CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

Final Regulations Issued with Respect to FBAR Filing Requirements

February 28, 2011

I. Introduction

On Wednesday, February 23, the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Treasury Department, issued final regulations (the "Final Regulations") describing the individuals and entities that are required to file Form TD F 90-22.1 – Foreign Bank and Financial Accounts Report ("FBAR"), and the foreign financial accounts that they must report.[1] The Final Regulations are substantively identical to the proposed regulations that were issued on February 26, 2010 (the "Proposed Regulations").[2] Most significantly, the Final Regulations continue to reserve on whether equity interests in foreign hedge funds, private equity funds, and other non-mutual company investment funds are treated as financial accounts subject to FBAR reporting.

The Final Regulations apply to foreign financial accounts maintained in 2010 and subsequent years. FBARs for calendar year 2010 are due June 30, 2011. In addition, individuals who elected to defer their pre-2010 FBAR filings pursuant to IRS Notice 2010-23 are permitted (but not required) to apply the Final Regulations in preparing their 2009 FBARs, which are also due on June 30, 2011.[3]

Although the Final Regulations are substantively identical to the Proposed Regulations, they make the following clarifications and modifications:

- The preamble to the Final Regulations clarifies that a financial account is not "foreign" and is not subject to FBAR reporting if it is maintained in the United States, even if the account contains foreign assets. In addition, an investor is not required to file an FBAR with respect to an "omnibus" account that pools assets outside of the United States if the investor can access the account holdings only through a domestic financial institution.

---

1 76 Fed. Reg. 10234 (February 24, 2011).

2 75 Fed. Reg. 8844 (February 26, 2010).

3 IRS Notice 2010-23 allows deferral for individuals holding "signature or other authority" over, but no financial interest in, a foreign financial account. 2010-11 I.R.B. 441 (February 26, 2010).

- The Final Regulations clarify that an individual has "signature or other authority" over a foreign financial account, and therefore must file an FBAR with respect to the account, only if the financial institution where the account is located would act upon a direct communication from the individual (or a direct communication from the individual in conjunction with direct communication from other individuals) regarding disposition of the account assets. Therefore, an individual who does not have a financial interest in a foreign financial account and does not have any direct or other authority over the account, but can participate in decisions relating to the allocation of assets or instruct or supervise other people who do have signature or other authority over the account, does not have signature or other authority over the account, and need not file an FBAR.

- The preamble to the Final Regulations provides that an individual with signature or other authority over an employer's foreign financial accounts, although generally required to file an FBAR, is not required to observe the recordkeeping requirements that apply to other FBAR filers.[4]

- The Final Regulations clarify that a life insurance policy or annuity constitutes a financial account for purposes of the FBAR rules only if it has a cash value. The Proposed Regulations treated all annuities as financial accounts.

- The Final Regulations revise the Proposed Regulations to provide that a person will not be treated as having a financial interest in a foreign financial account held by a foreign trust if the person is a discretionary beneficiary or holds a remainder interest in the trust, unless the person is the trust's grantor and has an ownership interest in the trust.[5]

- The Final Regulations withdraw the rule in the Proposed Regulations that a United States person will be treated as having a financial interest in a foreign financial account held by a foreign trust if the United States person establishes the trust and appoints a "trust protector" (i.e., a person appointed to direct the trustees' administration of the trust) that is subject to the United States person's direct or indirect instruction. According to the preamble to the Final Regulations, FinCEN believes that the anti-

[4] These recordkeeping requirements are discussed below in Part II.

[5] See Part V.

avoidance rule in the regulations prevents the use of a trust protector to evade FBAR reporting obligations.[6]

- The Final Regulations provide that an officer or employee of an entity does not have to file an FBAR if American depository receipts of the entity are listed on a U.S. national securities exchange or the class of equity securities underlying the American depository receipts is registered under section 12(g) of the SEC (i.e., the entity has $10 million of assets and 500 or more shareholders of record) and the officer or employee has signature or other authority over, but no financial interest in, the entity's foreign financial accounts.

