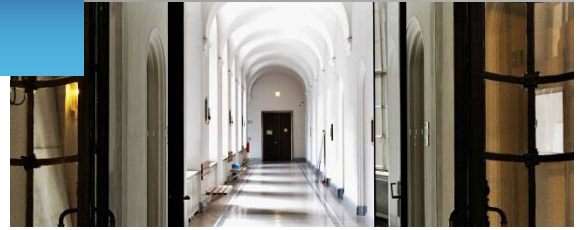


## Foreign Account Tax Compliance Act Challenges for Investors

On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment ("HIRE") Act. The HIRE Act was designed to provide various incentives to businesses to hire unemployed workers. In order to fund these incentives, the HIRE Act contained a number of revenue raising provisions, one of which is referred to as the Foreign Account Tax Compliance Act ("FATCA"). The intention of FATCA is to prevent U.S. taxpayers from avoiding the payment of U.S. income taxes by hiding money offshore. The FATCA provisions are scheduled to become effective on January 1, 2013.

Currently, there is no express tax law requirement for foreign financial intermediaries like banks and funds to disclose U.S. ownership of an account to the U.S. government (the "IRS"). FATCA changes that by requiring these institutions to enter into agreements with the IRS promising to disclose account information with respect to U.S. persons. If these institutions fail to comply, FATCA requires a 30% withholding tax on certain income and gross proceeds payments (a "withholdable payment") made to them. Additionally, FATCA imposes requirements on account holders in financial intermediaries. If the account holders do not comply, they will also be subject to this 30% withholding tax. FATCA's impact can therefore be both indirect, via a non-compliant financial intermediary, or direct, in the case of an account holder's non-compliance.

As background, a 30% U.S. withholding tax is already imposed upon certain types of U.S. income such as dividends and interest, but not upon gross proceeds from selling securities. **The 'big stick' of FATCA is the inclusion of gross proceeds in the definition of amounts subject to U.S. 30% tax withholding.** As an example, if a French bank fails to enter into an agreement with the IRS and report the required information but still wants to invest in U.S. securities, it will lose 30% of the gross proceeds when those U.S. assets are sold.



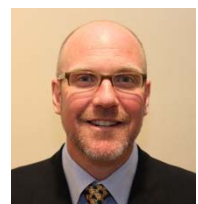
*Barbara Novick, Vice Chairman, is head of Government Relations and Public Policy*



*Harris Horowitz, Managing Director, is head of Global Tax and Public Policy*



*Roger Exwood, Director, is head of EMEA Product Tax*



*Rich Simpson, Director, Custody Tax*

### Key Investor Issues (subject to further guidance)

1. **Discourages foreign investment in U.S. capital markets.**  
Detrimental to the U.S. because foreign investment is necessary to finance the deficit and to support housing and other sectors of our economy.
2. **Harms innovative, yet transparent, products by diminishing their utility to foreign investors.**  
Encourages use of opaque derivatives.
3. **Creates barriers and expenses that outweigh potential benefits.**  
Costs of compliance by the private sector and costs of monitoring by the IRS will total millions of dollars.
4. **Mandates that foreign investors become clients of only qualifying foreign financial services enterprises.**  
Reduces investor choice and serves to consolidate providers thereby reducing competition.

## What Do We Know Today?

FATCA is so broad, encompassing and complex that it required the addition of an entirely new chapter (Chapter 4) to the U.S. Tax Code. Because of FATCA's scope, it is anticipated that the IRS will need to administer hundreds of thousands of agreements with financial intermediaries. For example, non-U.S.-domiciled funds may have thousands of distributors all of whom will need to enter into agreements with the IRS to avoid withholding. The statutory language of FATCA provides Treasury and the IRS broad authority to draft implementing regulations. For example, they have the power to completely exempt entities or payments from FATCA if there is a low risk of tax evasion. One of the challenges for Treasury and the IRS is to strike an appropriate balance in determining exactly which type of entities can be excluded from FATCA in order to create an administrable system while achieving the intent of the law.

Unfortunately, one year after its passage, no clarifying regulations have been issued. Instead, the IRS has issued two Notices, 2010-46 and 2011-34 (the "Notices"), that provide some insight on the direction that the regulations may take. We believe that some elements of the Notices indicate that the IRS is appropriately focusing on perceived higher risk arrangements, while beginning to consider more fully the consequences for investment funds.

### Effective date:

Applies to withholdable payments made or received on or after January 1, 2013.

### Who must comply or be subject to 30% Chapter 4 U.S. tax withholding?

FATCA is focused on two classes of non-U.S. entities, Foreign Financial Institutions ("FFI") and Non-Financial Foreign Entities ("NFFE"). An FFI is defined to include banks, entities that hold financial assets for the account of others like brokers, and investment funds.

