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November 8, 2002

CC:DOM:ITA:RU (REG-133254-02)
Room 5226
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

Re: Written Comments on Guidance on Reporting of Deposit Interest
Paid to NRAs [CC:DOM:ITA:RU;(REG-133254-02)]

Dear Sir or Madam:

The following letter comments on the re-promulgated Internal Revenue Service (hereinafter "IRS" or "Service") proposed rulemaking concerning reporting requirements for interest on deposits paid by U.S. financial institutions to residents of certain specified countries.

On January 17, 2001, immediately prior to the change in U.S. administrations, the Service promulgated a proposed regulation entitled "Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens."¹ That rule would have required payors of interest to all U.S. non-resident aliens (hereinafter NRAs) to file Form 1042-S. Form 1042-S, *inter alia*, requires the reporting of the payee's name and address, tax numbers and the amount paid. The January 17th rulemaking greatly enlarged upon an extant rule that only required reporting of interest paid from U.S. banks to residents of Canada [Reg. §1.6049-8(a)].

The new rulemaking would withdraw the widely and strongly criticized January 17th proposal, but only slightly narrows its scope. This new rule would require reporting of interest paid to residents of Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden and the United Kingdom. The reporting requirements would mandate that copies of Forms 1042-S be furnished to the Service and to NRAs who are residents of these countries with a copy to the Service. The rule would permit payors to choose to report bank deposit interest paid to all NRAs. As a prelude of things to come, the Treasury presages it may

¹ REG-126100-00.

expand upon this list of countries. The Service intends to collect this information in a central repository, so that it can be made available to unspecified authorities in the enumerated foreign nations. If the payor has not filed valid Forms W-8 or W-9, a payment made to a U.S. non-exempt recipient is generally subject to backup withholding.

Although the regulation, by its terms, is limited to bank deposit interest, the rationale of the rule is not limited to payments of interest, or even bank deposit interest payments to residents of the enumerated nations. The logic of the rule would require similar reporting with respect to other payments, such as portfolio interest and capital gains, and eventually of all U.S. non-resident aliens wherever resident. No doubt the Service will be urged by foreign powers to expand application of the rule, and will likely display the same resistance it has shown here.

These comments are highly critical of the proposed rulemaking. We ask that the rule be immediately withdrawn because of three fatal infirmities.

- The collection requirements of the rulemaking exceed the statutory authority of the IRS to impose such requirements, and hence the rulemaking is *ultra vires*. The Service's regulatory authority is limited to the promulgation of rules that enforce U.S. tax law. The Service may not impose requirements on U.S. persons in order to help foreign governments collect their taxes. This *ultra vires* action is not authorized by the unsubstantiated assertion that these regulations would significantly further, in unspecified ways, U.S. compliance efforts.
- The rulemaking overrides Congressional and Administration policy, which in turn is based on sound economic policy in the interest of the United States. For example, the U.S. has recently rejected the "EU Savings Tax Directive" and the Union's efforts to nullify tax competition; however, the EU would celebrate the interest reporting regulation as unilateral adoption of the EU Savings Tax Directive and of its anti-tax competition initiative. If implemented, this rule may provoke the exodus of hundreds of billions of dollars of foreign capital on deposit in the U.S., with a resulting detrimentally impact on the U.S. economy and U.S. capital markets. Moreover, the ruling imposes unnecessary and substantial costs on U.S. businesses in an attempt to enforce the tax laws of foreign nations.
- The Service is abrogating a host of due process requirements as set forth in statute and Executive Orders (EOs). The Service is patently violating the Regulatory Procedure Act (RFA) (5 U.S.C. 603), the Administrative Procedure Act (APA Section 553(b)), EO 12866, OMB Circular 94-A and certain other procedural protections designed to ensure protections against such faulty rulemakings. The Service might also want to consider whether the privacy protections of section 6103 or the zero withholding provisions of treaties are implicated.

These arguments are more fully set forth below.

I. The Service Lacks Regulatory Authority to Require Reporting of Foreign Interest Income Because Such Reporting is Not Required or Even Useful to Enforce U.S. Tax Laws

Strictly from a legal standpoint, the Service must know that it is beyond the scope of its authority to issue these rules. The Service maintains the collection of information requirements in Treas. Reg. sections 1.6049-4(b)(5)(i) and 1.6049-6(e)(4) (i) and (ii) are “required to determine if taxpayers have properly reported amounts received as income.” The Service further posits that, “[t]he IRS and Treasury believe that [such] reporting ... will facilitate the goals of improving compliance with U.S. tax laws and permit[] appropriate information exchange.”

