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Clients&FriendsMemo

Proposed Regulations Issued With Respect to FBAR Filing Requirements

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I. Introduction

On Thursday, February 25, the Financial Crimes Network (FinCEN), a bureau of the Treasury Department, published proposed regulations describing which individuals and entities are required to file Form TD F 90-22.1, the "Foreign Bank and Financial Accounts Report" (or "FBAR"), and the foreign financial accounts that are required to be reported on the FBAR. On Thursday, FinCEN also issued two notices that provide that (i) non-United States persons (i.e., persons that are not United States citizens, United States residents, or domestic entities) are not required to file an FBAR for 2009 and earlier calendar years (even if they are treated as a "United States person" in the 2008 FBAR instructions),[1] (ii) United States persons with signature authority over, but no financial interest in, a foreign financial account for which an FBAR would otherwise have been due on June 30, 2010 are not required to file FBARs with respect to 2009 and 2010 until June 30, 2011,[2] and (iii) the IRS will not enforce FBAR reporting requirements against individuals and entities that have financial interests in, or signature authority over, a foreign hedge fund, foreign private equity fund, or other "foreign commingled fund" (other than a foreign mutual fund) with respect to 2009 and prior years.[3]

II. Summary

The proposed regulations are disappointing. First, FinCEN ignored the requests of practitioners and industry groups to streamline and modernize the filing procedures. Therefore, if the proposed regulations are finalized as proposed, the FBAR filing requirements will be extraordinarily broad and burdensome. Under the proposed regulations, tens of thousands of duplicative FBARs will be required to be filed, and they will be required to be filed in paper (rather than electronic) form.

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1 Announcement 2010-16 (Feb. 26, 2010).

2 Notice 2010-23 (Feb. 26, 2010).

3 Notice 2010-23 (Feb. 26, 2010).

Second, the proposed regulations would expand the scope of FBAR reporting to require FBARs with respect to foreign annuities and foreign insurance contracts with cash surrender values, and would require FBARs to be filed in many counterintuitive and common situations, including, apparently, with respect to (i) accounts with Euroclear and Clearstream, (ii) interests in foreign financial accounts held through domestic financial institutions, (iii) derivatives with foreign financial institutions, and (iv) compensation arrangements with foreign entities. As a result of the extraordinary breadth of the FBAR reporting requirements, both sophisticated and unsophisticated individuals and entities will inadvertently fail to file the form. This is especially troubling because the penalty for inadvertent failures to file is as much as $10,000,[4] even mitigated penalties may be as high as $5,000,[5] and there is no extension of time to file an FBAR.

Third, FinCEN rejected recommendations to exempt pension plans and IRAs subject to ERISA, and universities (and their endowments) and other section 501(c)(3) organizations from the FBAR filing requirements. Therefore, all of these entities will continue to be required to file FBARs.

The only meaningful concessions in the proposed regulations are that:

- Foreign entities and nonresident individuals are not required to file an FBAR, even if they are in and doing business in the United States.
- Individuals who hold only signatory authority over (but no other interest in) a foreign account and are employed by certain regulated banks, U.S. broker-dealers, publicly-traded U.S. corporations (and certain of their subsidiaries), certain mutual fund service companies, and "section 12(g)" filers (i.e., companies with more than 500 shareholders of record and $10 million or more in assets) are exempt from filing FBARs.
- Beneficiaries of pension plans and IRAs are not required to file FBARs with respect to their plans or IRAs (although the plan or IRA is required to file an FBAR with respect to any foreign financial account in which it holds a financial interest).
- United States persons that are beneficiaries of trusts are not deemed to have a financial interest in a foreign financial account that is held in the name of the trust unless:
    - The trust is a grantor trust and the United States person is treated as the owner.

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[4] 31 U.S.C. section 5321(a)(5).

All references to section numbers are to sections of Title 31 of the United States Code and relate to the Bank Secrecy Act, the regulations promulgated or proposed thereunder, the Internal Revenue Manual or, where the context indicates, the Internal Revenue Code of 1986, as amended.

[5] I.R.M. section 4.26.16.4.6.2.

- The United States person has either a beneficial interest in more than 50% of the assets or receives more than 50% of the current income.
- The trust was established by the United States person, and the United States retains control over the trust's protector.

Employees of tax-exempt entities and most privately-held hedge fund investment advisors are not, however, included in these exemptions and, therefore, under the proposed regulations, if these employees have signatory authority over a foreign financial account, they would be required to file FBARs with respect to each such foreign financial account (even if they have no financial interest in the account).

III. Overview of the Bank Secrecy Act of 1970

The Bank Secrecy Act of 1970 (codified in section 5314(a) of Title 31 of the United States Code) provides that the Secretary of the Treasury shall require a United States 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.[6] 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.[7]

The existing 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 account in a foreign country to file an FBAR for each calendar year if the aggregate value of the accounts exceeds $10,000. FBARs must be filed on or before June 30 of each calendar year for accounts held in the previous year. [8]

Non-willful failure to file an FBAR is subject to a penalty of up to $10,000.[9] A 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

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

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

[8] In order to satisfy the June 30 deadline, the FBAR must actually be received by the Department of Treasury by June 30, unlike tax filing deadlines which are satisfied if the filing is postmarked by the deadline date.