An NFFE, on the other hand, is any other non-U.S. entity that may create an opportunity for U.S. residents to hide assets. In the NFFE context, the IRS is looking for substantial (defined as 10% or more) U.S. owners. Excluded from the NFFE definition are publicly-traded corporations, entities organized under the laws of a U.S. possession and wholly owned by a resident of such possession, foreign governments, international organizations, and any foreign central bank.

### Certain U.S. persons excluded from FFI / NFFE reporting:

Certain U.S. persons are considered to pose low or no risk of engaging in tax evasion. Thus, FATCA excludes FFIs and NFFEs from disclosing information on accounts that belong to corporations whose shares are publicly listed, U.S. tax-exempt entities (pensions, charities, educational institutions), the U.S. government, states and other political subdivisions, banks, REITs, mutual funds, and common trust funds.

### Main types of U.S. income and other payments considered to be a withholdable payment and, absent FATCA compliance, subject to 30% Chapter 4 U.S. tax withholding:

Interest, dividends, rents, salaries, wages, premiums, annuities, gross proceeds realized on the sale of U.S. debt or equity securities, and any other income from a source within the U.S.

"Passthru" payments are also subject to 30% Chapter 4 withholding. The intent of the passthru payment concept is to impose withholding on payments that are not directly attributable to a withholdable payment as well as to capture multiple intermediaries leading to the end account holder. For example, a portion of the proceeds received upon a non-compliant account holder's redemption in shares of an Irish fund will constitute a passthru payment subject to U.S. tax withholding if the fund invests in U.S. assets.

### Exemption from FFI status:

The Notices indicate that a very limited number of non-financial entities will not be required to enter into agreements with the IRS, including holding companies, start-up companies, liquidating companies, financial entities emerging from a reorganization or bankruptcy, hedging / financing centers within corporate groups, and insurance companies that do not issue cash value life insurance or annuities.

### Private Banking Relationships:

Enhanced due diligence and documentation procedures will be required for private banking accounts. The intent here is clear. Based on prior publicity, there is the perception that high net worth individuals, the key target of FATCA, are more likely to utilize private banking services.

### Deemed Compliant FFI Status:

The statute allows for designation of low-risk FFI entities as being "deemed compliant." Deemed compliant FFIs may either be completely exempt from FATCA's rules or subject to a more limited set of administrative and compliance requirements.

### ► Retirement Plans:

The Notices indicate that certain non-U.S. retirement plans pose a low risk of tax evasion and therefore will be exempt. The Notices' criteria for exception include qualification as a retirement plan under local law, sponsorship by a non-U.S. company, and a rule that the plan does not allow any U.S. participants or beneficiaries other than employees who worked in the country where the plan is established. The IRS has requested additional comments on this approach.

It is clear that the current IRS proposal is much too narrow in scope and will capture many non-U.S. retirement plans inappropriately. Thus, absent further IRS relief, non-U.S. retirement plans which invest in U.S. assets (either directly or indirectly) will have to enter into FFI arrangements

with the IRS and thereby have to gather requisite documentation from their account holders relative to their U.S. person status. Otherwise, U.S. tax withholding will occur.

#### ► **Certain Investment Funds:**

##### *Widely-Held Funds*

The Joint Committee on Taxation, in its technical explanation of the HIRE Act, suggested that widely-held investment funds such as a Luxembourg organized UCITS qualified fund could be considered to pose a low risk of tax evasion and be exempt from FATCA. Indeed, several investment fund trade associations have attempted to make the case for this treatment. The Notices, however, have not provided such an exemption.

Rather, the Notices have said that an investment fund will be deemed compliant if the following three conditions are met:

1) all fund distributors or intermediaries are themselves FFIs or deemed compliant FFIs, 2) the only direct shareholders of the fund are non-U.S. investors specifically excluded, and 3) the fund regularly provides information to intermediaries and other FFIs to calculate the appropriate amount of withholding (if applicable) by comparing its U.S. to non-U.S. asset holdings.

In practice, it is unclear if widely-held funds will be able to satisfy the IRS' three conditions. Fortunately, the Notices request additional comments and suggestions for granting deemed complaint status to funds with other categories of distributors and investors.

## Key Unknowns

### **Treatment of foreign charitable organizations:**

Some foreign charitable organizations may fall within the definition of an FFI. The Notices do not address this issue and instead request comments providing specific suggestions for defining and identifying specific classes of foreign charitable entities that should be exempt.

### **Documentation required to establish an investor's status under FATCA:**

Under the current U.S. tax withholding and information reporting system, both residents and non-residents are required to provide specific IRS forms to a U.S. financial institution or payor of U.S. source income. Non-residents must provide the appropriate Form W-8 and U.S. residents a Form W-9. It is anticipated that these forms may be altered to accommodate the identification and representations required under FATCA.

In instances where investors are not currently required to provide these IRS forms, it is unclear what information will be required. As an example, U.K. residents are not required to provide a Form W-8 to his/her local U.K. bank where they maintain a deposit account. However, because the U.K. bank invests in U.S. securities, it may likely be compelled to become a

participating FFI and enter into the reporting agreement with the IRS. This will then require the U.K. bank to "prove a negative," that its account holders are not U.S. residents. The same holds true for an investor in an investment fund organized outside of the U.S. For example, take an Australian-organized investment fund sold only to Australian investors. Again, the fund manager and all distributors will have to "prove the negative," i.e., that no U.S. persons are investing in this Australian fund.

