

**TESTIMONY**  
**BEFORE THE INTERNAL REVENUE SERVICE**  
**PROPOSED RULE MAKING:**  
**REG-133254-02 AND REG-126100-00**  
**GUIDANCE ON REPORTING OF DEPOSIT INTEREST PAID TO NONRESIDENT ALIENS**  
**DECEMBER 5, 2002**  
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**INTRODUCTION**

Thank you for allowing me to testify today on the Service's proposed rule requiring American banks to report interest payments made to non-resident aliens with US accounts. In addition to my written statement, I also ask that an accompanying article authored by Dan Mastromarco and myself, be made a part of the official record. That article explores this issue in more detail than I am able to delve into here.

I am testifying today in strong opposition to the proposed IRS regulation that would force American banks to report interest payments made to nonresident aliens with US accounts. This regulation is clearly contrary to America's national interests.

I oppose the proposed regulation on three grounds: 1) The rule exceeds the Service's legal authority since it is neither necessary nor effective in assisting the IRS improve compliance with or enforce US tax law; 2) The rule overturns long-standing settled policy enacted into law by the US Congress, and recently reinforced by the Administration's executive actions 3) The rule will significantly harm the US economy without producing any compensatory benefits.

Therefore, I urge the Service to withdraw the proposed regulation immediately. If the Service is unwilling to withdraw the proposed rule at this time, I urge it then to postpone making the rule final until the General Accounting Office has an opportunity to conduct an analysis of the regulation's effects on the US economy and federal revenues.

**THE PROPOSED REGULATION EXCEEDS THE SERVICE'S LEGAL AUTHORITY**

There is no legal predicate for this rulemaking since there is no legitimate need to collect information on foreign-owned bank deposit interest. The information this regulation would mandate be collected is not needed to enforce US law nor could one reasonably expect any direct improvement in tax-law enforcement if the regulation were adopted.

The Service has established a set of information requirements that it contends are "required to determine if taxpayers have properly reported amounts received as income." (See Treas. Reg. sections 1.6049-4(b)(5)(i) and 1.6049-6(e)(4) (i) and (ii)) The Service

attempts to justify adding information on foreign-owned bank deposit interest to that set of information requirements on the grounds that “[t]he IRS and Treasury believe that [the proposed interest] reporting ... will facilitate the goals of improving compliance with US tax laws and permit appropriate information exchange.” This statement is clearly nothing more than a *pro forma* justification of the rule for which the Service provides no substantiating empirical evidence. How can this rulemaking be required to improve compliance with or enforcement of US tax law when the **interest that is the subject of the reporting requirement is not even taxable?**

The Service argues that its unilateral action to require the reporting of non-taxable interest payments made to aliens with US accounts will “facilitate” information exchange with foreign governments, which in turn will produce information on US taxpayers, which in turn will improve compliance with US tax law. That assertion—the first in a long string of hypothetical assertions—provides no foundation for the rule because it depends ultimately upon a reciprocal exchange of information between the United States and other nations, which the Administration already has ruled out by executive decision.

The Bush Administration has twice refused to support European initiatives (the EU Savings Directive and the OECD Harmful Tax Competition Initiative) intended to accomplish, in part, the kind of information reporting that the Service now seeks to accomplish through the proposed rule. In addition to the US interest reporting, these multilateral proposals also provided for reciprocal reporting by foreign nations on beneficial payments to US taxpayers that would be taxable under US tax law. Such reciprocal reporting requirements, unlike the proposed rule, could actually result in the US government’s receiving information on US taxpayers, which could be argued to assist the Service enforce US tax law. However, both proposals have been rejected by the Administration thereby negating the need for US reporting on foreign-owned bank deposit interest. Moreover, it is hardly the Service’s place to implement through bureaucratic rule making policy that elected officials in the Administration explicitly have rejected.

In summary, there can be no reasonable expectation that the proposed regulation, as it stands, will improve compliance with US tax laws, and the Administration has ruled out more stringent and encompassing reciprocal information-exchange requirements that might be argued to improve compliance. Hence this IRS rulemaking not only is *ultra vires* as it stands, the Administration has ruled out implementing policies and ancillary rules that conceivably could make the proposed regulation pertinent to the Service’s enforcement activities.