The balance of this memorandum describes the FBAR reporting regime under the Final Regulations. Part II provides an overview of the FBAR rules. Part III describes the people and entities required to file FBARs. Part IV describes the accounts that are subject to FBAR reporting. Part V describes the types of financial interests in a foreign financial account that trigger FBAR reporting. Part VI describes the signature or other authority that also triggers FBAR reporting (including the exemptions from filing for certain persons that have signature or other authority over a foreign financial account but no financial interest in the account). Finally, Part VII describes the simplified reporting requirements for United States persons having a financial interest in, or signature or other authority over, 25 or more foreign financial accounts, the consolidated reporting rules, and exemptions from FBAR reporting for participants and beneficiaries of retirement plans and IRAs, and for holders of certain trusts.

II. Overview of the Bank Secrecy Act of 1970

The Bank Secrecy Act of 1970 provides that the Secretary of the Treasury shall require a U.S. resident or citizen, or a person in and doing business in the United States, to keep records and/or file reports when that person makes a transaction or maintains a relation for any person with a foreign financial agency.[7] These requirements were designed to gather information that could be useful in carrying out criminal, tax, or regulatory investigations and to allow enforcement officials to identify and track illicit funds and unreported income in an effort to prevent money laundering, terrorism, and other crimes.[8]

---

[6] The anti-avoidance rule is discussed below in Part V.

[7] 31 U.S.C. section 5314(a).

[8] 31 U.S.C. section 5311; IRS FBAR Workbook, available at http://www.irs.gov/businesses/small/article/0,,id=159757,00.html.

The regulations implementing the Bank Secrecy Act generally require each person subject to the jurisdiction of the United States that has a financial interest in, or signature or other authority over, bank, securities, or other financial accounts in a foreign country to file an FBAR for each calendar year if the aggregate value of the accounts exceeds $10,000.[9] FBARs must be filed on or before June 30 of each calendar year for accounts held in the previous year.[10] FBAR filers must generally maintain a record of (i) the name maintained on each reportable account, (ii) the number or other designation of the account, (iii) the name and address of the foreign bank or other person with whom the account is maintained, (iv) the type of account, and (v) the maximum value of the account during the reporting period, for five years.[11]

Non-willful failure to file an FBAR is subject to a penalty of up to $10,000.[12] Willful failure to file an FBAR is subject to a penalty equal to the greater of $100,000 or 50% of the amount of the transaction or of the balance of the account at the time of the offense.[13] Willful failure to file an FBAR is also potentially subject to criminal penalties of up to $250,000 and five years imprisonment.[14]

III. Persons Required to File an FBAR

Only "United States persons" are required to file FBARs. A United States person includes:

---

[9] 31 C.F.R. 103.24. The preamble to the Final Regulations clarifies that filers may rely on accurate periodic account statements or on bona fide statements prepared in the ordinary course of business for purposes of determining this amount and reporting the maximum value of each foreign financial account during a calendar year. Thus, if a United States person holds a financial account in a foreign financial institution and receives monthly statements that the financial institution provides in the ordinary course of its business, the United States person may report the highest monthly balance on the FBAR.

[10] In order to satisfy the June 30 deadline, the FBAR must actually be received by the Department of Treasury by June 30. (Tax filing deadlines are satisfied if the filing is postmarked by the deadline date.)

[11] 31 U.S.C. section 5311; 31 C.F.R. 103.32; IRS FBAR Workbook, available at http://www.irs.gov/businesses/small/article/0,,id=159757,00.html.

[12] See 31 U.S.C. section 5321(5)(B)(i). The penalty may be waived if the violation was due to reasonable cause and the amount of the transaction or the balance in the account at the time of the transaction was properly reported. 31 U.S.C. section 5321(5)(B)(ii). Reasonable cause is unlikely to exist for most inadvertent failures to file an FBAR.

The penalty may be mitigated if a person meets the following four threshold conditions: (i) the person has no history of past FBAR penalty assessments; (ii) no money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose; (iii) the person cooperated during the examination; and (iv) the IRS did not sustain a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account. See Internal Revenue Manual section 4.26.16.4.6.1. The examiner has discretion in determining reduced penalties, and may determine that the particular facts and circumstances of a case justify only a warning letter. Internal Revenue Manual section 4.26.16.4.4; Internal Revenue Manual exhibit 4.26.16-2.

[13] 31 U.S.C. section 5321(5)(C).

[14] 31 U.S.C. section 5322(A).

- A citizen of the United States.

