New EU, U.K., and U.S. Reporting Rules on Bank Deposit Interest Paid to Nonresidents

by Marshall Langer

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In 1979 I testified at a U.S. congressional hearing on offshore tax havens at which I made the following statement:[1]

> Our present tax laws make the United States one of the best tax havens in the entire world for non-Americans (nonresident aliens and foreign corporations). For example:
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> Non-Americans are exempt from U.S. income tax on the interest they receive from U.S. banks and savings institutions.

That statement is as true today as it was when I made it some 22 years ago. Moreover, most other countries similarly exempt bank deposit interest paid to nonresidents. Yet, the United States and most EU countries seek to impose income tax on bank deposit interest paid to residents, whether it is earned in the taxpayer's country of residence or elsewhere.

As stated in a very recent OECD report on *Tax Systems in European Union Countries*:[2]

> Since some tax administrations do not exchange interest information on an automatic basis, or apply a withholding tax on every non-resident's savings income, residents of Member States may be able unlawfully to escape the tax on this income imposed by their residence country, as well as lawfully earn the interest free of tax in the source country.

This situation is changing. The European Union, with the apparent assistance of the OECD Committee on Fiscal Affairs, wants to require all EU countries and many non-EU countries with substantial bank deposits to exchange interest information concerning bank deposits and other savings interest on an automatic basis. In 1998 the European Commission proposed a directive on the taxation of cross-border savings of individuals. The proposal was intended to ensure a minimum effective tax on cross-border interest payments within the European Union, either by a withholding tax or automatic exchange of information. The 1998 proposed directive met with substantial opposition from several EU member countries. Some countries felt that if EU countries were forced to impose a withholding tax or automatically exchange information on savings income, most deposits and other interest-bearing investments would be moved to other countries outside the European Union. A compromise was agreed to in principle in 2000 with the understanding that the European Union would negotiate with the United States, Switzerland, and some other non-EU financial centers over adopting similar measures. Austria and Luxembourg indicated that their eventual approval of any such directive would be conditional on the EU Commission reaching an agreement with key non-EU financial centers.

Recent developments make it likely that even if bank deposit interest paid to nonresident individuals remains tax-free in the source country, many countries will eventually report the amount of interest paid automatically to the taxpayer's country of residence. The following major developments occurred in the year 2001:

- In January 2001, the United States issued proposed regulations that would require all banks operating in the United States to report annually to the Internal Revenue Service all interest they pay to nonresident alien individuals, so the IRS can pass this information on to its tax treaty partners.
- In February 2001, the United Kingdom issued final regulations that require all banks operating in the United Kingdom to report annually to Inland Revenue all interest they pay to nonresident individuals who reside in the European Union or in certain other countries.
- In July 2001, the European Commission issued a revised

[1]Hearings Before the House Ways and Means Committee Subcommittee on Oversight, H.R. Serial 96-26, 96th Congress, 1st Session (1979).

[2]Joumard, Isabelle, *Tax Systems in European Union Countries,* OECD Economics Department Working Papers No. 301 (2001).

proposed directive that would eventually require every EU country to automatically exchange information concerning savings income with every other EU country.

We will now look at where we are in greater detail and how we got here.

The OECD Bank Information Report

In March 2000, the OECD Committee on Fiscal Affairs (CFA) declassified and published a report entitled *Improving Access to Bank Information for Tax Purposes,* (OECD bank information report).[3] As noted in its preface, the report focused "on improving exchange of information pursuant to a specific request for information related to a particular taxpayer." Although not declassified and published until 2000, the report was apparently prepared earlier and it was based on answers to questions submitted to all OECD member countries in 1997.

The preface to the OECD bank information report also noted that CFA was separately analyzing ways to improve the exchange of information on an automatic basis. The appendix to the report indicates that banks do not automatically report information to tax authorities in 11 OECD countries: Austria, Belgium, the Czech Republic, Germany, Iceland, Luxembourg, Mexico, Poland, Portugal, Switzerland, and Turkey.[4] Some other OECD countries have only limited automatic reporting. For example, the United States requires reporting as to all U.S. persons and nonresident aliens who are Canadian residents.

