

# PROSPERITAS

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## How the IRS Interest-Reporting Regulation Will Undermine the Fight Against Dirty Money

*On January 17, 2001, as part of a blizzard of rulemaking during the final days of the Clinton Administration, the IRS proposed a regulation to compel U.S. financial institutions to report bank deposit interest paid to nonresident aliens – even though this information is not needed to enforce U.S. law. The Bush Administration withdrew most of the controversial “midnight regulations” proposed by the previous Administration, but officials in the Office of Tax Policy at the Treasury Department inexplicably have fought to keep the IRS’s interest-reporting regulation alive. The latest argument used by these officials is that the regulation will help the fight against dirty money. Like every other assertion made by Treasury Department personnel, this claim is demonstrably false. Indeed, the regulation will make it harder for U.S. law enforcement officials to investigate and prosecute criminals and terrorists by driving funds to foreign banks. Treasury Secretary Snow should withdraw the regulation and fire department employees who put the interests of foreign governments before the interests of the U.S. economy.*

**By Daniel J. Mitchell**

### Introduction

The IRS has proposed a regulation (REG-133254-02) that would require financial institutions to report deposit interest paid to nonresident aliens.<sup>1</sup> The IRS has issued this proposal even though it flouts 82 years of law and threatens to drive capital from the US economy. The proposed regulation has generated widespread opposition from the financial services industry and Members of Congress, in large part because it would undermine the safety and soundness of financial institutions and weaken the competitive position of American banks. Advocates of the regulation, having been placed on the defensive, have switched tactics and now claim that the regulation will help the fight against terrorism and money laundering. This is a groundless assertion.

Last month, a memo was sent to Treasury Secretary John Snow explaining why there is no reason to believe that the IRS regulation would aid in the battle against criminal activity. This

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<sup>1</sup> Regulation 133254-02 is a revised version of the original Clinton-era proposal (REG – 126100-00). The only difference between the two regulations is that the revised version applies to interest paid to depositors from 15 specific nations while the original regulation would have applied to interest paid to all nonresident aliens. The revised regulation can be reviewed at <http://www.treasury.gov/press/releases/reports/po33011.pdf>.

memo, co-authored by Heritage Foundation colleagues Dan Mitchell and Paul Rosenzweig,<sup>2</sup> explained that the regulation actually would undermine the hunt for dirty money by driving funds out of the U.S. banking system and therefore making it more difficult for U.S. law enforcement officials to investigate and prosecute illegal behavior.

But even if the funds somehow could be locked inside U.S. borders, the memo explains that the interest-reporting regulation would have no value in the war against criminal money. Simply stated, all existing anti-money laundering and know-your-customer laws and regulations already apply to nonresident alien bank accounts. Moreover, there are no legal obstacles to the investigation of these accounts by federal or state law enforcement officials. There are even well established procedures allowing foreign governments to get information about the accounts.

The IRS's proposed regulation has one purpose, and only one purpose, and that is to help foreign governments tax income earned inside U.S. borders. If the regulation is finalized, U.S. banks will send the IRS information every year about the amount of interest paid to nonresident aliens from specified nations. This information then will be forwarded to the tax collection agency of the relevant foreign government, either automatically or in response to specific requests (Treasury officials have given conflicting statements in this regard). There is nothing about this process that will help governments identify, investigate, or prosecute drug runners, murderers, and terrorists who violate the commonly shared laws of all civilized nations.

## The Memo

As the memo to Treasury Secretary Snow stated:

- Nonresident alien bank accounts are already subject to all US anti-money laundering laws and regulations, including requirements for currency transaction reports and suspicious activity reports.
- Nonresident aliens already have to fill out a special form, W8-BEN, to confirm their status. This form documents their residency status and requires full identity verification.
- We are aware of no evidence that deposit interest reporting requirements have played any substantial – or even minor – role in enhancing law enforcement's ability to address money laundering violations by Americans. There is, therefore, no basis for believing that deposit interest reporting will enhance US ability – or the ability of foreign governments – to prosecute nonresident aliens.
- Law enforcement has the authority to compel the production of information about nonresident aliens bank accounts. There is no obstacle to investigating particular accounts or obtaining all transaction records when investigative leads warrant.

