filers are now required to provide the maximum value of each account during the calendar year whereas in the past the filer only needed to check a box to reflect a certain range in value of the account balance. The maximum value is the largest amount of currency or non-monetary assets reported at least on a quarterly basis or where no statements are available; it is valued as the largest amount at any point during the year. Foreign currency is translated using the official exchange rate at the end of the year. Any non-monetary assets are fair valued at the end of the year, and if the asset is withdrawn during the year, then the fair value at time of withdrawal should be used.

Consolidated reporting is still available for U.S. Persons that have financial interests in more than 25 accounts. In recently released guidance, the IRS has indicated that persons that have signature or other authority over 25 or more foreign accounts may also file on a consolidated basis.⁶ It should be noted, however, that FBAR filers that prepare the FBAR Form on a consolidated basis must retain the specific account information in their records for 5 years and produce such information if requested by the IRS.

If a non-U.S. individual or entity is deemed to be a U.S. Person for FBAR purposes because he is considered to be "in and doing business in the U.S." and does not have a U.S. taxpayer identification number, certain identifying information must still be provided on the FBAR Form. For individuals, the suggested information is a passport

⁶ Additional guidance on consolidated filing for signature or other authority over was issued in the Headliner Volume 265, dated April 2, 2009. See <http://www.irs.gov/businesses/small/selfemployed/article/0,,id=206219,00.html>

number; for entities, information such as a foreign registration number may be furnished.

Penalties

An individual who has an obligation to file Form TD F 90-22.1 can be assessed a penalty of up to \$10,000 for each violation. However, where there is reasonable cause the penalty may be waived. Each case will be evaluated based on the facts and circumstances.

For willful violations, the penalty is the greater of \$100,000 or 50% of the balance of the account. Criminal penalties may also apply for failure to file Form TD F 90-22.1 and the imposition of criminal penalties does not preclude civil penalties. The current version of the Form does provide an option to file an amended return, which requires the taxpayer to include a statement explaining the changes being made.

The IRS has recently announced an initiative to increase voluntary disclosure of offshore accounts relating to prior years. Reduced penalties are generally available for situations where the failure to file was attributable to reasonable cause. This initiative expires on September 23, 2009.

Application and observations

The application of these new and revised reporting instructions creates significant uncertainties when applied to typical hedge fund and private equity fund structures. If a foreign corporation is formed solely to hold interests in underlying investment partnerships, it is unclear whether this entity should be viewed similar to a mutual fund and thus constitutes a foreign financial account for FBAR purposes. There simply is no further guidance or clarification other than the addition of the term "mutual fund" in the revised instructions which makes it possible that a foreign feeder fund could be viewed in this manner. Similarly, passive foreign investment companies ("PFICs"), controlled foreign corporations ("CFCs") and foreign "blocker" companies may also be viewed as mutual funds.

Additional complexity exists from the addition of the term "in and doing business in the U.S" to the scope of persons required to file a FBAR Form. For example, it is unclear whether a foreign fund that has a U.S investment advisor and keeps its books and records in the U.S. is

deemed to rise to this threshold even though such fund may not be required to file a U.S. tax return and is otherwise trading stocks and securities for its own account. Furthermore, if such foreign fund or a foreign investor also receives income that is effectively connected to the U.S. by either a direct investment or an investment in a U.S. publicly traded or other partnership, this designation is further confused. However, a sustained physical presence appears to be necessary. Also unclear is the application to non-U.S. citizens or residents that may have signature authority over foreign accounts and may periodically visit the U.S. for business. As of this date, the only available guidance seems to indicate that a regular physical presence in the U.S. is required; however, such guidance was not issued from the perspective of investment funds but rather for athletes, entertainers and U.S. real estate owners. Due to the potential penalties, fund managers, their employees,

and their investors should carefully consider filing under all potential scenarios that the IRS could envision until specific guidance is provided.