- A resident alien of the United States for U.S. federal income tax purposes, except that the term "United States" includes any state, the District of Columbia, the territories and insular possessions of the United States, and Indian tribe lands.

  Thus, an individual who is not a citizen of the United States, and lives full-time in Puerto Rico, is a United States person for FBAR purposes, even though the person is not a United States person for U.S. federal income tax purposes.

- Any entity created, organized, or formed under the laws of the United States, any state, the District of Columbia, any territory or insular possession of the United States, or an Indian tribe.

  Thus, domestic corporations, trusts, partnerships, and limited liability companies are required to file FBARs.[15] For example, a domestic LLC with a single foreign owner and a financial interest in a foreign financial account would be required to file an FBAR, even though the foreign person would not be required to file an FBAR if it held an interest in the foreign financial account directly. Moreover, if a U.S. citizen wholly owns a single-member domestic LLC that, in turn, holds an interest in a foreign financial account, both the LLC and its owner must file separate FBARs.

Because the definition of "United States person" under the FBAR rules depends on where an entity is created, organized, or formed, and not where it conducts business, a foreign entity would not be required to file an FBAR, even if the foreign entity operates through a branch or other permanent establishment in the United States, even if the foreign entity is a "flow through" for U.S. tax purposes, and even if the foreign entity is entirely owned by United States persons.[16]

---

[15] It may be difficult to tell whether a trust is organized under the laws of a state. For example, assume that two foreign persons with no connection to the United States enter into a trust agreement and provide that the trust agreement is governed under Delaware law. Assume further that they appoint a foreign trustee and all of the trust assets are outside of the United States. It is entirely unclear whether the trust is a United States person for purposes of the FBAR rules. (The trust would not be a United States person for U.S. federal income tax purposes. See section 7701(a)(30)(E) of the Internal Revenue Code.)

[16] Moreover, a United States person who owns an interest in the entity will not generally be deemed to have a financial interest in any foreign financial account owned by the foreign entity and will not be required to file FBARs with respect to foreign financial accounts unless the United States person owns (i) more than 50% of the voting power or total value of the entity (if the entity is a corporation) or more than 50% of an interest in the profits or capital of the entity (if the entity is a partnership), or (ii) under an anti-avoidance rule, the entity was "created for a purpose of evading the reporting requirement."

Domestic tax-qualified plans and IRAs subject to ERISA, domestic tax-exempt colleges and universities (and their endowments), and domestic section 501(c)(3) public charities and private foundations are all subject to the FBAR reporting requirements. Moreover, as discussed below in Part VI, the employees of these entities with signature authority over their foreign financial accounts are also required to file FBARs with respect to those accounts.

IV. Reportable Accounts

A foreign financial account subject to FBAR reporting includes any "bank account," "securities account," or "other financial account" that is located in a foreign country (which includes all geographical areas located outside of the United States, its territories and possessions). For purposes of the FBAR rules:

- A "bank account" subject to FBAR reporting includes any demand, checking, deposit, time deposit, or any other account maintained with a financial institution or other person engaged in the business of a financial institution that is physically located in a foreign country.[17]

  An account maintained with the foreign branch of a U.S. bank is a foreign financial account. An account maintained with a U.S. branch of a foreign bank is not a foreign financial account.[18]

- A "securities account" subject to FBAR reporting includes any account with a person engaged in the business of buying, selling, holding or trading stock or other securities that is physically located in a foreign country.[19] This definition is intended to include a brokerage account and, presumably, a managed account, but is not intended to include an equity interest in a hedge fund or private equity fund.[20]

- "Other financial accounts" subject to FBAR reporting include:

The current FBAR instructions treat "any person in and doing business in the United States" as a United States person. We expect the draft instructions that were published with the Proposed Regulations (available at http://www.irs.gov/pub/irs-utl/draft_fbar_instructions.pdf), which did not include this provision, to replace the current instructions.

[17] 31 C.F.R. 103.24(c)(1).

[18] See draft FBAR instructions, available at http://www.irs.gov/pub/irs-utl/draft_fbar_instructions.pdf.

[19] 31 C.F.R. 103.24(c)(2).

[20] As discussed below, the Final Regulations reserve on the treatment of an equity interest in a foreign hedge fund or private equity fund.

