viewpoints

The 'U.S. Anti-Savings Directive'

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Pop Quiz

Please try this tax-policy spot quiz. There are only two standard questions and a bonus essay. First, a multiple choice question:

What do the European Union (EU) "Savings Directive," the Organization for Economic Cooperation and Development (OECD) "Harmful Tax Competition Initiative," and the recent Internal Revenue Service rulemaking entitled "Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens" have in common?

A. They are all examples of the extraordinary degree to which privacy rights must be sacrificed to sustain extraterritorial double taxation of saving in today's digital world.

B. They are all examples of how the United States government would become the business-tax collector for European countries wishing to impose double taxation on investments in the U.S.

C. None of the initiatives is actually needed to enforce U.S. tax law.

D. All the proposals are economically harmful and legally dubious because they would require the IRS to exceed its statutory authority by taking actions that would drive investments away from the United States and stifle beneficial competition among nations to attract mobile capital by providing a better tax environment.

E. They are all nearly the same proposal simply reconstituted in a different form.

F. All of the above.

If you answered "F. All of the above," you would be correct. Now try the elimination question:

Which of the following statements is (are) false?

A. The Bush administration opposes the EU Savings Directive.

B. The Bush administration opposes the OECD Harmful Tax Competition Initiative.

C. The Treasury renounces the interest-reporting requirements that were first proposed in the final days of the Clinton administration.

If you chose "C," you would be correct. The Service embraces the goals of the interest-reporting requirements, and recently reintroduced these requirements, while both the White House and Treasury have announced their public opposition to both the EU and OECD initiatives.

Now, for extra bonus points:

> Please explain how the administration can oppose multilateral information exchange as proposed by the EU Savings Directive and the OECD Harmful Tax Competition Initiative and yet permit the Treasury Department to embrace unilateral information exchange via the rulemaking.

When done with the last essay, please submit the response to the Treasury Department before they send the Europeans this Christmas present.

Background

Just as the tax code has become an instrument of social engineering for politicians, over and above its primary purpose of raising revenue for the government, so too has the tax-enforcement process become an instrument of general law enforcement for law-enforcement stretching far beyond the enforcement required to collect the taxes levied by the code.

The economic law of diminishing returns applies to tax-law enforcement just as it does to every other human endeavor. As a general proposition, resources should be expended on tax-law enforcement only up to the point at which the marginal (additional) increase in tax revenues generated by the extra enforcement effort exceeds the cost of the additional enforcement activities. It goes without saying that no amount of additional revenue can justify tax-enforcement activities that are in violation of the law or violate individuals' rights. And, even for the legal and socially acceptable curtailments of individual freedom required to enforce the tax law, the same calculus of diminishing returns should also apply.

Although the current IRS rulemaking on deposit interest is justified by the Service on the grounds that it is a legal and socially acceptable means of improving the enforcement of U.S. tax law and enhancing federal revenue collections, the real impetus behind the rulemaking is to expand the practice of using the tax code as a mechanism to enforce indirectly nontax federal laws that are otherwise difficult or impossible to enforce, such as money-laundering laws. In and of itself, the proposed rule would be inadequate to accomplish this broader "law-enforcement" objective. Further, more stringent and more encompassing regulations would be required. Therefore, the proposed rule must be understood both in terms of the larger context of other "information-reporting" requirements being considered internationally and in terms of the additional steps that would be required by the Treasury to accomplish these broader law-enforcement objectives."

To understand how closely the triad of proposals — the EU Savings Directive, the OECD Harmful Tax Competition Initiative, and the proposed IRS rulemaking — intertwines, consider their genesis. The EU Savings Directive was proposed at the European Council meeting in Feira, Portugal, in June 2000 and approved by the Council of Finance Ministers in November of that year. That directive, awaiting final approval, proposes that nations automatically exchange information on the investment earning of foreign investors.[1] To come into force, the directive must receive unanimous support from all EU Member nations, and six non-EU jurisdictions must agree to participate, including the United States, since the "proposal could incite paying-agent operations to relocate outside the EU." The directive seeks to overturn existing international norms in that nations would have no choice but to collect and disseminate information on foreign investors, although there is no need to amass that data for purposes of domestic law or administrative practices.[2]