Such *pro forma* statements appear necessary, if the rulemaking is to be sustained, but it is clear that: 1. there is no legal predicate for the rulemaking since it is not needed to enforce U.S. law, and 2. there is no authority for extending the return requirement to nontaxable interest recipients.

The law provides in section 7805(a)

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue [emphasis added].²

IRC section 6001 specifies the conditions under which the Service can require returns. The law provides:

Every person liable for any tax imposed by this title, or for the collection thereof, shall ... make such returns and comply with such rules and regulations as the Secretary may from time to time prescribe [emphasis added].

Likewise, IRC section 6011 provides:

When required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary [emphasis added].

The Service is not authorized to issue a rulemaking that is not “needful” for the “enforcement” of the Code; it is not authorized to require a return unless under a valid rulemaking; and, in any event, cannot require such a return unless a person is liable for any tax imposed by this title or for the collection thereof.

² All section references throughout this comment are to the Internal Revenue Code unless otherwise indicated.

The Service's reliance on IRC section 6049 (returns regarding payments of interest) to authorize reporting here does not nullify the above requirements that the rulemaking and the return be "needful" to enforce U.S. tax laws. IRC section 6049 provides that:

(a) Requirement of reporting - Every person ...who makes payments of interest (as defined in subsection (b)) aggregating \$10 or more to any other person during any calendar year, or ... who receives payments of interest (as so defined) as a nominee and who makes payments aggregating \$10 or more during any calendar year to any other person with respect to the interest so received, shall make a return according to the forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

Pursuant to section 6049(b)(2)(C)(ii) and (b)(5), "interest" was not generally meant to include an amount subject to withholding under subchapter A of chapter 3 (relating to withholding of tax on NRAs and foreign corporations) by the person paying such amount "if the payor thereof is exempt from the application of section 1441(a) by reason of 1441(c) or a tax treaty" or "such amount is described in section 871(i)(2)." The term "interest" was meant to exclude these nontaxable receipts, unless and until "provided in regulations."

While section 1441 (concerning withholding of tax on NRAs) provides that all persons paying items of income to any NRA individual shall deduct and withhold a tax equal to 30 percent thereof, sections 1441(c)(9) and (10) provide no tax shall be "be required to be deducted or withheld" for amounts paid on accounts exempt under sections 871(i)(2) and 871(h). Hence, under the law, payors are not required to make a return with respect to interest under IRC sections 871(h), 871(i)(2) or treaty based zero withholding. Section 871(h) exempts certain portfolio debt investments (described further below), and section 871(i) exempts interest on deposits not effectively connected with a U.S. trade or business.

It is axiomatic that the executive branch cannot issue regulations except pursuant to law.³ The proposed regulation should be void as arbitrary and unreasonable since it is not "reasonably related to the purposes of the enabling legislation."⁴ The proposed expansion to the 1042-S reporting requirements is not "required to determine if taxpayers have properly reported amounts received as income" when no amounts are reportable and no tax is due.

Can the Service truly explain how this rulemaking is needed to improve compliance with or enforce U.S. tax law when the interest that is the subject of the reporting is not taxable?

³ "The exercise of quasi-legislative authority by government departments and agencies must be rooted in a grant of such power by the Congress," *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 (1979). See also *Morrill v. Jones*, 106 U.S. 466, 467 (1883).

⁴ See, e.g., *Mourning v. Family Publication Serv.*, 411 U.S. 356, 369 (1973), *Bowen v. American Hosp. Assn.*, 476 U.S. 610, 626 (1986).

II. The Service Is Attempting to Promulgate Regulatory Policy That Abrogates U.S. Congressional Policy and Economic Interests

The Service concedes that most of the comments received on the January 17, 2001 proposed regulations were highly critical, and that this criticism required them to withdraw and re-promulgate the rule. In particular, many commentators expressed the view that the administrative burden imposed by the 2001 proposed regulations would significantly outweigh any benefits obtained by the IRS from the additional information collected. Some commentators also stated that the 2001 proposed regulations could have a severe negative impact on U.S. banks, particularly U.S. banks with a deposit base that included a significant number of NRA individuals, some of whom had expressed concerns that the information collected under the 2001 proposed regulations might be misused. However, while acknowledging these concerns, the Service has done nothing to address them in the new proposal.

The main problem is not that this newly reconstructed rule would continue to impose costs – which it does – but that it will impose these costs needlessly and in derogation of a sound U.S. policy, enacted into law and expressed in recent Bush Administration policy pronouncements, to attract investment from abroad. The U.S. is perhaps the world’s largest tax haven, by choice, and this proposal would substantially reverse that policy by bureaucratic fiat.