Two OECD countries took steps in early 2001 to provide bank information to other countries on an automatic basis. The United States issued proposed regulations in January 2001 that have been sharply criticized and have not yet been adopted in final form. A month later, the United Kingdom issued final regulations that took effect in April 2001. Both of these will be discussed in detail in this paper.

United States Has Always Been a Major Haven for Bank Deposits

For more than 80 years, U.S. banks have paid tax-free interest to foreign persons. More than US $1 trillion of bank deposits are held in the United States by nonresident aliens and foreign corporations. If the United States had ever seriously tried to tax the interest paid on these deposits, much of the money would have immediately disappeared from the United States, probably to one of the other OECD countries that similarly exempt bank deposit interest paid to foreigners.

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A U.S. citizen or resident receiving interest from a U.S. bank deposit must pay federal income tax of up to 39.6 percent on the interest. In most cases, he must also pay state income taxes. Every U.S. bank reports annually to the IRS the amount of interest paid to every U.S. citizen or resident.

A nonresident alien or foreign corporation pays no U.S. income tax on a U.S. bank deposit. Except for residents of Canada, the amount of interest paid to a foreigner is not reportable to the IRS, so the amount of that interest is obviously not being routinely reported to other countries under U.S. tax treaties or tax information exchange agreements (TIEAs). It is possible that some of these deposits may be held by or for U.S. persons claiming to be nonresident aliens or by foreign corporations that are owned by U.S. persons. However, most banks taking these deposits carefully check their foreign clients to make sure they are bona fide foreigners.

Interest paid on bank deposits held by foreign persons has been effectively exempt from U.S. income tax since 1921 if the income is not effectively connected with the conduct of a U.S. trade or business. And, if interest on the deposit is not taxable, the deposit itself is not taxable in the estate of a nondomiciled alien for purposes of the U.S. estate tax.

Congress Has Debated Whether to Retain Tax-Free Bank Deposits

The U.S. Congress debated the wisdom of retaining the tax exemption on bank deposit interest on several occasions during the 1960's and 1970's, with varied results. President John F. Kennedy's *Alliance for Progress* was supposed to encourage Latin Americans to repatriate their flight capital and reinvest it in their own countries. Latin American governments complained that the U.S. tax exemption encouraged Latin American taxpayers to invest in the United States. In 1966 Congress decided to impose tax on

[3] *Improving Access to Bank Information for Tax Purposes,* 116 pp., OECD (2000).

[4] *Id.* at 72.

bank deposit interest paid to foreign persons but, for balance of payments reasons, it postponed the effective date of the tax until the end of 1972. The effective date was postponed on two other occasions, the last of which was due to expire at the end of 1976. Then, after further debate, Congress once again made the exemption permanent.

During 1975 and 1976, Congress debated whether to extend the deposit exemption for three more years or make it permanent. The House of Representatives voted to make the deposit interest exemption permanent.[5] The bill was debated on the floor of the Senate in July 1976.[6] Senators Bob Packwood of Oregon and Ted Kennedy of Massachusetts sought to extend the exemption for only three more years so that Congress would be forced to review the subject again. During the debate, Senator Dick Stone of Florida (my former law partner) stated that in gateway cities like Miami, deposits from Latin Americans amount to as much as one-third of all bank deposits. Senator William Brock of Tennessee stated that no U.S. financial institution could survive the loss of one-third of its deposits in a short period of months. The Senate voted to extend the exemption for three years, but the conference report followed the House bill, and the 1976 Tax Reform Act made the exemption permanent.[7]

No one in Congress seems to have even looked at the provision since 1976. Members of Congress have apparently been convinced that imposition of the statutory 30 percent U.S. withholding tax on bank deposit interest would drive a large part of these deposits out of the United States. They are almost certainly correct.