The OECD Harmful Tax Competition Initiative emerged from an instruction from ministers to "develop measures to counter the distorting effects of "harmful tax competition" on investment and financing decisions and the consequences for national tax bases." In April 1998, the OECD Council adopted a Recommendation to the Governments of Member Countries and issued a report entitled "Harmful Tax Competition: An Emerging Global Issue." Worried that low-tax countries would attract "too much" capital from high-tax countries, OECD advanced the position that it was necessary to engage in a collective international effort to stop "harmful tax competition" by "harmful tax regimes."[3] To define the evil, the OECD considers a country a "harmful tax regime" if it has low tax rates, allows foreigners to invest at favorable tax rates, and respects financial privacy. To combat this perceived evil, the OECD was demanding that each jurisdiction sign a Memorandum of Understanding (MOU) agreeing to change its ways, or if it refuses, be "blacklisted" as a noncooperating jurisdiction. If so blacklisted, the OECD is prepared to impose sanctions including the disruption of normal banking and business operations, heretofore reserved for rogue nations that inflict the most grievous human rights violations. The U.S. was not specifically named as a culprit, out of respect for our diplomatic clout — although smaller nations were so named.

Widespread opposition within the United States convinced the administration to oppose both European initiatives on the grounds that the world's largest beneficiary of foreign investment, the United States, would suffer capital flight under both proposals. An even larger concern is that U.S. legal protections would be undermined by automatic information exchange.

The 'U.S. Anti-Savings Directive'

Now enter the proposed interest-reporting rule formally entitled, "Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens."[4] On January 17, 2001, immediately before the change in U.S. administrations, the Service promulgated this proposed rule to require payors of interest to all U.S. nonresident 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 17 rulemaking greatly enlarged on an extant rule that required reporting only of interest paid from U.S. banks to residents of Canada [reg. section 1.6049-8(a)]. The latest iteration withdraws the widely and strongly criticized January 17 proposal, but narrows its scope only slightly. 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 — surprisingly the same countries that are behind the EU Savings Directive and the OECD harmful tax competition initiative. 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.

Interestingly, the Florida Bankers Association and other groups were at first jubilant about the narrow scope of the rule, if only because it takes first aim at

[1]The European Union is a Brussels-based international organization representing the 15-member European Community. A description of the Savings Tax directive can be found at http://europa.eu.int/comm.taxation_customs/publications/official_doc/IP/ip011026/memo01266_en.pdf.

[2]Weiner, "EU Savings Talks Collapse at EU Finance Ministers Meeting," *Tax Notes*, Dec. 9, 2002, p. 1279, sheds light on further developments. That article points out that the EU Council of Economics and Finance (ECOFIN) ministers recently conceded they could not reach agreement on the controversial EU savings tax directive. The article stated, "The European Union must not only reach agreement among its own members, but it must also gain agreement with five other countries, including the United States, for the savings tax package to come into force. . . . The commission has also held negotiations with Andorra, Liechtenstein, Monaco, San Marino, and the United States to gain agreement among them to adopt 'equivalent measures'."

[3]For example, the report states at p. 14, section 23, "Globalization has, however, also had the negative effects of opening up new ways which companies and individuals can minimize and avoid taxes and in which countries can exploit the new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital."

[4]REG-126100-00, *Doc 2001-1610 (12 original pages), 2001 TNT 11-17*.

the Europeans. However, when Treasury reloads, capital instead from South America and elsewhere will be in its sights. 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 expand on 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. nonexempt recipient is generally subject to backup withholding.

Although the proposed regulation, by its terms, is limited to bank-deposit interest, the Treasury was correct in warning about its dilation. The rationale of the rule is not limited to payments of interest, or bank-deposit interest payments to residents of the enumerated nations. The logic of the rule would require similar reporting for other payments, such as portfolio interest and capital gains, and eventually to all U.S. nonresident 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 to the Europeans. There is very little doubt that the rulemaking was in response to European pressures to adopt an American equivalent of the EU Savings Directive, which more appropriately should be called the "U.S. Anti-Savings Directive" because that would be its consequence.