For nearly two decades, U.S. law has encouraged foreigners to invest in U.S. banks and debt securities by imposing no tax on interest earned on foreign deposits, except in very narrow circumstances. The policy is estimated to have attracted approximately one trillion dollars to the United States. Reversing this policy risks driving hundreds of billions of dollars out of the United States. This is a risk that is certainly not worth taking for a regulation which is not only unnecessary to enforce U.S. law but which runs counter to U.S. policy.

As the Treasury is aware, through the Organization for Economic Cooperation and Development “harmful tax competition initiative,” the EU Savings Directive, the proposed United Nations International Tax Organization and other similar initiatives, Europeans have aggressively demanded that nations stop seeking to attract mobile sources of capital through lower taxes or in the alternative routinely share financial information on investors. This will enable the resident countries to impose high extraterritorial taxes with impunity – taxes that have driven the funds offshore in the first place. It will permit them to avoid the sort of natural selection, where governments are restrained from increasing taxes by having to compete for greater tax efficiency. The European’s efforts are particularly troublesome since the type of taxes imposed – double and treble taxation of savings and investment – is counterproductive to capital mobility and global prosperity. Secretary O’Neill and other in the Administration, while cognizant of the need to enforce U.S. tax laws, have rightfully rejected these initiatives as problematic for the U.S. and other capital importing nations, especially because they nullify the salutary effect of promoting global tax competition for lower marginal rates on

capital returns and limited government. Recently, the EU savings tax directive -- a European initiative expressly dependent on U.S. approval -- has been resoundingly rejected by the Administration.

Through the rulemaking, the Service usurps and likely abrogates U.S. policy discussions with European and United Nations officials over such tax information exchange initiatives. The current proposal appears to be tailored to accomplish through regulation, what has been rejected by the Administration in order to satisfy the interests of our European friends who continue to lobby assiduously for U.S. approval of the European Savings Tax Directive. Thus, the rulemaking is meant to resolve a policy question, and one that has been resolved in the opposite direction by Congress and the Administration. Policy of this magnitude should be decided in a policymaking forum, and not through regulatory processes.

The IRS' ostensible rationale for requiring filing of Form 1042-S is faulty. The IRS suggests extension of reporting requirements is appropriate for two reasons. First, the Treasury argues that by requiring routine reporting to the IRS of bank deposit interest paid within the United States, we would minimize the possibility of avoidance of the U.S. information reporting system through U.S. residents' false claims of foreign status by U.S. residents. Again, however, under current Code, once a foreigner has filed a W-8 establishing foreign status, there is no need to file a Form 1042-S with respect to interest payments since there is no U.S. tax imposed. If the Service believes that frequent perjurious Forms W-8 are filed, what is the magnitude of the revenue loss or the direction of the trend? Has this been quantified? Are there other ways to improve compliance, for example, by increasing penalties, broadcasting prosecutions of this felony, assigning a task force, or instituting verification procedures with foreign officials? Is not the real question, whether the W-8 filer is truly a foreign resident, and not the amount paid unless and until the U.S. determines the recipient is a U.S. resident or citizen? Cannot these suspicious payments be singled out, rather than requiring reporting *en masse*? Would the filing of the Form 1042-S really have any effect on compliance? Does not the same alleged problem that exists here, exist as well for the payment of capital gains or other zero or low tax income paid to foreigners which foreign governments would view as sources of revenue? And most fundamentally, isn't this one of the central problems that the complex and extremely voluminous qualified intermediary rules were designed to address?⁵

Second, the IRS argues that several countries which have tax treaties or other agreements providing for the exchange of tax information with the United States have asked for information concerning bank deposits of individual residents of their countries. However, while Treasury and the IRS believe it is nice for the United States to try to facilitate, wherever possible, the effective exchange of all relevant tax information with

⁵ The QI rules are primarily set forth in Treasury Regs. §1.1441-1(e)(5), Rev. Proc. 2000-12 (2000-4 Internal Revenue Bulletin 387) effective January 24, 2000 and Notice 2001-4 (Internal Revenue Bulletin 2001-8, January 8, 2001). See also Announcement 2000-48. It is, at some level, remarkable that such a short statutory provision can give rise to so many hundreds of pages of rules, including the regulations under section 1441, the various information reporting requirements related to withholding, Revenue Procedure 2000-12 relating to QIs, and the many country specific attachments and approved KYC rules.

our treaty partners, this is not a sufficient reason to mandate costs on U.S. businesses to become tax enforcers for foreign governments or to ignore Congressional policy. Congress, with strong bi-partisan support, has enacted laws to attract foreign capital. Imposing needless costs on financial intermediaries attracting that capital and imposing needless disincentives to successfully attracting that capital is diametrically opposed to Congressional intent.