The chart below outlines investment fund structures and our interpretation of how the FBAR rules may apply to them, based on the guidance that is currently available. Due to significant ambiguities in the current instructions to the Form, it is anticipated that further guidance may be issued by the IRS prior to the June 30th filing deadline; however, given the significant scope of this reporting, it is important that investment fund managers begin to review the revised Form and filing requirements and make any necessary filings by June 30 in order to avoid any potential penalties.

Please consult your PricewaterhouseCoopers tax adviser for further information or guidance.

Entity/Person	Does Entity/Person need to file TD F 90-22.1	Explanation
Domestic Fund	Yes	The domestic fund is a U.S. Person and should report all its foreign financial accounts, if any, in which it has a financial interest.
Limited Partner in Domestic Fund	No (unless >50% profits or capital interest)	The domestic fund itself is not a foreign financial account, but a limited partner in a domestic fund will be attributed ownership in any underlying foreign funds or accounts only if it owns an interest in more than 50% of the profits or capital of the domestic fund.
Foreign Fund	Possibly	While a foreign fund is not a U.S. Person, it is possible that the fund could be deemed to be "in and doing business in the U.S." As a result, it would need to report any foreign financial accounts directly held by the foreign fund.
U.S. Shareholders of a Foreign Fund	Yes	If the foreign fund is considered to be a foreign "financial account," a U.S. shareholder would be required to report its interest in the fund. ⁸ If any U.S. shareholder owns greater than 50% of the vote or value of the foreign fund, that shareholder would also need to report any other foreign accounts owned directly by the foreign fund.

⁸ Note that this could lead to inconsistent filings if, based on the determination above, the foreign fund considers itself "in and doing business in the U.S." and thus files as a U.S. Person. Due to expanded penalties (both criminal and monetary) and lack of clarity in the instructions to the Form, investors may choose to file despite inconsistent positions.

Entity/Person	Does Entity/Person need to file TD F 90-22.1	Explanation
Foreign Master Fund	Possibly	While a foreign master fund is not a U.S. Person, it is possible that the fund could be deemed to be "in and doing business in the U.S."
U.S. General Partner ⁹	Yes	<p>A U.S. general partner is a U.S. Person and should report all of the foreign financial accounts that it owns directly. For example, a U.S. general partner in a foreign mini-master structure would need to report its investment in the underlying foreign master fund.</p> <p>If the U.S. general partner owns an interest in more than 50% of the profits or capital of any lower tier partnership (i.e., a domestic fund or foreign feeder fund) it would also need to report the foreign accounts held directly by that lower tier fund.</p> <p>The general partner would not have signature or other authority over the account because an entity itself cannot have such authority. Note that employees of the general partner may have signatory authority requiring reporting.</p>
U.S. Management Company	Yes	<p>A U.S. management company is a U.S. Person and should report all of the foreign financial accounts that it owns directly. This may occur if the management company has foreign offices and as a result would have non-U.S. accounts attributable to such operations.</p> <p>The management company would not have signature or other authority over the account because an entity itself cannot have such authority. Note that employees of the management company may have signatory authority requiring reporting.</p>
CFO or Principals of Management Company	<p>Yes - U.S. citizens or residents</p> <p>Possibly - Non-U.S. citizens or residents</p>	<p>U.S. citizens or residents are U.S. Persons for purposes of FBAR reporting and as a result, these individuals may likely have signature authority over the foreign financial accounts held by the managed funds or the funds themselves, and/or a financial interest if they own more than 50% of the profits or capital of an underlying fund. Note that consolidated reporting is now available for signature authority over 25 accounts.</p> <p>Unless such individuals are deemed to be "in and doing business in the United States," a term that is not currently defined but seems to indicate a prolonged physical presence in the U.S., such non-U.S. individuals would not be deemed to be U.S. Persons for purposes of signature or other authority over foreign financial accounts.</p>

⁹ The chart contemplates a separate general partner and management company which is typical for alternative investment funds with operations in New York City, although in other U.S. state and local jurisdictions, these entities may operate as a single entity.