The Treasury's interest-reporting regulation (the U.S. Anti-Savings Directive), like the OECD Harmful Tax Competition Initiative and the EU Savings Directive, would require the U.S. government to provide foreign governments information on their nationals but would not provide for reciprocal information flow on U.S. nationals investing in those countries. In other words, through the "U.S. Anti-Savings Directive, the U.S. government will systematically make available to Europeans the amounts paid out from U.S. financial institutions but, ironically, it will not receive similar information in exchange. Why would the administration advocate a proposal that claims is necessary to enforce U.S. tax law but fails to provide the U.S. government the information on U.S. taxpayers it claims to need? Conversely, why would the administration oppose the two European initiatives that actually would provide two-way information exchange and provide the U.S. government the information of which it claims to be in such critical need to enforce its tax law?[5]

Short Analysis of the 'U.S. Anti-Savings Directive'

The proposed rulemaking is fatally flawed, not just around the fringes. The rulemaking is flawed for the same reasons the EU Savings Directive and the OECD harmful tax competition initiatives are 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 United States — in contravention of developing U.S. policy and in violation of key procedural requirements, to help enforce the extraterritorial tax systems of foreign nations. If the EU Savings Directive and the OECD harmful tax competition initiatives were bad ideas, and they were, the Treasury has a duty to explain why this rulemaking is also not a bad idea.[6]

Before the Service implements its proposed rule, it should consider these problems with the rule:

- The collection requirements of the rulemaking may exceed the statutory authority of the IRS to impose such requirements, and hence the rulemaking may be *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 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. In fact, this assertion is belied by the administration's very refusal to support the two European initiatives, which actually would result in the U.S. government's receiving information on U.S. taxpayers that could be argued to assist the Service enforce U.S. tax law.
- The rulemaking overrides congressional and administration policy, which in turn is based on sound economic policy in the interest of the United States. As previously noted, the United States recently has rejected the "EU Savings Tax Directive" and the OECD's efforts to nullify tax competition; however, the EU would celebrate the Treasury's interest-reporting regulation as unilateral adoption of the critical component (from the EU's perspective) of its Savings Tax Directive and the anti-tax competition initiative, notwithstanding the administration's rejection of both initiatives. If implemented, this rule may provoke the exodus of billions of dollars of foreign capital on deposit in the United States, with a resulting detrimental impact on the U.S. economy and U.S. capital markets at a time when such tax generated monetary policy is clearly ill-advised. Moreover, the ruling imposes unnecessary and substantial costs on U.S. businesses in a gratuitous and extralegal attempt to help enforce the tax laws of foreign nations.
- Finally, the Service is abrogating a host of due-process requirements as set forth in statute and

[5]*See* Dana Milbank, "U.S. to Abandon Crackdown on Tax Havens, OECD Effort Is Too Broad and Could Raise U.S. Taxes, Treasury's O'Neill Says," *Washington Post*, May 11, 2002, p. A29. *See also* Statement of Paul H. O'Neill before the Senate Committee on Government Affairs Permanent Subcommittee on Investigations, OECD Harmful Tax Competition Initiative, July 18, 2001.

[6]Treasury Undersecretary Kenneth Dam has stated that the rule is not an "equivalent measure" for purposes of the EU Savings Directive. How can that be? The rule is effectively a unilateral adoption of the EU Savings Directive.

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 numerous 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.

The United States has prospered, in part, because it is an attractive venue for foreign investment. Certainly, America has offered a productive economy, relatively safe from government interference or fraud. Most relevant to the discussion at hand, the United States has maintained relatively low tax rates (thought still too high to be economically optimal) that act as a magnet to attract mobile capital to U.S. 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, nor do they hesitate to attack similar U.S. efforts of a much smaller scale. The U.S. should not be cajoled into repealing what is an honest and economically rational means of attracting foreign capital in some altruistic attempt to help EU-member states counteract their own economically harmful tax policies. Unilaterally abdicating the United States' 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. or the world economy.