To examine the economic costs of the proposal more specifically, consider the current law. If a NRA is engaged in a U.S. trade or business, a tax is imposed on income that is “effectively connected” to that trade or business; but if a NRA is not engaged in U.S. trade or business, a flat rate of 30 percent is imposed on income that is “fixed or determinable, annual or periodic income.” This means that a 30 percent tax is imposed on the gross income from dividends, interest and royalties from patents and copyrights coming from U.S. sources. This 30 percent rate still applies even if the NRA is engaged in the U.S. trade or business, as long as the income is not effectively connected. When it applies, no deductions are allowed even though attributable to the income taxed. The tax is generally collected by means of withholding by the person making the payment to the foreign recipients. Because the full 30 percent is withheld, there is no reason for the foreign person to file a tax return with the U.S.

Without more, this 30 percent tax on investment income would be a huge disincentive to investment. It would be levied in addition to any resident state taxes. This being said, the U.S. 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. A number of provisions exempt from tax certain categories of U.S. source income received by NRAs. For example, interest on bank deposits with U.S. 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 U.S., 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.

Although the regulation is limited now to bank deposit interest earned by certain countries’ residents, if one agrees with 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 interest (both of which are not currently taxed). Enacted in 1984, the portfolio interest exception (section 871(h)) is perhaps the greatest single example of our 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 U.S. 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 U.S. 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 1984 report accompanying the legislation (Tax Treatment of Interest Paid to Foreign Investors (JCS-23-84: April 28, 1984)), U.S. 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 U.S. 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 U.S. – Netherlands Antilles treaty, and exemptions claimed from the U.S. withholding tax on the interest payments by the U.S. 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 U.S. or Netherlands Antilles withholding tax on the interest paid by the U.S. 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 U.S. corporations decreased [They decreased] in large part due to questions about the exemption from the U.S. 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 U.S. 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 U.S. 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 or repeal is to cause foreign investors to shift from short to medium term U.S. securities ..., then medium term interest rates would decline [T]his would benefit the U.S. 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 U.S. 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 estimates that private foreign investment here is \$8 trillion, of which about \$1 trillion is bank deposits.⁶ There are also many foreigners that own Treasuries and hold bonds.

In summary, the regulation operates at cross purposes with the successful Congressional policy inaugurated in 1984 of attracting foreign capital to the United States. The regulation, if implemented, will have a substantial adverse impact on U.S. capital markets and the U.S. economy by encouraging a significant portion of the estimated one trillion dollars attracted by the portfolio interest exception to be withdrawn from U.S. capital markets.

III. The Service is Patently Ignoring Procedural Requirements

The Service has determined:

that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

In other words, the Service is claiming that the proposal is not subject to the Executive Order 12866, is not subject to the Administrative Procedure Act, and is not subject to the Regulatory Flexibility Act. Apparently, the only reason why the Service promulgated the rulemaking as a proposed regulation and not a notice or lesser pronouncement (or did so retroactively which would also be permitted) is to attempt to *pro forma* satisfy the procedural requirements that the rulemaking be issued in regulatory form to justify the imposition of reporting requirements under IRC 6049. However, the Service is wrong in seeking to excuse itself from these and other procedural safeguards. It is wrong not only legally, but as a matter of principle. These safeguards are not punishments that dilate the process, but rather tools meant to assist in the promulgation of better rules.

While not discussed in detail here, the Service issues are raised about whether the routine disclosure of this “return information” is permissible within the meaning of section 6103(2)(A) or under tax treaties. Under section 6013(k) tax information properly collected may be disclosed to competent authorities under tax conventions, “but only to the extent provided in, and subject to the terms of, such convention or bilateral agreement.” The various treaty provisions – typically under Article 11 --

⁶ See, e.g., “New Threats to Foreign Investment: The U.S. Treasury and Information Sharing,” Stephen J. Entin, Competitive Enterprise Institute and Institute for Research on the Economics of Taxation (Congressional Advisory #116).

impose a zero rate of taxation on interest income and the information shared therefore are not needed to avoid double taxation or to prevent fraud. The application of the backup withholding provisions also raise issues as they apply a sort of penalty to residents of treaty countries who do not provide necessary forms for the U.S. to report the amount of income paid to the treaty country. It is questionable whether Article 11 countenances backup withholding of interest since the U.S. has already agreed to a zero rate of withholding.