Some Banks May Report Nonreportable Interest Payments

For many years, there was no reporting of bank deposit interest paid to foreign persons. Now, however, U.S. banks must report to the IRS the amount of interest paid to nonresident aliens who are Canadian residents.[8] At least until 2002, there is no required reporting of bank deposit interest paid to foreign persons who are not Canadian residents.

There has been an interesting anomaly concerning the current requirement that a U.S. bank must report to the IRS the amount of interest paid to nonresident aliens who are Canadian residents. The instructions to IRS Form 1042-S require a bank receiving new or renewed forms from customers to identify Canadian account holders and report the bank deposit interest paid to them. It then reads:

> Although you only have to report payments you make to residents of Canada, you can comply by reporting bank deposit interest to all foreign persons if that is easier.

Some foreign persons have expressed horror at the thought that their U.S. bank might choose the easy way out. The United States has more than 8,000 separate banks with more than 60,000 branches, any of which might be reporting to the IRS nonreportable bank deposit interest paid to foreign persons who are not Canadian residents simply because *that is easier*.

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U.S. Banks May Have to Report Interest Paid to Nonresident Aliens

Just four days before the end of the Clinton administration, the IRS issued proposed regulations (with the apparent approval of the outgoing Treasury Department) that would, if made final, collect zero taxes for the U.S. government, but could have a destructive effect on the U.S. banking system.[9] The proposed regulations would require reporting of bank deposit interest paid to *all* nonresident aliens, not just those who are residents of Canada.

The proposed rules would require banks to report these interest payments annually on a Form 1042-S and to send a copy of the form to the depositor. If there is a joint account and all joint holders are foreign persons, the bank must report the interest as having been paid to the nonresident alien individual who is a resident of a country that has an income tax treaty or a TIEA with the United States. If more than one of the joint holders is a resident of a tax treaty country or

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[5]*See* H.R. 10612, Sec. 1041, 94th Congress, 1st Session (1975).

[6]122 Congressional Record, S. 12502 - S. 12508 (26 July 1976).

[7]Public Law 94-455 (1976).

[8]Reg. Sec. 1.6049-8(a).

[9]Proposed Regulations on Reporting Requirements for Deposit Interest Paid to Nonresident Aliens, REG-126100-00, issued 16 Jan. 2001, published at 66 Federal Register 3925-3928 (17 Jan. 2001), as corrected by IRS Announcement 2001-50, 2001-20 Internal Revenue Bulletin 1184 (14 May 2001).

TIEA country, the interest must be reported as paid to the *primary account holder*. The United States currently has income tax treaties with more than 60 countries and TIEAs with 14 countries.

Interest on bank deposits paid to nonresident alien individuals (and foreign corporations) remains tax-free if the interest is not effectively connected with the conduct of a U.S. trade or business.[10] The proposed regulations would not change the tax-free status of this interest, but they would require every bank operating in the United States to report to the IRS interest paid to all nonresident alien individuals so that the IRS could pass the information on to its tax treaty partners. Until now, the IRS has collected this information only as to U.S. persons and individuals resident in Canada. The United States has no tax interest in collecting this information, given that it will not result in the collection of any U.S. tax. Many tax practitioners feel that the promulgation of a law that collects taxes only for other countries is a matter that should be determined by Congress, not by the IRS.

The 1976 Senate hearings clearly indicated that many senators felt the imposition of tax on this bank deposit interest could result in a substantial outflow of funds from U.S. banks to foreign competitors. Many other countries, including major U.S. trading partners, similarly exempt bank deposit interest paid to foreign persons. Collecting information concerning this deposit interest and passing it on to other countries will almost certainly have the same effect as imposing tax on the interest. If these regulations are adopted in final form, there could be a massive outflow of funds from U.S. banks. Most of these funds would go to banks located in countries that do not collect taxes on this interest and that have no rules to collect information on these accounts.