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<sup>2</sup> Paul Rosenzweig is Senior Legal Research Fellow with The Heritage Foundation Center for Legal & Judicial Studies. His bio is available at <http://www.heritage.org/About/Staff/PaulRosenzweig.cfm>.

- There are effective procedures, pursuant to treaties and other bilateral and multilateral agreements, to facilitate cooperation between foreign and domestic law enforcement officials. There are well-established routines for sharing information about these accounts with foreign law enforcement officials.
- The regulation will detract from the fight against terrorist financing. U.S. financial institutions are devoting substantial personnel and system resources to implement the procedures required by the U.S. Patriot Act. Requiring them simultaneously to implement procedures to comply with a broad, nonspecific information collection requirement will detract from these efforts. In addition, devoting governmental resources to enforce this regulation will detract from ongoing anti-terrorism enforcement efforts.
- If foreign law enforcement officials have identified someone who merits investigation, they can obtain that information directly by making requests to US law enforcement officials.
- Indiscriminate and automatic sharing of tax information increases the likelihood that confidential data will get in the hands of non-tax authorities, where it could be used for improper reasons. Some of the governments listed in the regulation have misused tax information for other purposes, including commercial gain and political mischief.
- The regulation will drive funds out of the U.S. financial system, making it more difficult for law enforcement to investigate and prosecute potential criminals. Money driven out of the American banks likely will migrate to jurisdictions that are less likely to cooperate with US – or foreign – law enforcement.
- Because bank deposit interest paid to nonresident aliens is tax-exempt, no valid US law enforcement objectives will be injured by the lack of deposit interest reporting.
- The assertion that unilateral information-sharing by the U.S. government will lead to reciprocal steps by foreign governments is unsubstantiated. The U.S. government has been very successful in expanding its network of bilateral tax treaties and tax information exchange agreements.

### **Some Treasury Officials Put Foreign Governments Above American Interests**

The battle against the IRS interest-reporting regulation is now in its third year – but the fight should have been over a long time ago. Like other regulations proposed in the waning days of the Clinton Administration, the interest-reporting regulation was motivated by ideology. Bush Administration officials quickly withdrew many of those “midnight regulations.” Unfortunately, a small handful of Treasury Department officials in the Office of Tax Policy have succeeded in keeping the interest-reporting regulation alive.

While we do not know their motivations, we do know Treasury Department personnel have been duplicitous in their actions. They argued that the law required the collection of bank deposit interest paid to nonresident aliens, but it is now known that the proposed regulation overturns existing law.<sup>3</sup> They argued that tax treaties required the collection of bank deposit interest paid to nonresident aliens, but it is now known that tax treaties do not require governments to collect information not needed for domestic enforcement purposes.<sup>4</sup> Now they argue that they need to collect information on bank deposit interest paid to nonresident aliens to help the fight against money laundering, but this is a specious assertion.

Ironically, there are many steps that lawmakers could take to improve money laundering laws, actions that would reduce regulatory burdens on the private sector while facilitating greater international cooperation in the fight against criminal activity. Many of these policies were outlined in a report produced by the Task Force on Information Exchange and Financial Privacy.<sup>5</sup> Yet this report has been ignored, indicating that Treasury Department officials are merely using money laundering rhetoric as a smokescreen for their real agenda.

Unfortunately, that agenda is completely inconsistent with good tax policy. Governments should not be double-taxing income that is saved and invested, and they certainly should not be trying to impose bad tax law on income earned outside their borders. In any event, it is not the job of the U.S. government to help foreign governments tax income earned in the United States – particularly since implementation of the IRS regulation will cause capital to flee the American economy and therefore have adverse consequences for homebuyers, small business owners, and others who benefit from accessibility to credit.

## Conclusion

Like all cabinet officials, Treasury Secretary John Snow must oversee a Department filled with career bureaucrats, many of whom are either ambivalent or hostile to the goals of the President. But the Treasury Secretary faces a special challenge since some of the political appointees in his Department support the IRS interest-reporting regulation – even though the regulation was first proposed by the Clinton Administration and even though it will hurt the U.S. economy if it is finalized.