A. The Rule is Subject to APA Section 553(b)

An understanding of the significance of the procedural breaches in implementation of the rulemaking should begin with the Service's implicit assertion without explanation that the rule is "interpretive" in nature and therefore not subject to the APA. By side-stepping the APA, the Service is able to argue that it is neither subject to the same judicial review provisions of the APA nor to the requirements of the Regulatory Flexibility Act. If that were the case, the logical corollary is that notice and comment would not be needed. However, the APA clearly applies to this rulemaking.

The Service is implicitly maintaining that this rule, as other rules not expressly mandated by the Congress in the underlying statute, can be successfully labeled an "interpretive" rulemaking. In 5 U.S.C. 553(b), the APA provides that:

[A] [g]eneral notice of proposed rulemaking shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. ... Except when notice or hearing is required by statute, this subsection does not apply ... to interpretive rules [or] general statements of policy (emphasis added).⁷

The statute continues:

After notice required by this section, the agency shall give interested persons an opportunity to participate in the rulemaking through submission of written data, views or arguments with or without the opportunity for oral presentation.... The required publication or service ... shall be made not less than 30 days before its effective date, except ... interpretive rules and statements of policy (emphasis added).⁸

⁷ 5 U.S.C. 553(b)(3)(A).

⁸ *Id.* at 553(d)(2).

The Service’s Pavlovian reflex that the rule is “interpretive” is not supported by legal precedent. Courts have routinely found that substantive rulemakings have resulted from agency pronouncements, even where the Congress has not mandated the regulation. In *Columbia Broadcasting Systems, Inc. v. United States*, for instance, the Supreme Court held that a regulation of the Federal Communications Commission constituted an order subject to judicial review.⁹ In so holding, the Court emphasized, “[t]he particular label placed upon it by the Commission is not necessarily conclusive, for it is the substance of what the Commission has purported to do and has done which is decisive.”¹⁰ In *Pharmaceutical Manufacturers Association v. Frinch*,¹¹ the District Court of Delaware found:

The Commissioner has characterized the regulations as “procedural and interpretive” and thus contends that they fall within the exception to the notice and comment requirement. But the label placed on the rules does not determine whether the notice and comment provisions are applicable. ... Attempting to provide a facile semantic distinction between an “interpretive and procedural” rule on the one hand and a “substantive” rule on the other does little to clarify whether the regulations here involved are subject to the notice and comment provisions Rather that determination must be made in the light of the basic purpose of those statutory requirements. .

The court went on to find that the regulations were “pervasive in scope and [had] an immediate and substantial impact on the PMA Members.”¹² Therefore, they were substantive rules.

Similarly in *Mr. Diablo Hospital District v. Bowen*,¹³ the 9th Circuit found that “when an administrative policy acts as a substantive rule and alters an existing regulatory scheme, the policy must be adopted according to the procedures set forth in the APA.”

There are numerous other cases that support the proposition that notice and comment is required for rules of general applicability.¹⁴ Indeed, in one case, even a circular and a policy letter issued by the Bureau of Apprenticeship and Training at the Department of Labor were considered substantive rulemakings subject to the APA notice and comment requirements.¹⁵ And some courts have found that the exception for interpretive rules does not extend to rules that are intended to have the force of law.¹⁶

⁹ 316 U.S. 407.

¹⁰ *Id.* at p. 416.

¹¹ 307 F.Supp 858 (D.Del. 1970).

¹² *Id.* at 864.

¹³ 860 F.2d 951 (9th Cir. 1988).

¹⁴ *Texaco, Inc. v. Federal Power Commission*, 412 F.2d 740 (3rd Cir. 1969); *National Motor Traffic Association v. United States*, 268 F. Supp 90 (D.Ct. D.C. 1967), *aff’d*, 393 U.S. 18; *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 764; *Seaboard World Airlines, Inc. v. Gronouski*, 230 F.Supp 44, 46 (D.D.C. 1964).

¹⁵ *See, Associated Builders and Contractors, Inc. v. Reich*, 922 F.Supp 676 (D.Ct. D.C. 1996).