Proposed EU Directive Still Faces Many Obstacles

EU officials have tried very hard in recent years to enact a directive that would compel all 15 EU countries to exchange tax information concerning savings from investments made by a resident of one EU country in any other EU country. Although they reached a compromise agreement on this issue in 2000, the "agreement" had more holes than a Swiss cheese. For example, Austria and Luxembourg said the directive would be nullified unless the information exchange system was also agreed to by certain third countries including Andorra, the Channel Islands, the Isle of Man, Liechtenstein, Monaco, Switzerland, and the United States. Switzerland then stated that it would not lift its bank secrecy under any circumstances but that it might consider taxing savings income of foreigners with Swiss bank accounts. Switzerland also demanded that any agreement be accepted by all major Asian financial centers.

The 1998 proposed EU directive met with substantial opposition from several EU member countries.

In July 2001, the EU Commission published a revised *proposed directive* on savings taxation that superseded an earlier 1998 proposal.[11] The revised directive would create a system for the exchange of information that would allow EU member countries to collect taxes on interest earned by their residents in other EU member countries. The proposed directive would only apply to savings income of individuals, and not to interest payments to companies. Unlike the earlier proposed directive, the new one would not allow member countries to choose between exchanging income and imposing a withholding tax. However, Austria, Belgium, and Luxembourg could impose a withholding tax instead of exchanging information during a seven-year transition period. The new directive would apply to interest on bank deposits and interest from new bonds. Existing bonds would have special rules.

The EU Council will not approve the proposed new directive unless Andorra, Liechtenstein, Monaco, San Marino, Switzerland, and the United States agree to pass similar rules. In the absence of a deal with Switzerland and other third countries, the proposed directive will never take effect, and some major European financial centers will continue to welcome bank deposits from foreign persons and pay them unreported tax-free bank deposit interest.

When and if all of the world's major financial centers can reach agreement and simultaneously begin to exchange information on savings deposits or simultaneously begin to withhold an agreed rate of tax on these bank deposits, it

[10]IRC Sec. 861(a)(1)(A) and (c).

[11]EU Commission, Brussels, 18/07/2001, COM (2001) 400, Proposal for a Council Directive to Ensure Effective Taxation of Savings Income in the Form of Interest Payments Within the Community (18 July 2001).

might make sense for the United States to participate in the agreement. In the absence of such an agreement, it would be financial suicide for the United States to take measures unilaterally either to exchange information concerning the deposits or impose its statutory 30 percent withholding tax on bank deposit interest paid to foreign persons.

Many Banks Attacked Proposed U.S. Reporting Regulations

As is customary, the IRS invited written comments on the proposed regulations and scheduled a hearing. The IRS received a large number of comments, virtually all of which were unfavorable. Many of them came from banks and banking organizations that complained about the substantial loss of deposits they would face if the regulations were made final and the substantial costs they would have to incur to comply with the proposed regulations.

More than 30 banks and financial institutions and a large number of individuals sent the IRS written comments opposing the proposed regulations. A letter from a Jacksonville, Florida, banker[12] gave these three reasons why his bank opposed the proposed regulation, saying that if the rule is adopted:

- nonresident alien depositors will seek foreign banks that do not report interest instead of U.S. banks that do;
- the outflow will adversely affect the liquidity of banks who hold the funds; and
- liquidity concerns of affected banks would inspire safety and soundness questions of all Florida banks, even those that do not hold the deposits.

Florida Governor Jeb Bush (brother of President George W. Bush) wrote U.S. Treasury Secretary Paul O'Neill expressing serious concern about the proposal.[13] He indicated that the perceived loss of confidence in the privacy of U.S. deposits could trigger a massive withdrawal of nonresident alien deposits in U.S. banks that would severely impact local communities, businesses, and individuals that depend on bank loans for credit. He urged Treasury to conduct a cost-benefit analysis of this regulation. A response from Mark Weinberger, Treasury's Assistant Secretary for Tax Policy, noted that Treasury appreciates the governor's concerns and will carefully consider all the potential implications of the proposed regulations.[14]

The IRS received a large number of comments on its 2001 proposed regs, virtually all of which were unfavorable.