#### **THE PROPOSED REGULATION OVERTURNS LONG-STANDING, SETTLED POLICY ENACTED INTO LAW BY THE US CONGRESS**

For nearly two decades, US law has encouraged foreigners to invest in US banks and debt securities by imposing no tax on interest earned on foreign deposits, except in very narrow circumstances. On more than one occasion, Congress has chosen not to tax that income because of a desire to attract job-creating private capital. This means that

information on this income is completely unnecessary for purposes of enforcing US tax law. Indeed, many regulatory experts and tax lawyers make persuasive arguments that the IRS is abusing its regulatory authority by promulgating a regulation that overturns existing law.

The US has made a conscious choice not to thwart foreign direct investment, even if this means that we reject the economic principle of capital import neutrality, which is to treat investments in the US similarly regardless of the status of the investor. A number of provisions exempt from tax certain categories of US source income received by non-resident aliens (NRAs). For example, interest on bank deposits with US banks is exempted (871(i)(2)(A)). Most treaties reduce the withholding rate considerably, often to zero in the case of interest. More specifically, it is generally the negotiating position of the US, as expressed in Article 16 of the Treasury's model income tax treaty, to fully exempt interest from tax. The withholding tax is reduced to zero currently under treaties with many nations including Austria, Denmark, Finland, Germany Greece, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Poland, the UK and Sweden. Under other treaties the interest and dividend rates are lowered and certain types of income are exempted. Remarkably, these are the same countries to which this rulemaking relates.

Although the proposed regulation is limited now to bank-deposit interest earned by certain countries' residents, if one subscribes to its rationale there is no logical reason not to: 1) extend the rule to other countries (and no reason to assume Treasury would not be lobbied heavily by European tax authorities to do so), and 2) extend the reporting requirements to capital gains and other portfolio dividends and interest (none of which are currently taxed).

Enacted in 1984, the portfolio-interest exception (section 871(h)) is perhaps the greatest single example of Congress's attempt to attract offshore investment. This provision exempts from tax most US source 'portfolio interest' received by a NRA. With respect to interest on 'bearer' obligations, i.e. obligations which are not issued in registered form, the interest can qualify as portfolio interest only if the obligations are issued in a manner which 'targets' the issue to foreign markets and the interest is payable outside of the US. If the obligations are issued in registered form, the interest qualifies as portfolio interest if the U.S borrower paying the interest receives a statement from the beneficial owner of the interest that the recipient is not a US person. In addition the interest cannot be received from a corporation or partnership in which the recipient has a ten percent or greater interest, thus ensuring that the interest is truly a "portfolio-type" investment (arm's length).

The rationale of the portfolio-interest exception is perhaps the purest example of enlightened self-interest and realism in attracting foreign capital. According to the Joint Committee on Taxation's (JCT) 1984 report accompanying the legislation (Tax Treatment of Interest Paid to Foreign Investors (JCS-23-84: April 28, 1984)), US companies were not "currently issuing bonds directly in the Eurobond market due to the 30 percent withholding tax" (p. 7). The JCT continued:

*The most common practice of borrowers seeking funds for use in the US is to establish a finance subsidiary in the Netherlands Antilles. This structure is designed to avoid the US withholding tax by claiming the benefits of the tax treaty between the Netherlands as extended to the Antilles. The subsidiary borrows funds from foreign lenders and the subsidiary then re-lends the borrowed funds to the parent or another affiliate with the corporation groups. The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S parent. ... Pursuant to Article VIII, of the US – Netherlands Antilles treaty, and exemptions claimed from the U.S withholding tax on the interest payments by the US parent ... The interest payments which the Antilles subsidiary in turn pays to the foreign [entity] are not subject to tax by the Antilles. .... Thus there is no US or Netherlands Antilles withholding tax on the interest paid by the US company to its Antilles finance subsidiary, nor (sic) on the interest paid by the finance subsidiary to foreign bondholders. Use of the foreign finance subsidiary to may also increase the parent's ability to utilize foreign tax credits because the ... net income is foreign source income in the hands of the parent.*