¹⁶ *National Nutritional Foods Association v. Weinberger*, 512 F.2d 688 (2nd Cir. 1975), *cert. denied*. Of course, as no rationale is provided for why the Service claims inapplicability of the APA, the Service could conceivably claim that the rulemaking is a general statement of policy; however, this is even more difficult to justify. Under the APA, statement of policy merely guide future exercise of agency discretion by advising agency officials, staff and public of the manner in which the agency intends to exercise discretionary power. A policy statement is distinguishable from the substantive rule in part in that it leaves agency decision-makers free to exercise their own discretion. *See, Professionals and Patients for*

The Service's proposed rule here clearly was issued with discretion. The rule clearly has substantial impact and wide applicability. The rule was intended to affect all recipients of U.S. interest from enumerated nations. The proposal was intended as a substantive rule that would alter an existing statutory scheme which does not require reporting in the absence of a rule. The rule is also intended, upon finalization, to have the force of law.

If the Service now maintains that this rulemaking is not subject to the APA then it will go against the weight of such legal precedent, but it will also go against this Service's own outward representation as to the standards it applies. For example, in the testimony of Commissioner Roscoe Egger before a House Subcommittee, he asserted that the difference between the rules is primarily "the degree of discretion that we have in applying the rules. In other words, if the statute is not specific but says 'this is the objective we want to achieve and you (IRS) write the rules to achieve it' we regard those as legislative; but when they say 'these are the rules,' obviously then they are interpretive."¹⁷ To find out how much discretion was given and discretion was exercised, one must look to the underlying law and compare it with the proposed rule. We assert that the Service has exercised discretion delegated under IRC section 6049. In fact, it has exercised such "discretion" that it has wrongly engaged in policymaking.

As an aside, it is important to note that the Service's pronouncement that the APA does not apply is technically the same statement repeated verbatim in thousands of rulemakings since enactment of the RFA.¹⁸ During the past 17 years, the Service has habitually maintained that rules were not subject to the RFA on the grounds that they were "interpretive" only.¹⁹ We hope the rubber stamp is wearing thin.

B. The Service Failed to Conduct a Regulatory Flexibility Analysis

By claiming that the rule is interpretive, the Service tries to then make the argument that the Regulatory Flexibility Act is inapposite by claiming that the rulemaking "do not impose a collection of information (sic) on small entities." Title 5 U.S.C. 603 provides that "the [RFA] applies to interpretive rules ... but only to the extent such interpretive rules impose on small entities a collection of information requirement."

Reliance on this exception is misplaced for two reasons. Of course, as noted, the rulemaking is not interpretive, but substantive. The exception to the RFA, therefore, is inapposite. Assuming *arguendo* that the Service were to properly invoke this exception,

Customized Care v. Shalala, 847 F. Supp 1359 (D. SD. Tex. 1994); and, Jean v. Nelson, 711 F.2d 1455 (11th Cir. 1983).

¹⁷ See, Testimony of Commissioner Roscoe Egger, Internal Revenue Service, Implementation of the Regulatory Flexibility Act: Hearings Before the Subcommittee on Special Small Business Problems of the House Committee on Small Business, 99th Cong., 2d Sess. (1986), p. 70.

¹⁸ Pub. L. No. 96-354. (codified in Title 5 U.S.C. 600 *Et seq.*).

¹⁹ The Service was able to escape application of the RFA through this assertion since, according to the Judiciary Committee's Report on the bill, "The APA is the fundamental legislation upon which the Federal rulemaking is based, and, together with the case law that has grown up around it, provides a foundation for nearly all significant regulatory agency actions." *See*, S. Rep. No. 878, 96th Cong. 1st Sess., 10.

the spirit and the letter of the RFA would still subject this rulemaking to the RFA, because the very purpose of this rulemaking is to impose a collection of information requirement on payors of interest.

It is difficult to understand how the Service could make an assessment that it is not subject to the RFA in this rulemaking because there is no collection instrument. The assertion is particularly troublesome when one considers that during consideration of the Taxpayer Bill of Rights, and the regulatory reforms that led to SBREFA, the Service argued assiduously that it should be exempted from the normal RFA procedures applicable to other agencies, and should not be required to perform an RFA unless there is a collection requirement. The Service embraced that requirement.

Collection requirements are the heart and soul of this proposed rule. The sole purpose of the rulemaking is collection and transmittal of information to the Service and to foreign governments on interest paid to non-resident-aliens. The Service states, “[t]he collection of information is mandatory. The likely respondents are businesses and other for-profit institutions.” The Service states, “these proposed regulations affect persons making payments of interest with respect to ... deposits [in U.S banks and financial institutions]. The Service specifically requests comment on “how the quality ... of the information to be collected may be enhanced; [h]ow the burden of complying with the proposed collection of information may be minimized, ... estimates of ... start-up costs and costs of operation, maintenance, and purchase of service to provide information.” The collection of information requirements in these proposed regulations are in Secs. 1.6049-4(b)(5)(i) and 1.6049-6(e)(4) (i) and (ii).