A spokesperson for Banco Atlantico[15] wrote that due to public corruption, there is no assurance that sensitive financial information coming into the hands of a Latin American government will remain strictly confidential. He estimated that his bank would lose half of its customer base if the proposed regulations were adopted. Such a loss would have a dramatic negative effect on the bank's operations and place in danger the future of its U.S. activities.

Eleven witnesses spoke at the June 2001 IRS hearing on the proposed regulations, all of them in opposition to the reporting requirements. The witnesses who spoke represented two foundations, a credit union association, the Institute of International Bankers, the Florida Bankers Association, and several banks.[16] Some of this testimony is summarized below.

Andrew Quinlan, of the Center for Freedom and Prosperity, and several other witnesses stated that U.S. banks benefit greatly from the deposits of nonresident aliens. Congress has considered and rejected the idea of taxing the deposits. If the proposed reporting requirements are adopted, this will put a substantial portion of an estimated US $1.7 trillion of foreign deposits at risk.

Daniel Mitchell, of the Heritage Foundation, and several other witnesses stated that the proposed regulations are not required by law and blatantly ignore clear congressional intent. It is estimated that banks use US $1 trillion of deposits by individual nonresident aliens as a source of capital that generates jobs, promotes business expansion, and boosts U.S. financial markets. Much of this capital will flee the

[12]Letter from Julian E. Fant III of First Guaranty Bank & Trust Company, Jacksonville, Florida to Treasury Secretary Paul O'Neill, *2001 WTD 109-38* or *Doc 2001-14757 (1 original page)*, 8 May 2001.

[13]Letter from Florida Governor Jeb Bush to Treasury Secretary Paul O'Neill, *2001 WTD 123-45* or *Doc 2001-17100 (2 original pages)*, 7 June 2001.

[14]Letter from Treasury Assistant Secretary (Tax Policy) Mark Weinberger to Florida Governor Jeb Bush, *2001 WTD 131-37* or *Doc 2001-18333 (1 original page)*, 20 June 2001.

[15]Letter from Emilio Martinez, of Banco Atlantico, New York, to the Internal Revenue Service, *2001 WTD 61-31* or *Doc 2001-8383 (2 original pages)*, 26 Feb. 2001.

[16]Tax Analysts published an unofficial transcript of the IRS hearing on the proposed regulations. *See 2001 WTD 130-42* or *Doc 2001-18055 (55 original pages)*.

U.S. economy if the IRS forces banks to act as informers. People resident in many countries keep their funds in safe havens like the United States because they have a legitimate fear of corruption, expropriation, and other criminal activity. Other countries will welcome these investors and their funds. The potential loss of hundreds of billions of dollars of deposits makes this proposed regulation a *significant regulatory action* for which the Congressional Review Act should have required the IRS to perform a cost-benefit analysis.

The representative of an organization representing thousands of state and federal credit unions, most of which have assets of less than US $20 million each, complained about the immense regulatory burden and compliance costs credit unions would face under the proposed regulations. Because they are cooperatives, these costs would be borne by the individual members that own the credit unions.

Counsel for the Miami subsidiary of Banco Santander, a large Spanish bank, stated that his bank is permitted to take deposits only from foreign persons. Many of its clients place deposits in the United States because of political and economic instability in their home countries, sometimes exacerbated by random and wanton violence. Many of the bank's clients would view the transfer of information concerning their deposits as a threat to their personal safety. Its clients are concerned the information may be filtered to criminal elements that target wealthy individuals for extortion and kidnapping. A small number of clients are responsible for most of the bank's deposits. If the regulations are adopted, most large deposits will immediately be moved abroad. Wealthy clients will leave only nominal deposits to cover payment of their U.S. expenses, leaving the bank unable to support its current structure and its employees.

