SIMPSON THACHER

MEMORANDUM

The Controversy Over FBAR Reporting

June 24, 2009

31 U.S.C. §5314, which is part of the Bank Secrecy Act, was enacted in 1970 to address the use by U.S. persons of bank accounts in bank secrecy jurisdictions. Pursuant to this statute, the IRS has for many years required U.S. persons to file reports regarding their foreign financial accounts on form TD F 90-22.1, which is commonly referred to as the "FBAR".

Until recently, it had never been supposed that the FBAR required reporting of investments in hedge funds or private equity funds that are organized under foreign law. However, in October 2008, the IRS added the parenthetical "(including mutual funds)" to the definition of "financial account", which now provides, in pertinent part: "This term includes any bank, securities, securities derivatives or other financial instruments accounts. Such accounts generally also encompass 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)." Also, a March 2009 IRS FAQ states that the term "foreign financial account" includes an interest in a "mutual fund" or a "unit trust" (which, like mutual funds, are redeemable on demand from the issuer) and, in a June 12, 2009 teleconference, IRS panelists stated that the term financial account includes interests in hedge funds that function like mutual funds. These developments have resulted in widespread speculation that all interests in foreign hedge funds and perhaps even in foreign private equity funds are subject to FBAR reporting.

The Treasury Department has the authority to apply the various BSA requirements to all types of financial institutions (including investment companies), but in practice it has carefully tailored the application of the requirements to specific categories of financial institutions. The Treasury Department has generally subjected "mutual funds" (defined by cross reference to the definition of "open-end company" in the Investment Company Act) to BSA regulations, including the requirement to establish anti-money laundering and customer identification programs and to report suspicious transactions; however, it has not subjected hedge funds and private equity funds to these requirements. The rationale for the distinction is that mutual funds are required to provide shareholders the right to redeem shares on a daily basis and money launderers are "more likely to use mutual fund accounts in the layering and integration stages of money laundering." A Treasury Department proposal (later withdrawn) to require "unregistered investment companies" to adopt anti-money laundering programs would have applied only to unregistered investment companies that give the investor the right to redeem any portion of its ownership interest within two years after that ownership interest was purchased—again, because companies that offer interests that are redeemable only after a lengthy holding period lack the liquidity that makes certain financial institutions attractive to money launderers.

The FBAR reporting requirement stems from the BSA and there appears to be no reason why the distinctions made among types of investment companies elsewhere in BSA regulations should not continue to apply to FBAR reporting. The recent changes to the FBAR instructions and IRS comments regarding those changes are in fact consistent with those distinctions. In particular, the addition of the references to "mutual funds" in the FBAR instructions and FAQ is consistent with the fact that mutual funds are generally covered under other BSA regulations.

Private equity funds do not function like mutual funds in that they are "closed-ended" and thus provide no means for liquidity from the issuer. Therefore, we see no basis in the recent FBAR report changes or IRS staff comments relating to them for concluding that private equity funds are subject to FBAR reporting. The case of hedge funds is more difficult. IRS officials apparently have stated that hedge funds—or at least those that function like mutual funds—are subject to FBAR reporting. It would not be unreasonable for the IRS to view hedge funds that function like mutual funds, in that they are readily redeemable, as subject to FBAR reporting. Therefore, absent sufficiently distinguished features of a particular hedge fund (e.g., an extended lock-up period applicable to withdrawals), we would recommend that investors in offshore hedge funds make the FBAR filing.

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