Moreover, the degree of collection requirements that trigger an RFA are admitted by the Service. The RFA exception for rules that do not impose recordkeeping requirements is narrowly crafted. Under Title 5 U.S.C. §601(7) the term ‘collection of information’ means “the ... causing to be obtained ... of facts ... for an agency, regardless of form or format, calling for ... identical reporting or recording requirements imposed on, 10 or more persons.”

In interpreting this provision, the Honorable Henry J. Hyde, the sponsor of the legislation in the House embellished the Congressional Record of April 19, 1996. According to Congressman Hyde the IRS should take an expansive view of this requirement:

Many IRS rulemaking involve “interpretive rules” that the IRS contends need not be promulgated pursuant to 553 of the Administrative Procedures Act. However, these interpretive rules may have significant economic effects on small entities and should be covered by the RFA ... The requirement that IRS interpretive rules comply with the RFA is further limited to those involving a “collection of information.” The terms ... is defined in the Act The intend to the phrase “collection of information” in the context of the RFA is to include all IRS interpretive rules of general applicability that lead to or result in small entities keeping records, filing reports or otherwise providing information to IRS or third parties. ... [M]ost IRS interpretive rules involve some aspect of defining or establishing requirements for compliance with the CFR or otherwise require small entities to maintain records to comply with the CFR now [are] covered by the RFA. ... [T]o reduce compliance burdens ... wherever possible ... the IRS should take an expansive approach in interpreting the phrase “collection of information” when considering whether to conduct a regulatory flexibility analysis.²⁰

This particular rule requires reports to be maintained by many more than 10 persons, and its impact would be substantially greater than the impact of a collection requirement on 10 persons. In the Paperwork Reduction Act section of the proposal, the Service itself avers that the estimated number of respondents would number 2,000.

While the substantiality of this collection requirement is not material, the Service is clearly wrong in downplaying not only the number of effected entities, but the costs and burden hours imposed. While the estimated average annual burden per respondent and/or record keeper required is under Secs. 1.6049-4(b)(5)(i) and 1.6049-6(e)(4) (i) and (ii), the Service actually seeks to quantify the burden only insofar as the statement required by Sec. 1.6049-6(e)(4)(i) is concerned. The Service posits that the total nationwide annual reporting burden is merely 500 hours, because the average annual burden per respondent (of which there are an estimated 2,000) is merely 15 minutes.

With all due respect, it would take that long just to speed read the proposed rule.

Moreover, the Service’s estimate ignores the time involved in securing legal and accounting advice, establishing or modifying information technology systems to comply with the rule, extracting the relevant information, printing and mailing the forms to the customer and the IRS, etc. Quite apart from out-of-pocket costs, are estimated revenue losses from the flight of capital. 500 hours is an absurdly low estimate for reporting on thousands of accounts amounting to approximately one trillion dollars. The estimate demonstrates conclusively that the IRS has no conception of the real-world effects of its actions on the private sector. What is ironic, is that by ignoring the procedural mandate conduct a regulatory flexibility and the cost-benefit analyses, the Service bypasses the means by which it can obtain a more realistic view of costs.

Not only is the collection requirement central to the rulemaking, but what is most disturbing, the Service knows the collection requirements are the one thing that triggers an RFA. This suggests that the denial of the obvious is an attempt to skirt the procedural requirements.

²⁰ Cong. Rec. (April 19, 1996), incorporating within the Extension of Remarks a Speech by Honorable Henry Hyde of March 28, 1996, p. E572-573.

The importance of the requirements are highlighted by President Bush's Recent EO (Executive Order 13272--Proper Consideration of Small Entities in Agency Rulemaking (August 13, 2002)). That EO requires the IRS, as all agencies, to establish procedures and policies to promote compliance with the Regulatory Flexibility Act, as amended (5 U.S.C. 601 et seq.), which includes the thorough review of draft rules to assess and take appropriate account of the potential impact on small businesses, small governmental jurisdictions, and small organizations, as provided by the Act.

C. The Service Ignored Executive Order 12866

The Service has also violated Executive Order 12866. That Executive Order, issued September 30, 1993, was intended "to reform and make more efficient the regulatory process ... and to make the process more accessible and open to the public." Under its 'Statement of Regulatory Philosophy and Principles,' the Order provided that:

Each agency shall tailor its regulations to impose the least burden on society, including individuals, businesses of differing sizes, and other entities (including small communities and governmental entities), consistent with obtaining the regulatory objectives ...