Lawrence Uhlick, of the Institute of International Bankers, confirmed that nonresident alien individuals hold a very significant portion of the US $1.5 trillion of foreign deposits in the United States. Unilateral adoption of across-the-board reporting would strongly encourage withdrawal of the funds. This would have a significant negative effect on the liquidity of U.S. banks and the availability of credit.

David Blair, a lawyer who spoke for the Florida Bankers Association and the Florida International Bankers Association, stated that up to 50 percent or more of the deposit base of some banks in Florida consists of nonresident alien deposits. This is very highly mobile capital. Even a partial loss of these deposits could lead to serious safety and soundness concerns for those banks.

Much capital will flee the U.S. economy if the IRS forces banks to act as informers.

The president of First Union National Bank stated that his bank had about US $4 billion of nonresident alien deposits. Much of this money comes from Latin American clients who keep their funds in the United States because they fear kidnapping and extortion if their money or information concerning it is available in their home countries.

The president of Eagle National Bank, Miami, described the impact of the proposed regulation on community banks. His bank has 1,700 nonresident alien depositors, representing 43 percent of the bank's deposits. He estimated that 50 to 60 percent of these deposits would move if the proposed regulations were made final. Compliance would require major changes in the bank's records concerning these accounts and compliance costs would be very high.

A spokesman for Bank of America said his bank has over 750,000 nonresident alien accounts, representing well over US $10 billion in deposits. The records concerning these accounts clearly document that the clients are legitimate nonresident aliens but these records are paper-based. Many of the accounts have multiple owners, some of whom reside in different countries. This could lead to double reports of the same earnings.

Counsel for the Florida Bankers Association was the final speaker. The association has commissioned an economic study to try to quantify the amount of deposits that are in jeopardy if the proposed regulations are adopted. The loss of deposits will create serious liquidity issues for banks. There are stories in some countries about kidnappers using tax return information to determine how much ransom to demand. In many countries, citizens have absolutely no confidence in the confidentiality of their own government's records.

About a month after the IRS hearing on the proposed regulations, Florida Congressman Dave Weldon offered an amendment to a pending appropriations bill that would have blocked Treasury from spending any funds to implement, administer, or enforce this regulation. Weldon withdrew the amendment after House Ways and Means Committee Chairman William Thomas took to the House

floor to oppose it and promised to work to ensure that Treasury understands the potential impact of the regulation. Chairman Thomas opposed any interference with the regular rulemaking process, but made it clear that if the proposed regulations are fully implemented he will hold hearings that could lead to a change in the law.[17] This was apparently a prearranged colloquy that enabled Congressman Weldon and Chairman Thomas to state their views on the record.

Now let us look at the situation in the United Kingdom.

New U.K. Reporting Requirements Took Effect in April 2001

The U.K. Inland Revenue issued regulations in February 2001 that set forth "improved information reporting on savings income." The regulations are supposed to help Inland Revenue to cooperate more effectively with tax authorities in other countries to combat international tax evasion and avoidance.[18]

The regulations implemented a new reporting regime announced in the Finance Act 2000, and they took effect as of the start of the 2001/02 tax year in April 2001. The requirement automatically to report interest payments to nonresidents currently applies only to interest paid to *individuals*.

The original regulations issued in February 2001 covered reporting for the 2001/02 U.K. tax year. The regulations were amended in June 2001 and now also cover reporting arrangements for the 2002/03 tax year. The regulations cover requirements under two sections of the U.K. Taxes Management Act 1970.[19] Two sets of guidance notes are set forth on Inland Revenue's Web site. They provide guidance for making information returns for:

- U.K. banks and other deposit takers and building societies,[20] and
- any persons, including U.K. branches of nonresident banks, who pay interest to or receive interest for other persons.[21]

Inland Revenue apparently now requires every bank operating in the United Kingdom to make an annual report of interest paid to nonresident individuals (including partnerships of individuals). Reporting does not cover interest paid to nonresident entities such as nonresident companies. Nor are reports required on certificates of deposit or on investments held at bank branches situated outside the United Kingdom.