- An account physically located in a foreign country with a person that is in the business of accepting deposits as a "financial agency."[21]

- An insurance or annuity policy with a cash value.

  It is unclear when an insurance policy or annuity is deemed to exist in a foreign country. For example, is the location of the policy determined by the jurisdiction in which the insurance company is organized, the branch out of which the policy is issued, the place where the policy is held, or the location of the owner?

- An account with a person that acts as a broker or dealer for futures or options transaction in any commodity on or subject to the rules of a commodity exchange or association.

- A mutual fund or similar pooled fund that issues shares available to the general public, has a regular net asset value determination, and has a regular redemption feature.

  The preamble to the Final Regulations explicitly provides that a "mutual fund" includes only funds whose shares are available to the general public and that, as a result, this category of financial accounts does not include hedge funds or private equity funds.

The Final Regulations continue to reserve on the treatment of foreign hedge funds, venture capital funds, and private equity funds. The preamble to the Proposed Regulations expressed concern about the potential use of these types of funds to evade taxes, but referred to pending legislative proposals that would apply additional regulation and oversight over these types of investment funds.[22] The Final Regulations do not refer to any pending legislative proposal or indicate when the issue will be resolved.

---

[21] The preamble to the Proposed Regulations explains that the term "financial agency" is intended, in this context, to cover accounts in other countries that are similar to bank accounts but may have a different label or operate under a different legal framework.

[22] After the Proposed Regulations were published, the Hiring Incentives to Restore Employment Act (P.L. 111-147) (March 18, 2010) established the "FATCA" foreign reporting and withholding regime, pursuant to which, beginning in 2013, certain "foreign financial institutions," including foreign hedge funds and private equity funds, will be required to enter into an agreement with the Treasury Department to report certain information with respect to any U.S. "account holders" to the IRS or else be subject to a 30% withholding tax on certain U.S.-source income. For a detailed discussion of the FATCA regime

The current FBAR instructions exclude from the definition of foreign financial account individual bonds, notes, stock certificates, and unsecured loans to a foreign trade or business that is not a financial institution. The Final Regulations do not include this exception. We do not believe that FinCEN intended to treat equity interests in entities other than mutual funds as financial accounts and we do not believe that FinCEN intended to treat notes, bonds, and other indebtedness as financial accounts, unless the indebtedness qualifies as a bank account or securities account. However, the deletion of the exception for individual bonds, notes, bank certificates, and unsecured loans raises questions.

The following accounts are excluded from the definition of "financial account":

- An account of a U.S. agency or department, an Indian tribe, or any state or political subdivision of a state (or a wholly-owned entity, agency, or instrumentality of any of these).
- An account of an entity established under the laws of the United States, an Indian tribe, or any state or political subdivision of a state (or any intergovernmental compact between two or more states or Indian tribes) that exercises the power to tax, the power of eminent domain, or police powers on behalf of the United States, an Indian tribe, or any state or political subdivision of a state.
- An account of an international financial institution of which the U.S. government is a member.
- An account of a "United States military banking facility" designed to serve U.S. governmental installations abroad.
- Correspondent (or "nostro") accounts used solely for bank-to-bank settlements.

V. Financial Interest

United States persons are required to file an FBAR if they have a "financial interest" in a foreign financial account. A United States person has a financial interest in a foreign financial account under the FBAR rules if:

---

please see our Clients & Friends Memo, "IRS Notice 2010-60: Preliminary Guidance on the 'FATCA' Reporting and Withholding Rules," available at http://www.cadwalader.com/assets/client_friend/090710_IRSNotice2010-60_.pdf.

- The United States person is the owner of record or has legal title to the account (whether the account is maintained for its own benefit or for the benefit of others).
- The owner of record or holder of legal title is acting as agent, nominee, attorney, or in another capacity on behalf of the United States person.
- A corporation is the owner of record or holder of legal title, and the United States person owns (directly or indirectly) more than 50% of the corporation's vote or value.
- A partnership is the owner of record or holder of legal title, and the United States person owns (directly or indirectly) more than 50% of the interest in profits or capital of the partnership.
- A trust is the owner of record or holder of legal title, and a United States person (i) is the trust's grantor and has an ownership interest in the trust for U.S. federal income tax purposes, or (ii) either (A) has a present beneficial interest in more than 50% of the trust's assets or (B) receives more than 50% of the trust's current income.