The IRS and Treasury are considering use of existing know-your-customer and anti-money laundering rules but have expressed reservations since there is a perception that in the past, exclusive reliance on these rules has allowed U.S. tax evaders to remain undetected.

### **How will the IRS administer the FATCA system and what will it cost?**

The breadth of and challenges posed by FATCA have resulted in more submissions to the IRS than any other tax regulation. Depending upon the final rules, the extent and nature of what parties must comply with, and the required documentation, the IRS could be overwhelmed with applications to enter into FATCA agreements, all before the 2013 effective date. We note that if the more stringent requirements imposed on private banking and high value accounts are balanced with thoughtful options for deemed compliant status, FATCA should be able to reach its targets. However, if this balance is not achieved, based on prior experiences in comparable settings, one might question the IRS' ability and capacity to monitor adherence to the rules, especially on a global basis. Lastly, there are questions about the magnitude of the 'cost' of FATCA, not just to financial institutions (where implementation costs will be deductible and thus decrease tax revenue) and their clients but also to the IRS which is charged with carrying out the law. That is, **is the FATCA 'stick' proportionate to the costs involved to both the public and private sectors?**

It should be noted that **FATCA's costs could include more than simply direct administrative costs but could lead to changes to the effective functioning of the capital markets, including migration of investment flows and liquidity, use of derivatives and reduced transparency, encouragement of distinct U.S. v. non-U.S. products, and loss of U.S. competitiveness, both in terms of jobs and product innovation.**

### **Potential Impacts for Investors**

When FATCA is fully implemented, **both** U.S. resident investors and non-U.S. resident investors will be impacted. Failure to comply with the rules could result in severe penalties for both U.S. financial institutions making withholdable payments and the FFIs that have entered into reporting agreements with the IRS. Accordingly, there will be pressure on these organizations to obtain potentially new information from their investors.

U.S. resident investors will need to ensure their status under the FATCA rules is appropriately reflected in the books and records of any institution where they maintain an account or invest. If they invest in non-U.S. funds or maintain bank accounts outside of the U.S., they will need to ensure that the fund or bank is a compliant FFI in order to avoid unnecessary withholding.

In addition to the general principle applicable to U.S. residents, non-U.S. resident entities will have the additional burden of determining if they are an FFI or an NFFE. If the answer is 'yes,' then the party must make a determination if they want to be 'inside or outside' of the FATCA system. **It is conceivable that small investors or intermediaries may find the compliance costs or other concerns of participating too high, via entering an agreement with the IRS and maintaining adequate documentation, and, in practice, these institutions may simply opt out of FATCA.** However, by doing so, they may be forced to abandon direct investment in the U.S. capital markets. We believe this result would negatively impact global capital markets. In addition, investors looking for U.S. exposure may be driven into less regulated and opaque forms like over-the-counter derivatives.

**We are concerned that retail fund managers, fund distributors and end investors will find considerable difficulty with FATCA in practice.** For example, how can one determine the correct status, under FATCA, of an investment fund that only invests in other investment funds that have both U.S. resident and non-U.S. resident investors (i.e., funds oftentimes referred to as a Fund-of-Funds or Master-Feeder structure)? Another practical issue is an individual with dual nationality, or one who certified (accurately) on investing into an investment fund that he was not a U.S. resident but was subsequently transferred to work in the U.S.

## What is BlackRock Doing?

As a global organization, we are acutely aware of the potential impact to our clients and the global capital markets. We support the U.S. government's goal to ensure that all U.S. residents pay their legally due taxes. To that end, we are actively engaged in dialogue directly with the IRS and Treasury and via trade associations in an attempt to assist in the development of rules that are fair and administrable without creating undue hardship, including confusion for our clients or disrupting the efficient functioning of the capital markets.

Specifically, we recommend that Treasury and the IRS exercise their authority to:

- ▶ Exclude U.S. mutual funds entirely,
- ▶ Exclude non-U.S. organized widely-held investment funds,
- ▶ Substantially broaden the exemption for foreign retirement plans, and
- ▶ Provide a **de minimis** rule to exempt funds with minor investments in U.S. assets.

## Conclusion

BlackRock supports the initial goals of FATCA to prevent U.S. taxpayers from avoiding the payment of taxes. However, we are concerned that an overly strict interpretation of the law will cause numerous unintended consequences, including a shift in capital markets flows away from U.S. securities and an increased use of derivatives. In addition, the costs of compliance and the costs of monitoring compliance with hundreds of thousands of agreements could be extraordinarily expensive. Our recommendations respect the intent of the law while providing common sense exceptions and de minimis exclusions that will significantly mitigate the unintended consequences.

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