[9] 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

transaction or of the balance of the account at the time of the offense.[10] Willful failure to file an FBAR is also potentially subject to criminal penalties of up to $250,000 and five years imprisonment.[11]

Part IV of this memorandum describes the persons and entities required to file FBARs. Part V describes the accounts that are subject to FBAR reporting. Part VI describes the types of "financial interests" in a foreign financial account that trigger FBAR reporting. Part VII 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 VIII describes the simplified reporting requirements for United States persons having a financial interest in or signatory 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.

IV. Persons Required to File an FBAR

Until 2008, the FBAR instructions defined a "United States person" subject to the FBAR reporting obligations to mean (1) a citizen or resident of the United States, (2) a domestic partnership, (3) a domestic corporation, or (4) a domestic estate or trust.

The proposed regulations generally follow this pre-2008 definition of "United States person." Under the proposed regulations, a "United States person" that is potentially required to file an FBAR includes:

- A citizen of the United States.
- A resident alien of the United States for federal income tax purposes. However, for this purpose, the "United States" includes any State and the District of Columbia, and (under the proposed regulations) the territories and insular possessions of the United States, and Indian tribes. Thus, an individual who is not a citizen of the United States, but 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.

report income related to any amount in a foreign account. See I.R.M. 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. I.R.M. section 4.26.16.4.4; I.R.M. Exhibit 4.26.16-2.

[10] 31 U.S.C. section 5321(5)(C).

[11] 31 U.S.C. section 5322(A).

- Any entity created, organized, or formed under the laws of the United States, any State, the District of Columbia, and (under the proposed regulations) the territories and insular possessions of the United States, and Indian tribes.

  Thus, domestic corporations, trusts, partnerships, and limited liability companies are required to file FBARs.[12] Under the proposed regulations, single-member domestic LLCs are expressly treated as United States persons for the purpose of FBAR filing. Thus, 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, under the proposed regulations, if a United States 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.

In October 2008, the FBAR instructions were revised to include in the definition of a "United States person" "any person in and doing business in the United States."[13] As a result of this revision, foreign entities that were doing business in the United States through a branch were required to file an FBAR, even if the branch was not incorporated in the United States.

The proposed regulations reverse the October 2008 revision. Accordingly, under the proposed regulations, a foreign entity would not be required to file FBARs, 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. This complete exemption for foreign entities is surprising.[14]

Under the proposed regulations (as under the existing rules), 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 VII, the employees of these entities

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[12] 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.)

[13] 2008 FBAR Instructions. This revision conformed the FBAR instructions to the specific language in the Bank Secrecy Act. See 31 U.S.C. 5321(a).

[14] Moreover, under the proposed regulations, 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 (for a corporation) or more than 50% of an interest in the profits or capital of the entity (for a partnership), or (ii) under an anti-abuse rule, the entity was "created for a purpose of evading the reporting requirement" (which purpose presumably cannot exist for any entity that already existed when the proposed regulations were issued).

with signature authority over the foreign financial accounts will also be required to file FBARs with respect to those accounts.

V. Reportable Accounts

Under the proposed regulations, 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.[15]

  An account maintained with the foreign branch of a United States bank is a foreign financial account. An account maintained with a United States branch of a foreign bank is not a foreign financial account.[16]

- 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.[17] 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.[18]

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

  - An account physically located in a foreign country with a person that is in the business of accepting deposits as a "financial agency".[19]

  - An insurance policy with a cash value or an annuity policy.

    The addition of insurance policies with cash value, and annuity policies, is new. The preamble for the proposed regulations expresses concern that life

[15] 31 CFR 103.24(c)(1).

[16] See proposed FBAR instructions.

[17] 31 CFR 103.24(c)(2).

[18] As discussed below, the treatment of an equity interest in foreign hedge funds and foreign private equity funds is reserved.

[19] Financial agency is not defined. The preamble, however, explains that the term "financial agency" is intended to cover accounts in other countries that are substantially similar to bank accounts but may have a different label or operate under a different legal framework.

insurance policies with a cash surrender value are potential money laundering vehicles because the cash value may be redeemed; similarly, the preamble expresses concern that annuity contracts pose a similar money laundering risk because they potentially allow the exchange of illicit funds for immediate or deferred income streams, or the purchase of deferred annuities and receipt of clean funds upon redemption.

However, it is unclear under the proposed regulations 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 was issued, the location 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.

  This category of "financial account" was included in the pre-2008 definition of "financial account," but was not included in the definition of "financial account" when the FBAR instructions were revised in 2008.

- A mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions.