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An appendix to the regulations lists all *fully reportable countries*. The list currently includes all 15 EU member countries (including the United Kingdom itself), the Channel Islands, the Isle of Man, Gibraltar, and most U.K. dependent territories. It also includes several third countries: Australia, Canada, Japan, New Zealand, Norway, the Republic of Korea, and the United States. The list will probably be expanded from year to year, but Inland Revenue must give banks six months notice of any change before the start of a new tax year.

In determining whether it must report interest paid to a particular person, a bank must normally use as the *reportable address* the correspondence address it uses for that person. If it uses any other address as the reportable address, it may have to show on audit why it did so.

A bank must report all interest paid to an investor who has a reportable address in the United Kingdom or in any other *fully reportable country*. The bank must report interest on a joint account if any individual party to the joint account has a reportable address.

Banks are apparently encouraged to report interest paid to *all* individual investors, including those whose reporting addresses are not in a fully reportable country. By doing so, they escape special audit requirements that are imposed on a bank that chooses to report only interest paid to an investor who has a reportable address in a fully reportable country. A bank that chooses to report only interest paid to individual investors in the United Kingdom and other fully reportable countries must appoint an experienced independent auditor, at its own expense, who verifies that all nonreportable accounts have been properly classified as such and provides assurances that the bank is ready to comply with full reporting of all accounts in a future year if it is then required.

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[17]Congressional Record, House of Representatives, 25 July 2001, pages H4592-H4593.

[18]U.K. Inland Revenue Press Release Number 19, 16 Feb. 2001.

[19]Secs. 17 and 18 U.K. Taxes Management Act 1970.

[20]Sec. 17 U.K. Taxes Management Act 1970.

[21]Sec. 18 U.K. Taxes Management Act 1970.

Why Have Companies Been Excluded?

The U.S. proposed regulations, the U.K. final regulations, and the revised EU proposed directive were all issued during the first seven months of 2001. Each of them would require reporting of bank deposit interest paid to nonresident individuals. None would require reporting of bank deposit interest paid to foreign companies or other entities. This cannot have been a coincidence. We must assume that the OECD Fiscal Affairs Committee has recommended the adoption of these regulations and that other countries will adopt similar rules. Why don't any of these regulations require banks to report interest paid to nonresident companies or other entities? Will this omission encourage millions of depositors to move their bank deposits from individual ownership into offshore holding companies?

Neither the United Kingdom nor the United States seems to have commented on this omission. Nor have I seen any mention of this omission in the numerous comments on the proposed U.S. regulations sent to the IRS and Treasury. The only place where I have seen any mention of this issue is in a memo issued by the EU Commission simultaneously with its revised proposed directive. The memo attempts to answer some *frequently asked questions.*[22] The relevant questions and answers are:

Why Would Interest Payments Made to Companies Be Excluded From the Scope of the Directive?

"Because there are many more problems of tax evasion in the individual taxation area than in the company tax area. Companies are required to lodge annual tax returns and they are audited or subject to the possibility of being audited on a regular basis. As far as companies are concerned, non-taxation of interest payments is not the main problem for tax administrations. The issue is more that of tax avoidance through aggressive tax planning.

"Some concerns have been expressed that individuals will claim to be representatives of companies in order to avoid the application of this proposal for a Directive. The Commission hopes that Member States will, on the basis of the standards and rules laid down in this Directive, be able to establish the true identity of beneficiaries of interest and that the scope for tax evasion will be limited."

None of the reporting rules would require reporting of bank deposit interest paid to foreign companies or other entities.