The JCT continued:

*Following the decision by the United States to abandon the fixed exchange rate system and to allow the value of the dollar to be determined by market forces ... Eurobond offerings by US corporations decreased .... [They decreased] in large part due to questions about the exemption from the US withholding tax, which arose when the IRS ... revoked ... prior rulings that [held] properly structured finance subsidiaries would qualify (Rev. Rul. 74-464, 1974-2 C.B. 46).*

So there was a real fear that the US would not be able to access the Eurobond market if nothing was done to repeal the withholding requirement. Since the marketing of a Eurobond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the US parent for payment, many tax planners thought that – no matter how clever they were -- bonds might be treated by the IRS as debt of the parent rather than the subsidiary. If they were so treated, they would require withholding.

There was also recognition that repeal would bring positive economic results. According to the JCT, “if the primary effect of repeal is to cause foreign investors to shift from short to medium term US securities ..., then medium term interest rates would decline .... [T]his would benefit the US economy by stimulating investment in plant and equipment....” JCT also pointed out that “proponents of repeal of the ... withholding tax argue that the attractiveness of US bonds in the international bond market is greatly diminished by the withholding tax, so that the tax is a barrier to international trade in assets.”

This exception only applies to unrelated borrowers and lenders and is otherwise restricted, but it is quantitatively very important. Although it is difficult to know for certain, analysts generally believe that this provision has attracted somewhat over \$1 trillion in foreign capital to the United States. Former senior Treasury official, Stephen J. Entin (currently President of the Institute of Research on the Economics of Taxation) estimates that private foreign investment here is \$8 trillion, of which about \$1 trillion is bank deposits. There are also many foreigners that own Treasuries and hold bonds.

In summary, the regulation operates at cross purposes with the successful congressional policy enacted into law in 1984 of attracting foreign capital to the United States and, if successfully implemented, would effectively undermine congressional intent.

**THE PROPOSED REGULATION WILL SIGNIFICANTLY HARM THE US ECONOMY WITHOUT PRODUCING ANY COMPENSATORY BENEFITS**

Non-resident aliens who place deposits in US banks demonstrate by their actions that they believe US financial institutions to be a safer and sounder steward of their money than alternatives available to them elsewhere. Some of them may be escaping oppressive tax burdens, while others may be fleeing corruption and crime. In either event, the US economy benefits greatly from gaining access to their capital. If the IRS undermines the confidentiality of the American banking system with the proposed regulation, it will substantially reduce the incentive for nonresident aliens to deposit their money in our banks

Residents of other nations view the United States as a safe haven and have about \$1 trillion of deposits in American banks. This capital stimulates economic growth and creates jobs, benefiting US workers and business owners. But if this regulation is implemented, a substantial portion of this liquid capital will flee to more hospitable jurisdictions, which in turn would produce a permanent reduction in growth. Therefore, unless it is absolutely essential to the IRS's tax-enforcement activities, the Service should refrain from doing anything to weaken financial markets and stifle economic growth by causing foreign capital to flee American banks. And even if it could be shown that the offsetting benefits to tax collections outweighed the economic damage the collection efforts entailed, making that trade-off by reversing current law is a prerogative of the Congress, not the IRS.

The IRS claims that foreign governments will help collect US taxes if we help them collect their taxes, but this is a specious claim. It is highly unlikely that any Americans have hidden their money in the 15 nations (high-tax countries like France and Sweden) on the list. Instead, the regulation would merely serve to drive capital from America. But this regulation will not even result in higher tax collections for other governments. Depositors will quickly shift their funds out of America and to London, Hong Kong, Zurich, and other places that respect the need for a safe and stable banking system.

In summary, the proposed regulation, if implemented, will have a substantial adverse impact on US capital markets and the US economy by encouraging a significant portion of the estimated one trillion dollars attracted by the congressionally-enacted portfolio-interest exception to be withdrawn from US capital markets.

Thank you.