PROSPERITAS

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Who Writes the Law: Congress or the IRS?

The Internal Revenue Service has proposed a regulation (133254-02) that would require U.S. financial institutions to report bank deposit interest paid to certain nonresident aliens. The IRS admits that the information is not needed to enforce U.S. tax law, and instead seeks to collect the information so it can be provided to the tax authorities of 15 specified nations. But since nonresident alien depositors easily can shift their funds to other jurisdictions if they wish to protect their privacy, the regulation has attracted considerable opposition. Critics fear the regulation would drive capital from the U.S. economy and undermine the competitiveness of American financial institutions. These are very legitimate concerns, but they are overshadowing another important issue: Is the IRS overstepping its authority and abusing the regulatory process by proposing a regulation that is fundamentally inconsistent with the law? The answer is yes. Congress clearly wanted to attract capital to the U.S. economy when it chose not to tax bank deposit interest paid to nonresident aliens. Helping other nations tax that income – which is the explicit goal of the IRS regulation – unambiguously would thwart this goal and therefore undermine congressional intent. To help protect the rule-of-law, the regulation should be withdrawn.

By Daniel J. Mitchell

Introduction

Three days before the end of the Clinton Administration, the IRS proposed a regulation that would require US banks to report the interest they pay to all nonresident aliens with bank accounts in America. Widespread opposition from Capitol Hill, the financial services industry, and taxpayer organizations resulted in the original regulation being withdrawn, but the IRS in July proposed a nearly identical rule (the only difference being that banks will only be required to report interest payments to nonresident aliens from 15 specified nations).

This new proposal is equally controversial. The Administration already has received communications from more nearly 50 members of Congress, all of them against the regulation. In addition, 30 of the nation's most significant think tanks, taxpayer organizations, and free market groups have registered their strong opposition. The financial services industry opposes the revised rule, and even the Federal Deposit Insurance Corporation has denounced the regulation because of concerns that it might undermine the safety and soundness of U.S. financial institutions.

It is important to attract capital to the U.S. economy. And it also is important to maintain a competitive financial services industry and promote fundamental tax reform. But this debate is not just a matter of economic policy. The proposed IRS regulation also raises important issues about the rule-of-law and democratic accountability. Government agencies are supposed to enforce the laws approved by Congress. If a regulatory agency uses bureaucratic edict to create law or overturn law, that undermines our democratic form of government.

Unfortunately, this is exactly what the IRS is trying to do. The IRS's proposed bank interest reporting regulation is a blatant effort to subvert the law.

Congress most recently addressed the tax treatment of nonresident alien bank deposit interest in the Tax Reform Act of 1976 (Public Law 94-455) and the Tax Reform Act of 1986 (Public Law 99-514). The 1976 law clearly re-emphasized that lawmakers wanted to retain the long-standing U.S. policy (since at least 1921) of attracting capital to the American economy by not taxing interest paid to non-resident aliens. In its description of the 1976 law, the Joint Committee on Taxation (JCT) wrote, "Congress has concluded that the elimination of the exemption would result in a significant decline in the substantial deposits by nonresident aliens and foreign corporations in banks in the United States." The 1986 law retained this policy, but used a different method (declaring the interest to be "exempt U.S.-source income" instead of "foreign-source income").

The law – both today and in the past – clearly is designed to attract capital to the U.S. economy. Congressional documents, including Joint Committee on Taxation descriptions of the law, unambiguously support this position. Any regulation to require the reporting of bank deposit interest paid to nonresident aliens surely would be contrary to legislative intent.

The Law

The tax treatment of bank deposit interest paid to nonresident aliens is governed by Section 871(i) of the Internal Revenue Code, approved as part of the 1986 tax Reform Act. The law reads:

(i) Tax not to apply to certain interest and dividends

> (1) In general - No tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a) on any amount described in paragraph (2).
>
> (2) Amounts to which paragraph (1) applies - The amounts described in this paragraph are as follows:

> (A) Interest on deposits,[[1]] if such interest is not effectively connected with the conduct of a trade or business within the United States.