For students of tax policy, wishing extra points, these arguments are explained in greater depth below. You may also want to look at the transcript of the December 5 IRS hearing, at which 10 witnesses opposed the rule, and not a single witness supported it. These witnesses included the U.S. Small Business Administration, Office of Advocacy, and the Conference of State Bank Supervisors (see *Tax Notes*, Dec. 9, 2002, p. 1272).

Brief Against the 'U.S. Anti-Savings Directive'

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."

These *pro forma* statements appear necessary if the rulemaking is to be sustained, but it is clear that there is no legal predicate for the rulemaking since it is not needed to enforce U.S. law. Nor could one reasonably expect any direct improvement in tax-law enforcement if the rule were adopted.

Section 7805(a) provides that:

> 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].[7]

Section 6001 specifies the conditions under which the Service can require returns:

> *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, 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 therefore*, 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.

The Service's reliance on 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. 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 sections 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."

[7]All section references throughout this article are to the Internal Revenue Code unless otherwise indicated.

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 regarding interest under 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.[8] The proposed regulation should be void as arbitrary and unreasonable since it is not "reasonably related to the purposes of the enabling legislation."[9] 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, especially in light of the fact that the administration explicitly rejected two European initiatives requiring similar U.S. interest reporting that also provided for reciprocal reporting by foreign nations on beneficial payments to U.S. taxpayers that would be taxable?

While not discussed in detail here, other 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 — impose a zero rate of taxation on interest income and the information shared therefore is 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 of the model U.S. treaty countenances backup withholding of interest since the U.S. has already agreed to a zero rate of withholding.

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. However, if that is so, how did the Service accommodate these concerns in the new rulemaking? Or did the Service instead yield to pressure from Congressman Dave Weldon, who weighed in on behalf of the Florida Bankers Association since their clientele was excluded?

Let us consider the comments received. In the comments — none of which was remotely favorable — many 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.

In fact, by excluding the entire Southern Hemisphere from the rule, the Service is tacitly accepting the notion that only by sharing information with Europeans can it best fulfill its mission of "improving compliance with U.S. tax laws." What information did the Service have that U.S. citizens or bona fide U.S. resident aliens were falsely claiming residence in Europe as opposed to say, Columbia, Mexico, China, or for that matter, the Middle East? And more to the point, since the U.S. would impose tax only if these individuals were residents or citizens, why can't the Treasury Department simply ask the State Department for the status of these individuals? Is reliance on European immigration officials more trustworthy than our own?

The main problem is not that this newly "reconstructed" rule would continue to impose costs — which it does — but that it is for all intents and purposes unreconstructed and will impose these costs needlessly, without a rational basis and in derogation of sound U.S. policy, enacted into law and expressed in recent Bush administration policy pronouncements, to attract investment from abroad. The United States is perhaps the world's largest "tax haven," by congressional choice, and this proposal would illegitimately 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 $1 trillion to the United States. Reversing this policy risks driving hundreds of billions of dollars out of the

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[8]"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).

[9]*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).

United States. This is a risk that is certainly not worth taking for a regulation that not only is unnecessary to enforce U.S. law.

As the Treasury is aware, through the OECD 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 either stop seeking to attract mobile sources of capital through lower tax rates or, in the alternative, routinely share financial information on savers and investors. This policy, if universally implemented, would enable governments to impose high extraterritorial taxes with impunity — taxes that have driven the funds the EU is chasing offshore in the first place.

Asset mobility, like freedom to emigrate, creates a natural check on governments against excessive taxation. The European initiatives are designed specifically to destroy that check by eliminating the beneficial competition among nations to provide a popular mix of public goods and services at the lowest possible tax rates.

The Europeans' efforts are particularly troublesome since the type of taxes they seek to preserve — double and treble taxation of saving and investment — are counterproductive and retard economic growth. By disrupting asset mobility, the proposals prevent capital from being efficiently allocated around the world, which undermines global prosperity — all so that it is easier for politicians to raise tax rates and maintain them at levels that citizens would not otherwise tolerate if the EU cartel of governments were not able to intervene and tamper with global capital markets through their directives and initiatives.