The Order applies to "significant regulatory action", meaning any regulatory action that is likely to result in a rule that may have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, or a sector of the economy. Simply put, a rule that has the potential to cause hundreds of billions of dollars of capital to leave the United States will have an annual effect on the economy of over \$100 million.

In the event the rule is a "significant regulatory action" numerous steps are mandated. One of the principal steps is an assessment of the potential costs and benefits of the regulatory action, including an explanation of the manner in which the regulatory action is consistent with a statutory mandate. This assessment is to include the underlying analysis of costs anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation).

As in the case of the RFA, there is little question but that the Executive Order should have been triggered given the breadth and scope of this rule. To take one measuring device, the Treasury might want to take the future value of the 1984 tax expenditure estimate for the portfolio interest exception and adjust it to account for the loss of deposits. However, there is no indication that the Treasury Department even considered this possibility or performed an estimate of predicted economic loss.

D. The Service has Failed to Comply with the OMB Circular 94-A Requiring a Cost-Benefit Analysis

There is no mention of cost-benefit analysis in the Special Analysis, despite the requirement for such an analysis as noted above. The Service should itself publish a

thorough cost-benefit analysis for review on this rulemaking and seek comment on such an analysis before promulgating the rule.

OMB Cir. A-94 states that "benefit-cost analysis is recommended as the technique to use in a formal economic analysis of government programs or projects." Through it, agencies try to determine whether a government program can be justified on economic principles, i.e. whether the monetized value of expected net benefits greatly exceed costs. According to OMB Circular A-94, cost-benefit analyses "that arise in relation to particular measures" can be useful, although highly subjective, since they impose a form of logical self-constraint on rulemakings. Net present value is computed by assigning monetary values to benefits and costs, discounting future benefits and costs using an appropriate discount rate, and subtracting the sum total of discounted costs from the sum total of discounted benefits."

Although net present value is not always computable (and it does not usually reflect effects on income distribution), efforts to measure it can produce useful insights. It is clear that Treasury has not engaged in a serious analysis of the compliance costs imposed on the private sectors. Has Treasury considered the costs of providing sensitive information to foreign nations and whether the requirements of section 6103 would be met?

A comprehensive enumeration of the different types of costs and benefits whether monetized or not, can be helpful in identifying the full range of effects. Rather than doing any of this, Treasury simply asserts that the standards are "required" to enforce U.S. tax law. How? What specific monetized benefit to they provide? Quantifying benefits and costs should be prerequisites to such a change in U.S. tax policy.

Conclusion

The IRS and Treasury rightfully concluded that the 2001 proposed regulations were overly broad in requiring annual information reporting with respect to U.S. bank deposit interest paid to any NRA. However, the changes in this proposed rule do not address the underlying infirmity that itself warranted immediate withdrawal.

The rulemaking is fatally flawed, and not merely because some detail in the regulation fails to properly diminish administrative costs, make reporting clearer or deal with such logistical trivialities as ensuring Form 1042-S requirements accommodate joint accounts or whether payors may rely on actual knowledge of the individual's residence address. The rulemaking is flawed because it is based on a misguided policy assumption that it is the Treasury's role, at great loss to the economic interests to the U.S., in contravention of developing U.S. policy, and in violation of key procedural requirements, to help enforce the extraterritorial tax systems of foreign nations.

The U.S. has prospered in part because it is an attractive venue for foreign investment. Certainly, we have offered a productive economy, relatively safe from government interference or fraud. Most relevant to the discussion at hand, we have maintained low

tax rates that act as a magnet to attract mobile capital to our shores. European nations are not reluctant to use legal devices such as refundable, border adjustable value added taxes or tax sparing to gain competitive advantage, or to attack U.S. efforts of a much smaller scale. The U.S. should not be cajoled into repealing what is an honest means of attracting foreign capital. Unilaterally abdicating our superior position will only accommodate the European interest in enforcing high marginal tax rates on mobile sources of income with no advantage to the U.S.

In summary, the proposed regulation will:

- unilaterally abdicate U.S. bargaining positions on other issues;
- use U.S. government and private resources to help collect foreign taxes;
- harm the U.S. economy;
- harm U.S. capital markets
- encourage bad global tax policy;
- disregard sound U.S. Congressional policy and intent; and,
- short-circuit procedural protections under domestic law in order to do so.

Accordingly, we respectfully request that this rulemaking, like its predecessor be withdrawn forthwith. We also request an opportunity to be heard at the hearing scheduled for December 5th, 2002. Enclosed is out outline.

Sincerely yours,

Phil Kent
President

Lynn Hogue, Chairman
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