A United States person is required to file an FBAR with respect to the foreign financial account of an entity only if the entity is the owner of record or holder of legal title. Thus, if a United States person wholly owns a foreign corporation, and a third party is the record holder of and holds legal title to a foreign financial account as the corporation's agent, the Final Regulations would not require the United States person to file an FBAR with respect to that foreign financial account.[23]

The Final Regulations retain an anti-avoidance rule from the Proposed Regulations that provides that a United States person that causes an entity to be created for a purpose of evading the reporting requirement is deemed to have a financial interest in any bank, securities, or other financial account in a foreign country for which the entity is the owner of record or holder of legal title. However, the anti-avoidance rule applies only to an entity that was "created" for a purpose of evading the FBAR rules, and only if the entity is the owner of record or holder of legal title. The anti-avoidance rule does not appear to apply to pre-existing entities that are used for abusive purposes and does not apply if an entity is the beneficial owner of a foreign financial account that is held in the name of another person.

[23] The anti-avoidance rule would not apply under these facts.

VI. Signature or Other Authority

Any United States person with signature or other authority over a foreign financial account is generally required to file an FBAR with respect to that account. Under the FBAR rules, an individual is deemed to have signature or other authority over a foreign financial account if the individual can control the disposition of money or other property in the account by direct communication (whether in writing or otherwise, and whether alone or with the consent of other individuals) to the person with whom the account is maintained.[24]

Officers and employees who have signature or other authority over, but no financial interest in, an entity's foreign financial accounts are not required to file an FBAR with respect to the accounts if the entity is:

- A bank examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the Office of Thrift Supervision, or the National Credit Union Administration.
- A financial institution registered with and examined by the Securities Exchange Commission (the "SEC") or the Commodities Futures Trading Commission.
- An entity registered with and examined by the SEC that provides services with respect to the account to an investment company registered under the Investment Company Act of 1940 (i.e., the entity is an investment advisor to a mutual fund that owns the account).
- An entity with a class of equity securities or American depository receipts listed on a U.S. national securities exchange, or a U.S. subsidiary named in a consolidated FBAR report of a parent entity that has a class of equity securities listed on a U.S. national securities exchange.
- A U. S. entity that has a class of equity securities, or foreign entity with American depository receipts in respect of equity securities, registered under section 12(g) of the Securities Exchange Act (i.e., the entity has $10 million of assets and 500 or more shareholders of record).

[24] The preamble to the Final Regulations clarifies that the definition of "signature or other authority" applies only with respect to individuals.

However, no exception is provided for employees of privately held investment fund managers that are not registered with the SEC, U.S. employees of foreign banks and funds, or employees of tax-exempt entities that do not otherwise fall under one of the above exceptions.

VII. Special Rules

A United States person that has a financial interest in 25 or more foreign financial accounts may file an FBAR form that indicates only the number of financial accounts and certain other basic information on the FBAR report, if the United States person agrees to provide detailed information regarding each account to the IRS upon request. In addition, an entity that is a United States person and owns (directly or indirectly) more than a 50% interest in an entity that is required to file an FBAR may file a consolidated report on behalf of itself and the other entity.[25]

Participants and beneficiaries in retirement plans under sections 401(a), 403(a), or 403(b) of the Internal Revenue Code, as well as owners and beneficiaries of IRAs under section 408 or Roth IRAs under section 408A of the Internal Revenue Code, are not required to file an FBAR with respect to a foreign financial account held by or on behalf of the retirement plan or IRA. (However, the retirement plan/IRA itself must file an FBAR.)

Finally, a United States person that either has a present beneficial interest in more than 50% of a trust's assets or receives more than 50% of a trust's current income, and would be required to file an FBAR, is not required to report the trust's foreign financial accounts if the trust, a trustee of the trust, or agent of the trust is a United States person that files an FBAR disclosing the trust's foreign financial accounts.

* * * *

If you have any questions regarding this memorandum or the FBAR rules, please contact any member of the Cadwalader Tax Department.

[25] The preamble to the Final Regulations indicates that one commentator urged the introduction of analogous rules for funds organized by the same fund manager, and suggests that this issue may be addressed in the form of specific guidance.