Former Treasury Secretary Paul H. O'Neill and other administration officials, while cognizant of the need to enforce U.S. tax laws, have rightfully rejected these directives and initiatives as problematic for the United States 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 — was resoundingly rejected by the administration.

Remarkably, through its own rulemaking, the IRS is attempting to undermine settled U.S. policy while usurping and likely abrogating the Bush administration's policy discussions with European and United Nations officials over such tax-information-exchange initiatives. The current proposal appears to be tailored to accomplish indirectly through regulation what has been rejected directly by the administration to satisfy the interests of our European friends who continue to lobby assiduously for U.S. approval of the EU Savings Directive. The rulemaking, thus, can have no purpose other than to reverse a policy decision already taken by Congress and the administration. If that policy is to be reversed, the Constitution demands that it be done through proper legislative action, not regulatory rulemaking.

The IRS's ostensible rationale for requiring filing of Form 1042-S is faulty. The Service 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, it would minimize the possibility of U.S. residents avoiding U.S. information-reporting requirements through false claims of foreign status. Again, however, under the current code, once a foreigner has filed a W-8 establishing foreign status, there is no need to file a Form 1042-S for interest payments since no U.S. tax is 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 that 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?[10]

Second, the IRS argues that several countries that have tax treaties or other agreements with the United States providing for the exchange of tax information 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 tax information with 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 bipartisan 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.

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[10]The QI rules are primarily set forth in Treasury reg. section 1.1441-1(e)(5), Rev. Proc. 2000-12, 2000-4 IRB 387, *Doc 2000-1307 (65 original pages)*, *2000 TNT 6-7*, effective January 24, 2000, and Notice 2001-4, 2001-2 IRB 267 (January 8, 2001), *Doc 2000-31816 (19 original pages)*, *2000 TNT 238-13*. *See also* Announcement 2000-48, 2000-23 IRB 1243, *Doc 2000-13805 (3 original pages)*, *2000 TNT 95-15*. 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.

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, which is to treat investments in the U.S. similarly regardless of the status of the investor. A number of code and treaty 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 (section 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 U.K., 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 the rulemaking relates.

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 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 our attempt to attract offshore investment. This provision exempts from tax most U.S.-source "portfolio interest" received by an NRA. With respect to interest on "bearer" obligations, that is, obligations that are not issued in registered form, the interest can qualify as portfolio interest only if the obligations are issued in a manner that "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 10 percent or greater interest, thus ensuring that the interest is truly a "portfolio-type" investment (arm's length).

The portfolio-interest exception is perhaps the purest example of enlightened self-interest and realism in attracting foreign capital. According to the 1984 Joint Committee on Taxation (JCT) 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 U.S. 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 on 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 of 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 US economy by stimulating investment in plant and equipment. . . . " The 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 applies only to unrelated borrowers and lenders and is otherwise restricted, but it is quantitatively very important.

It is difficult to know for certain what this new rule will cost the U.S. economy (because no cost-benefit analysis was conducted). Former senior Treasury official Stephen J. Entin estimates that private foreign investment here is $8 trillion, of which about $1 trillion is bank deposits.[11] Many foreigners also own Treasuries and hold bonds.

In his December 5 testimony to the Service on the proposed rule, Entin states:

> A flight of such capital from the U.S. could entail a flight from the dollar, which would either force the Federal Reserve to raise interest rates to protect the currency, or result in a falling dollar and higher prices for imports and import-competing products. The rise in the price level could raise wage demands and reduce confidence in price stability, and would boost federal outlays on indexed programs. The Treasury has no estimate of the amounts at risk of flight, and no estimate of the effect on the dollar, domestic investment and growth, employment, or federal revenue. It is shooting blind. . . .
>
> During the adjustment period, the outflow of foreign saving would reduce the value of the dollar and elevate the U.S. price level. Short term interest rates might be a bit higher. Businesses would have a somewhat harder time raising funds for investment. The amount of capital formation would be reduced, permanently, with adverse consequences for productivity, wages and employment. Reduced output and income would trim tax revenue for federal, state and local governments. . . .
>
> Let us assume, erosion of financial privacy rules causes a shift of $400 billion in foreign saving out of the United States. . . . Assume that half of the flight capital is replaced. . . . We might . . . expect to see an ultimate reduction in the U.S. capital stock of about 0.8 percent from levels that would otherwise be achieved. . The level of employment is not likely to decrease by the same 0.8 percent as investment, but the productivity drop would add to the decline of labor output. With less labor and capital available, the level of GDP would be nearly 0.8 percent lower than otherwise. . . .
>
> In dollar terms, U.S. GDP might be reduced by up to $80 billion annually. Of that, roughly $40 billion would be a loss in after-tax U.S. wages and salaries (about $300 per worker), a bit under $30 billion would be a reduction in federal, state and local tax collections (about two-thirds, or nearly $20 billion, would be federal), and about two-thirds of the remainder would represent lower depreciation of the lost capital stock. . . .

What about tax evasion on U.S. assets held abroad by U.S. residents? In 1997, the Treasury's Statistics of Income division reported only $2.5 billion in taxes withheld on $133 billion in foreign-owned U.S.-source income, of which $97 billion was interest and $18 billion was dividends. These withheld amounts are a plausible amount of tax due on the noninterest portion of that income, assuming the interest was largely tax exempt if earned by foreign depositors. Given this, Entin asked in his testimony: "Is there enough tax evasion by U.S. residents pretending to be foreigners in these interest figures to yield $20 billion in recovered revenue from the proposed regulations?" He answered his own question as follows: "Over half of the $97 billion would have to be falsely represented offshore interest earnings of U.S. residents, with tax due at the maximum marginal tax rate of nearly 40 percent, to yield $20 billion in uncollected revenue. If only five percent of the income is going to U.S. tax evaders, there would be only $2 billion in uncollected revenue. Since most of the $97 billion is actually going to genuine non-U.S. residents, the higher figure is not a plausible scenario."

The bottom line, according to Entin, is that the reduction in federal tax collections due to the reduced national income might well exceed the additional taxes collected by means of the proposed regulations from U.S. tax evaders attempting to use foreign accounts to hide either U.S.-source or foreign-source income from the Internal Revenue Service.

In summary, the regulation operates at cross purposes with the successful congressional policy inaugurated in 1984 of attracting foreign capital to the United States, and is not justified even by outlandish predictions of U.S. resident and citizen evasion from falsely claiming foreign residency (and as discussed, asking foreign governments about U.S. residency seems a bit embarrassing at best). The regulation, if implemented, will have an unnecessary and substantial adverse impact on U.S. capital markets and the U.S. economy by encouraging a significant portion of the estimated $1 trillion 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:

[11] *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 No. 116).

> 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 Executive Order 12866, is not subject to the Administrative Procedure Act, and is not subject to the Regulatory Flexibility Act. Apparently, 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) only 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 section 6049. However, the Service is wrong in excusing itself, and 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 slow the process, but rather tools meant to assist in the promulgation of better rules.

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 assertion without explanation that the rule is "interpretive" in nature and therefore not subject to the APA. By sidestepping 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." 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).[12]

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)*.[13]

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.[14] In so holding, the Court emphasized, "[t]he particular label placed on 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."[15] In *Pharmaceutical Manufacturers Association v. Frinch*,[16] the U.S. District Court for 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."[17] Therefore, they were substantive rules.

Similarly in *Mr. Diablo Hospital District v. Bowen*,[18] the Ninth 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.[19] 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.[20] And some courts have found that the exception for

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[12] 5 U.S.C. 553(b)(3)(A).

[13] *Id.* at 553(d)(2).

[14] 316 U.S. 407 (1942).

[15] *Id.* at 416.

[16] 307 F.Supp. 858 (D.Del. 1970).

[17] *Id.* at 864.