When reviewing this issue, the Treasury Secretary should take into account the widespread opposition to the regulation on Capitol Hill and in the financial services industry.<sup>6</sup> But he also should listen to the counsel of other government agencies. The Chairman of the Federal Deposit Insurance Corporation, for instance, warned that, “[a] shift of even a modest portion of these [nonresident alien] funds out of the U.S. banking system would certainly be termed a significant economic impact.”<sup>7</sup> The Office of Advocacy at the Small Business Administration also weighed in, criticizing the IRS for failing to obey legal requirements,

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<sup>3</sup> See <http://www.freedomandprosperity.org/Papers/irsreg/irsreg.shtml>.

<sup>4</sup> The Southeastern Legal Foundation produced an analysis on treaty requirements, which can be found at <http://www.freedomandprosperity.org/slf-memo.pdf>.

<sup>5</sup> The Task Force report is available at <http://www.freedomandprosperity.org/task-force-report.pdf>.

<sup>6</sup> <http://www.freedomandprosperity.org/against-irsreg.pdf>.

<sup>7</sup> <http://www.freedomandprosperity.org/fdic.pdf>.

including preparation of a regulatory flexibility analysis, when issuing regulations that affect small business. According to the SBA office, "...there is ample evidence that the impact of the regulation is significant and that a substantial number of small businesses will be impacted."<sup>8</sup>

Secretary Snow should permanently withdraw the proposed regulation. He also should make sure that his underlings are not able to undermine the President's agenda of lower taxes and tax reform. Indeed, he should remove any Department officials who disregard the law in pursuit of an ideological agenda.

*Daniel J. Mitchell is the McKenna Senior Fellow in Political Economy at The Heritage Foundation.*

For more information on the proposed IRS Interest Reporting Regulation please visit CF&P's dedicated web page:

<http://www.freedomandprosperity.org/update/irsreg/irsreg.shtml>

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### **Additional Issues of Prosperitas:**

8) April 2003, Prosperitas Volume III, Issue II, "Markets, Morality, and Corporate Governance: A Look Behind the Scandals," by Daniel J. Mitchell, Web page link below:

<http://www.freedomandprosperity.org/Papers/corpgov/corpgov.shtml>

7) February 2003, Prosperitas Volume III, Issue I, "Who Writes the Law: Congress or the IRS?," by Daniel J. Mitchell, Web page link below:

<http://www.freedomandprosperity.org/Papers/irsreg/irsreg.shtml>

6) April 2002, Prosperitas Volume II, Issue II, "The Case for International Tax Competition: A Caribbean Perspective," by Carlyle Rogers, Web page link below:

<http://www.freedomandprosperity.org/press/p03-25-02/p03-25-02.shtml>

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<sup>8</sup> Available at [http://www.sba.gov/advo/laws/comments/irs02\\_1114.html](http://www.sba.gov/advo/laws/comments/irs02_1114.html).

5) January 2002, Prosperitas Vol. II, Issue I, “U.S. Government Agencies Confirm That Low-Tax Jurisdictions Are Not Money Laundering Havens,” by Daniel J. Mitchell. Web page link below:

<http://www.freedomandprosperity.org/Papers/blacklist/blacklist.shtml>

4) November 2001, Prosperitas, Vol. I, Issue IV, “The Adverse Impact of Tax Harmonization and Information Exchange on the U.S. Economy,” by Daniel J. Mitchell. Web page link below:

<http://www.freedomandprosperity.org/Papers/taxharm/taxharm.shtml>

3) October 2001, Prosperitas, Vol. I, Issue III, “Money Laundering Legislation Would Discourage International Cooperation in the Fight Against Crime,” by Andrew F. Quinlan. Web page link below:

<http://www.freedomandprosperity.org/Papers/kerry-levin/kerry-levin.shtml>

2) August 2001, Prosperitas, Vol. I, Issue II, “United Nations Seeks Global Tax Authority,” by Daniel J. Mitchell. Web page link below:

<http://www.freedomandprosperity.org/Papers/un-report/un-report.shtml>

1) August 2001, Prosperitas, Vol. I, Issue I, “Oxfam's Shoddy Attack on Low-Tax Jurisdictions,” by Daniel J. Mitchell. Web page link below:

<http://www.freedomandprosperity.org/Papers/oxfam/oxfam.shtml>

Complete List of Prosperitas Studies, including summaries:

<http://www.freedomandprosperity.org/fpf/prosperitas/prosperitas.shtml>