In its General Explanation of the 1986 Tax Reform Act,[2] the Joint Committee on Taxation explained (on page 940) that, "Prior law effectively exempted certain income paid by U.S. persons to foreign persons from U.S. withholding tax by treating the income as foreign source income. Under the [1986] Act, the income is treated as U.S. source, but the exemption from U.S. withholding tax is made explicit. The interest affected includes interest on deposits or withdrawable accounts…" In other words, Congress did not want to tax bank deposit interest paid to nonresident aliens. Prior to 1986, this goal was achieved by declaring that such interest was foreign-source income (and therefore non-taxable since the U.S. government would never tax the non-U.S. income of non-U.S. taxpayers). After 1986, this goal was achieved by declaring that the interest was tax-exempt U.S.-source income.

The pre-1986 approach – treating bank deposit interest paid to nonresident aliens as foreign-source income – was first implemented as part of the Revenue Act of 1921, which was passed on November 23, 1921. The 1921 Act amended Section 217 of the Internal Revenue Code to treat as foreign source "interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein..."[3]

Other than some minor reshuffling of code sections, this policy remained in effect until the 1960s when Congress considered whether interest income paid to nonresident aliens should be reclassified as U.S.-source income in part because of a desire to help encourage Latin Americans to bring their flight capital back to Latin America. Congress decided that bank deposit interest paid to nonresident aliens no longer would be considered foreign-source income, but concerns about balance of payments and the impact on U.S. capital markets caused them to delay the implementation until the end of 1971. In 1972, Congress decided to postpone the expiration of the deposit interest exemption until 1975, and then later the expiration of the provision was postponed yet again until 1976.

Congress decided in 1976 to once again make the deposit interest exemption permanent. The Joint Committee on Taxation published an explanation of the 1976 law,[4] and that report (on pages 255-256) states that, "Interest on bank deposits paid to nonresident aliens and foreign corporations has been exempt from U.S. tax continuously

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[1] (3) Deposits: For purposes of paragraph (2), the term ``deposits'' means amounts which are--

(A) deposits with persons carrying on the banking business,

(B) deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, but only to the extent that amounts paid or credited on such deposits or accounts are deductible under section 591 (determined without regard to sections 265 and 291) in computing the taxable income of such institutions, and

(C) amounts held by an insurance company under an agreement to pay interest thereon.

[2] JCS-10-87, May 4, 1987

[3] The Senate Finance Committee Report did not contain any relevant comments. Neither does the Conference Committee Report to the 1921 Act.

[4] JCS-33-76, December 29, 1976

since 1921." The report notes that the exemption was permanent before 1966, but was changed to a temporary exemption by the Foreign Investors Tax Act of 1966. The 1976 law shifted back to a permanent exemption. According to the JCT, "The Act continues without any termination date the exemption in prior law for interest earned by nonresident aliens and foreign corporations on deposits with banks, savings and loan institutions, and insurance companies…"

The Intent[5]

The law is quite clear. The U.S. government does not tax bank deposit interest paid to nonresident aliens. The legislative history also is very clear on why lawmakers chose this policy. In the Ways and Means Committee Report that accompanied the 1921 legislation (pp. 11-12), it was noted that "[i]t is urged in support of this suggestion that the loss of revenue which would result if this deduction were allowed would be relatively small in amount, while the exemption of such interest from taxation would be in keeping with the action of other countries and would encourage nonresident alien individuals and foreign corporations to transact financial business through institutions located in the United States."

The 1976 Joint Committee on Taxation report echoes this view. It states that, "Congress has concluded that the elimination of the exemption would result in a significant decline in the substantial deposits by nonresident aliens and foreign corporations in banks in the United States." The report also explained why Congress chose to make the exemption permanent (in other words, why it decided to revert to the pre-1966 law): "It is believed that the temporary nature of the exemption in recent years may have discouraged foreign investors from investing in fixed term bank deposits such as certificates of deposit where those obligations were due to mature after the dates the exemption was due to expire."