[18] 860 F.2d. 951 (9th Cir. 1988).

[19] *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. D.C. 1967), *aff'd* 393 U.S. 18 (1968); *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).

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

interpretive rules does not extend to rules that are intended to have the force of law.[21]

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 bank 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, on 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 the Service's own outward representation as to the standards it applies. For example, in testimony before a House subcommittee, IRS Commissioner Roscoe Egger 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."[22] 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 under 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.[23] 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.[24] 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[es] 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. However, assuming *arguendo* that the Service were to properly invoke this exception, 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 requirements on payors of interest.

It is difficult to understand how the Service could conclude 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 nonresident aliens. The Service states that "[t]he collection of information is mandatory. The likely respondents are businesses and other for-profit institutions." The Service adds that "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 found in sections 1.6049-4(b)(5)(i) and 1.6049-6(e)(4) (i) and (ii).

Moreover, the Service admits the degree of collection requirements that trigger an RFA. The RFA exception for rules that do not impose recordkeeping re-

[21]*National Nutritional Foods Association v. Weinberger*, 512 F.2d 688 (2nd Cir. 1975), *cert. denied.* Of course, as the IRS provides no rationale for why it 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 guides future exercise of agency discretion by advising agency officials, staff, and the 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 decisionmakers free to exercise their own discretion. *See Professionals and Patients for Customized Care v. Shalala,* 847 F. Supp. 1359 (S.D. Tex. 1994); *Jean v. Nelson*, 711 F.2d 1455 (11th Cir. 1983).

[22]*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.

[23]Pub. L. No. 96-354 (codified in Title 5 U.S.C. 600 *et seq.*).

[24]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.

quirements is narrowly drafted. Under Title 5 U.S.C. section 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, Rep. Henry J. Hyde, R-Ill., the sponsor of the legislation in the House in remarks published in the *Congressional Record* of April 19, 1996, said 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.[25]

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 be 2,000.

While the Service's own assessment of the number of respondents well exceeds the trigger for an RFA, 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 found in prop. reg. sections 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 prop. reg. section 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. Five hundred hours is an absurdly low estimate for reporting on thousands of accounts amounting to approximately $1 trillion. The estimate demonstrates conclusively that the IRS has little conception of the real-world effects of its actions on the private sector. Quite apart from out-of-pocket costs are estimated revenue losses from the flight of capital. What is ironic, is that by ignoring the procedural mandates to conduct a regulatory flexibility, and cost-benefit analyses, the Service bypasses the means by which it can obtain a more realistic view of costs.

> ***The estimate demonstrates conclusively that the IRS has little conception of the real-world effects of its actions on the private sector.***

Not only is the collection requirement central to the rulemaking, but what is most disturbing is that 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.

The importance of the requirements are highlighted by President Bush's recent 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, 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. The Service is due to come out with its draft procedure soon.

It can be anticipated that the Service will advance two creative arguments against application of the RFA. First, the Service will argue that the collection instrument is not "new," in that the Form 1042 already exists. Second, the Service may argue that it is not a collection of information that leads to the assessment of U.S. taxes. Neither argument should be persuasive. The spirit of the RFA was to capture collection instruments that impose new "burdens" through regulatory extension, not just collection instruments that bear a new form number. Second, if the collection of information burden is not required to enforce U.S. taxes against U.S. taxpayers, which it is given the back-up withholding rules, then does this not undermine the whole rationale for the rule in the first place?

C. The Service ignored Executive Order 12866. The Service has also violated EO 12866. That Executive Order, issued September 30, 1993, was intended "to reform and make more efficient the regulatory process . . . and

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

to make the process more accessible and open to the public." Under its "Statement of Regulatory Philosophy and Principles," the EO 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 EO 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 more than $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 EO 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 OMB Circular A-94, which requires 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 Circular 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, that is, 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 sector. 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 do 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 warranted withdrawal. For the same reasons the administration rejected the EU Savings Directive and the OECD Harmful Tax Competition initiative, it should reject the idea to unilaterally adopt the "U.S. Anti-Savings Directive."