This answer naively assumes static behavior on the part of the millions of individuals who now have trillions of dollars on deposit in countries other than that of their primary residence. That is highly unlikely. Many of these investors are likely to react in some or all of the following ways:

- They will begin by transferring their nonresident deposits from their individual names to those of foreign companies, trusts, or other entities.
- Some will take advantage of the fact they already have or can easily establish a secondary residence in another country, preferably one that will not impose any tax on their foreign-source income. For EU residents of countries other than the United Kingdom or Ireland, the most likely candidate for a second residence is Ireland or the United Kingdom, neither of which imposes any tax on unremitted foreign income of *non-domiciled residents.* Britain has recently had a flood of so-called "non-doms" from France.[23] This is likely to increase the number of new ones rapidly. A French or German resident can keep his overseas bank account if he also becomes resident in the United Kingdom or Ireland and uses that residence address for his bank account. Under EU rules, he has an absolute right to establish residence in any EU or EEA country.
- Others will establish a new residence in an offshore country that does not tax anyone's foreign-source income. Examples are Costa Rica, Grenada, Hong Kong, Panama, etc.

When Will the New Rules Take Effect?

The new U.K. reporting rules are already in effect. They currently apply only to U.K. nonresident individuals who are resident in designated fully reportable countries. Beginning with the current 2001/02 tax year, Inland Revenue will have information that it could pass on automatically to the tax authorities of other

[22]EU Commission, Brussels, 18/07/2001, Savings Tax Proposal: Frequently Asked Questions, Memo/01/266 (18 July 2001).

[23]*See* "Foreign-born millionaires save £10bn from Brown's tax U-turn," *Sunday Times* (London), 18 June 2000, pp. 12-13, and Langer, Marshall J., "Harmful Tax Competition: Who Are the Real Tax Havens?" *Tax Notes Int'l,* 18 Dec. 2000, p. 2831, at 2837-2838, *2000 WTD 243-17*, or *Doc 2000-33531 (9 original pages)*.

fully-reportable countries. It may begin doing so or it may wait until the proposed EU savings directive takes effect, because it is unlikely to receive comparable information from other countries until then.

A number of steps are still required before the revised proposed EU savings directive can take effect. In August 2001, the EU Council established a timetable of the steps needed to implement these rules.[24] At this time, we have only a *modified proposal for a directive.*The EU Council of Economic and Finance Ministers (ECOFIN) is expected to reach agreement on the formal text of the savings directive and assess progress reports on negotiations with other countries in December 2001. It hopes to conclude agreements with other countries and unanimously adopt the savings directive in December 2002. If it succeeds in doing so, article 18(1) of the proposed directive would require all EU member countries to bring into force implementing laws and regulations by 1 January 2004. The transition period of seven years during which Austria, Belgium, and Luxembourg can withhold tax instead of exchanging information will begin at that time so these countries do not have to begin exchanging information with other EU countries until 2011.

The proposed U.S. reporting regulations provide that they will take effect on 1 January of the year following the year in which they are adopted as final regulations. Because so many U.S. banks and banking organizations have attacked these proposed regulations and because the basic purpose of these rules is to provide information to treaty partners, it would make little sense for the IRS to finalize these rules until the EU savings directive takes effect. It would be financial suicide for the IRS to finalize these rules before 2003, effective as of the beginning of 2004. Even then, they should restrict required reporting to nonresident alien individuals from designated countries.

We must assume that the next step will be for all of the tax authorities to extend these reporting rules to cover payments to companies and other entities as well as individuals. In May 2001, the OECD declassified a *Report on the Misuse of Corporate Vehicles for Illicit Purposes* prepared by the OECD Steering Group on Corporate Governance.[25] That report suggests various steps that may be taken to force disclosure of the beneficial ownership of offshore companies, trusts, and other entities. ✦

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[24]"EU Council Sets Timetable for Tax Package," *Tax Notes Int'l,* 3 Sept. 2001, p. 1148, *2001 WTD 164-1*, or *Doc 2001-22339 (3 original pages)*.

[25]*Report on the Misuse of Corporate Vehicles for Illicit Purposes,* OECD Steering Group on Corporate Governance, 70 pp., OECD (2001). This report was declassified on 9 May 2001.