The 1986 JCT report does not provide any additional elaboration, but there is no possible basis for thinking that there was any change in legislative intent. As quoted above, Congress made an explicit decision to retain the non-taxation policy.

Private-sector analyses also conclude that the law was designed to make America an attractive repository for foreign capital. The Bureau of National Affairs[6] states, "Capital gains [for nonresident aliens] will usually be exempt from U.S. tax; interest and interest equivalents will also be exempt from tax in most cases…" and "In order to encourage nonresident alien investors to invest in the U.S.…, U.S. law has long provided a 'safe harbor' for nonresident alien investors."

[5] From a legal perspective, legislative history and legislative intent are not the same thing. Official documents from the tax-writing committees are considered legislative history and can be used in legal proceedings. Joint Committee on Taxation documents, by contrast, do not necessarily have an impact on legal decisions even though they help explain legislative intent.
[6] Thomas St. G. Bissell, Esq., "U.S. Income Taxation of Nonresident Alien Individuals" *Tax Management*, Bureau of National Affairs 1999, p. A-24.

Tax Notes International published a thorough analysis on March 19, 2001.[7] The author explained that, "The 1976 Senate hearings clearly indicated that many senators felt that the imposition of tax on such bank deposit interest could result in a substantial outflow of funds away from U.S. banks to foreign competitors. Most other countries, including major U.S. trading partners, similarly exempt bank deposit interest paid to foreign persons. Collecting information concerning such deposit interest and passing it on to other countries will almost certainly have the same effect as imposing tax on the interest. If these regulations [the author was referring to the original version of the bank deposit interest reporting regulation, REG 126100-00] are adopted in final form, there will be a massive outflow of funds from U.S. banks. Most of these funds will go to banks in major countries that do not collect taxes on such interest and have no rules to collect information with respect to such accounts."

Conclusion

The U.S. Congress repeatedly has chosen not to tax bank deposit interest paid to nonresident aliens, and it also is clear that this policy is designed to attract capital to the American economy. This goal would be undermined if the IRS required the income to be reported. As Mr. Langer wrote in *Tax Notes International*, "***Collecting information concerning such deposit interest and passing it on to other countries will almost certainly have the same effect as imposing tax on the interest***." And since there is clearly no legal requirement to require the reporting of this interest, the proposed regulation clearly would undermine congressional intent. Indeed, it would use bureaucratic edict to overturn a policy approved by democratically-elected officials.

It is worth noting that the IRS does not even pretend to offer a legal justification for the most recent version of the proposed rule.[8] Interestingly, the original version cites a report from the Senate Foreign Relations Committee – which does not have jurisdiction over tax policy. This report (dealing with a very narrow topic – approval of a tax convention with Italy) does express support for information sharing, but it is difficult to see how a report from a Senate committee should carry more weight than laws enacted by the entire Congress and signed into law by the President – particularly since the relevant passages do not endorse automatic collection of information. There also have been reports that the IRS is claiming that the automatic collection of information on bank deposit interest paid to nonresident aliens is required by tax treaties. This is not true. Tax treaties do not require governments to automatically collect information solely for the benefit of a treaty partner.[9]

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[7] Marshall Langer, "Proposed Interest Reporting Regulations Could Cause Massive Outflow of Funds," Tax Notes International," March 19, 2001.
[8] An earlier version of the regulation – which would have required reporting of bank deposit interest paid to all nonresident aliens – was proposed three days before President Clinton left office. This version was withdrawn in the Summer of 2002.
[9] For more information, see http://www.freedomandprosperity.org/slf-irs.pdf.

The proposed IRS rule is not only bad policy, but it also is a flagrant abuse of the regulatory process. The IRS is unilaterally seeking to change the law. This is neither the agency's role nor its prerogative. The IRS should withdraw the regulation. And if the IRS refuses to live under the law, the White House should intervene to ensure the regulation is permanently withdrawn.

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Note: For Additional information on the proposed IRS rule and for a complete list of lawmakers and organizations opposing the Regulation, please visit CFP Dedicated Web Page on the issue: http://www.freedomandprosperity.org/update/irsreg/irsreg.shtml

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