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The IRS's Qualified Intermediary (QI) Regulations: Less Investment, Less Privacy, Less Fairness

The *U.S. Internal Revenue Service* (IRS) has decided to implement new regulations governing money that is invested in America from overseas. These so-called QI (Qualified Intermediary) regulations, which will impose costly reporting requirements on foreign institutions, are ostensibly designed to increase tax collections by catching U.S. taxpayers trying to hide income earned in America from the IRS by anonymously investing through foreign institutions. To the extent that such tax evasion exists, however, tax evaders can avoid the net by shifting investments out of the U.S. While failing to reduce tax evasion, the new regulations will have an impact. Unfortunately, that impact will be negative. Likely effects include capital flight out of the U.S. market, less future foreign investment in the U.S., a loss of privacy, a reduction in national sovereignty, a reduction in international commerce, and a discriminatory burden against medium- and small-sized businesses.

Equally important, the QI regulations create a disquieting precedent. In effect, the U.S. is trying to impose rules on the rest of the world. This will create an obligation on the part of the U.S. government to acquiesce to rules that foreign tax collectors will want to impose on U.S. citizens and businesses.

The QI regulations will be simultaneously costly but ineffective. Indeed, serious shortcomings already caused their enactment to be *twice postponed.* Yet, the *legally required cost/benefit analysis* is still lacking. And while significant adverse effects are a certainty, experts foresee no real dent on U.S. tax evasion. The IRS should thus withdraw the proposal and reconsider how best to tax the U.S. income earned by U.S. taxpayers and foreigners.

What are QI Regulations?

The IRS decided to change its withholding tax regime, enforcing new QI regulations, effective January 1, 2001 which are aimed in particular at "U.S. persons"- i.e. U.S. citizens, dual nationals, green card holders, U.S. residents - who invest in the U.S. market through financial institutions abroad. Recipients of U.S.-source income are thus faced with the choice of either withdrawing their investments from the U.S. market or disclosing their identity to the IRS, under threat of a penalty of *over 30% of their investment (not just the income, but 30% of any financial flow).* The tax would be collected on behalf of the IRS by Qualified Intermediaries (QI). Overseas financial institutions practicing IRS-approved know-your-customer rules (KYC) can apply for entering into an agreement with the IRS for directly enforcing these new regulations as QIs, with IRS-approved and QI-paid fiduciaries serving as auditors acting under U.S. laws.

Are foreign investments an important component of the U.S. economy?

In its latest report, the U.S. Federal Reserve Board stated the total foreign-held U.S. financial assets to be $6.3 trillion. The Institute for International Economics puts the figure at $10 trillion. These investments have helped trigger America's unprecedented prosperity. Yet the QI regulations will encourage both "U.S. persons" and foreign investors to reduce or eliminate their investments from the U.S. market. It appears that the IRS, so far, has published no studies analyzing the risks associated with the QI regulations. More specifically, it appears that the cost/benefit analysis required by the *Administrative Procedures Act* has not been completed.

What is the Supposed Need for QI?

Unlike many other nations, the United States asserts the right to tax the world-wide income and assets of its citizens and businesses residing abroad. The IRS worries that some U.S. taxpayers may be "hiding" income by anonymously investing through foreign financial institutions. The QI regulation is designed to catch these taxpayers.

Why Is the QI Regulation Misguided?

In effect, the IRS seeks to swat a fly with a sledgehammer. To the extent that U.S. taxpayers are trying to evade taxes by investing in the U.S., through foreign institutions, they simply will shift their investments out of U.S. assets to avoid the QI regulations. These untested IRS regulations, however, will inevitably cause significant collateral damage. For instance, they will be:

Bad for investment

The QI regulations create a damned-if-you-do, damned-if-you-don't quandary for overseas institutions and investors. Failure to qualify means higher withholding taxes, yet the decision to qualify forces the institutions and investors to endure considerable red tape and a costly regulatory burden. The easy way to avoid this catch-22 is to invest someplace other than America.

- Professionals and banking executives have warned that the new regulations *"could trigger an exodus from U.S. securities."*
- The regulations would hit all persons investing in the U.S., especially non-U.S. firms.

Bad for privacy

The QI regulations, stripped of fancy rhetoric, represent an attempt by the IRS to export nosy and intrusive know-your-customer rules that force financial institutions to spy on their customers, i.e. to act contrary to their legal duties and traditional fiduciary obligations. American consumers revolted against similar provisions that regulators attempted to impose in the U.S. Yet the IRS seeks to get these invasive rules overseas.

- Foreign institutions would be forced to engage in a massive data collection exercise to determine whether or not their clients are "U.S. persons".
- This is a costly, time-consuming task, particularly given the complex rules governing dual citizens, green card holders, varying tax rules for different types of investments, and the use of multi-tiered structures and multi-country entities.

Bad for sovereignty

Using the threat of higher withholding taxes, the IRS is trying to deputize foreign institutions to assist in the collection of U.S. taxes. This puts long-term U.S. interests at risk as foreign taxmen will likely insist on and receive reciprocal treatment. The specter of foreign tax authorities having power over U.S. citizens and companies may not be to the liking of many U.S. lawmakers either—particularly since it would mean a costly new regulatory burden for U.S. institutions and investors.

- A managing partner at one overseas bank justifiably complained that *"The U.S. is trying to impose its own rules on the rest of the world."* Indeed, this effort to impose U.S. information-gathering requirements on an extraterritorial basis is not seen to be in the U.S. interests. For it could badly backfire. And it could violate and generally undermine the respect for existing tax and other treaties.
- The QI regulations interfere with nations which genuinely respect financial privacy.

Bad for free trade

The QI regulations are going to create a discriminatory system that imposes different tax rates on global investment. This favoritism is a violation of open trade rules. Moreover, the costs of compliance may simply lead many institutions to avoid the U.S. market altogether.

- In order to fully comply, foreign institutions would have to endure large information technology costs, huge legal fees, and ongoing auditing costs.
- These regulations would create a non-tariff barrier to non-U.S. investment custodians.

A regulatory burden

U.S. international tax specialists that have commented have all criticized these regulations for their extraordinarily bewildering complexity. Needless to say, it will be almost impossible for foreign institutions and investors – particularly those from the non-English speaking world – to decipher the intricacies of U.S. regulations that cross-reference numerous provisions of the *Internal Revenue Code*.

- The burden is particularly harsh for small- and medium-sized companies that lack the in-house legal assistance and/or the resources to engage costly outside counsel.
- There is high costs for interpreting *"60-odd pages of American legalese."*