As mentioned above, in prior (informal) guidance, the IRS had taken the position that foreign hedge funds and foreign private equity funds are foreign financial accounts. The proposed regulations reserve on the treatment of foreign hedge funds and private equity funds. The preamble expresses concern about the lack of regulation and the potential to use these types of funds to evade taxes. However, the preamble also refers to pending legislative proposals that would apply additional regulation and oversight over these types of investment funds.[20]

The instructions to the existing FBAR 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 proposed regulations do not include this exception. We do not believe that FinCEN intended to treat equity interests in entities other than mutual funds as a financial account and we do not believe that FinCEN intended to treat notes, bonds, and other indebtedness as a financial account, unless the indebtedness qualifies as a bank account or

[20] The preamble may be referring to the Tax Extenders Act of 2009 (discussed here) which, if enacted, would impose withholding on certain foreign financial entities, possibly including foreign hedge funds and private equity funds, unless the foreign entity provides information reporting with respect to its U.S. holders.

securities account. However, the deletion of the exception for individual bonds, notes, bank certificates, and unsecured loans raises questions.

The proposed regulations would exclude from the definition of "financial account": (i) an account of a United States 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) and (ii) an account of an international financial institution of which the United States is a member. These two exclusions were added by the proposed regulations.

VI. Financial Interest

Under the existing regulations, 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 existing rules if:

- The United States person is the owner of record or has legal title over 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 record owner or holder of legal title and the United States person owns directly or indirectly more than 50% of the vote or value of the corporation.
- A partnership is the record owner 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.
- The owner of record or legal title is a trust and a United States person has, directly or indirectly, either a beneficial interest in more than 50% of a trust's assets or receives more than 50% of the trust's current income.[21]

The proposed regulations add two more categories:

- The owner of record or holder of legal title is a grantor trust and the United States person is treated as an owner of the trust for federal income tax purposes.

[21] The proposed regulations do not indicate when a contingent beneficiary is considered to have a beneficial interest in more than 50% of the assets of a trust.

The proposed regulations provide that beneficial owners of these trusts need not file an FBAR with respect to a trust account if the trust, trustee of the trust, or agent of the trust is a United States person that files an FBAR with respect to that account.

- The owner of record or holder of legal title is a trust, the trust was established by the United States person, and the United States person has appointed a "trust protector" that is subject to the United States person's direct or indirect instruction.

The proposed regulations require a United States person to file an FBAR with respect to the foreign financial account of an entity only if the entity is the record holder or holder of legal title. Thus, if a United States person owns a foreign corporation and a third party is the record holder of, and holds legal title to, a foreign financial account as agent of the foreign corporation, the proposed regulations as drafted do not require the United States person to file an FBAR with respect to that foreign financial account.[22] We expect this oversight to be corrected in the final regulations.

Finally, the proposed regulations include an anti-abuse rule 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-abuse 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-abuse rule does not appear to apply to pre-existing entities that are used for abusive purposes and does not apply if the entity is the beneficial owner of a foreign financial account that is held in the name of another person. We expect that these oversights will be corrected.

VII. Signature or Other Authority

Under the Bank Secrecy Act, 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 proposed regulations, a person is deemed to have signature or other authority over a foreign financial account if the person can control the disposition of money or other property in the account by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the person with whom the account is maintained.

Under the current FBAR rules, there are three limited exceptions from the filing requirements for persons who have only signature authority over a foreign financial account (but no financial interest in the account): for officers and employees of banks currently examined by federal bank agencies, for officers and employees of U.S. corporations that are publicly traded, and for officers and employees of companies with $10 million in assets and at least 500 shareholders of record.

The proposed regulations helpfully expand and clarify these exceptions. Under the proposed regulations, officers and employees who have signatory authority, but no financial interest, in a

[22] As discussed below, the anti-abuse rule would not apply under these facts.

foreign financial account and are officers or employees of the following institutions are not required to file FBARs:

- A bank that is 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 (the "CFTC").
- An entity registered with and examined by the SEC that provides services to an investment company registered under the Investment Company Act of 1940 with respect to an account owned or maintained by the investment company.
- An entity with a class of equity securities listed on any United States national securities exchange, or a United States subsidiary of such an entity that is named in a consolidated FBAR report of the parent.
- A United States corporation that has a class of equity securities registered under section 12(g) of the SEC (i.e., $10 million of assets and 500 or more shareholders of record).

However, the proposed regulations do not to provide any exception 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.

VIII. Special Rules

Under the existing 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 it agrees to provide detailed information regarding each account to the IRS upon request. The proposed regulations retain this rule.

In addition, the proposed regulations permit 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 to file a consolidated report on behalf of itself and the other entity.

The proposed regulations also provide that 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 individual retirement accounts under section 408 of the Internal Revenue Code or

Roth IRAs under section 408A of the Internal Revenue Code will not be 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 beneficiary of a trust that would be required to file an FBAR by reason of having either a beneficial interest in more than 50% of the trust assets or receiving more than 50% of the trust's income 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 regarding that account and provides any additional information required by the IRS.

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