Southeastern Legal Foundation

Phil Kent, **President**

MEMORANDUM

Re: Proposed IRS Regulation and Data Collection Requirements

Question
Under current tax treaties, is the United States obligated to collect information about deposit interest paid to non-resident aliens so that the data can be provided to foreign governments?

Summary of Findings
Because deposit interest paid to non-resident aliens is not subject to U.S. tax, financial institutions are not required to report that income. The IRS has proposed a regulation to require the reporting of that income, however, and some supporters have justified the proposal on the basis that tax treaties with other nations require the collection of this data. This justification is inaccurate.

Major U.S. tax treaties have been in effect for decades, and no administration, Democratic or Republican, has interpreted our treaties as requiring this sort of regulation. Tax treaties do not require governments to collect data that they do not normally collect and to share that data with treaty partners. Moreover, the treaties impose no obligation to automatically collect data solely for the benefit of a treaty partner.

There are two situations where tax treaties may obligate the U.S. government to share information. The first situation is where the U.S. ordinarily collects information as part of the administration of U.S. tax law and because that information could be helpful to a treaty partner in enforcing its tax laws, the U.S. may be required regularly to share such information. Under current treaties in force and the model U.S. treaty, the U.S. government has an obligation to share information that it collects but the U.S. has no obligation to broaden the type of information that it routinely collects.

The second situation is where a treaty partner makes a specific request for information in connection with a specific investigation arising from an individual's failure to comply with his or her tax obligations in the requesting country. In these situations the U.S. is obligated to provide as much information as it may have about the subject of the request and could be required to obtain information that is not routinely collected for the administration of U.S. tax law. The proposed IRS rule concerning the reporting of deposit income earned by NRAs would have no effect on such obligations.

Detailed Analysis
Article 26 of the Model U.S. Treaty and extant U.S. treaties generally requires the sharing of information with regard to taxpayers from other nations, but with important limitations. Specifically:

1. Treaties do not require administrative measures at variance with the laws and administrative practice of the United States.

2. Treaties do not require collection of information that is not obtainable under the existing tax laws or in the normal course of the tax administration of the United States.

3. There is no requirement to share information that would be contrary to public policy of the United States.

The commentaries to the analogous provisions of the OECD Model treaty make clear that information is not "obtainable" if the requested state must go outside of the normal course of the administration of its tax laws to acquire it. Paragraph 15 of the commentaries to Article 26 of the OECD Model Treaty (dealing with the exchange of information) makes clear that the requested state is not required to carry out administrative measures that are not in the normal course of administration of its own internal domestic law. Moreover, paragraph 16 of the commentary to Article 26 of the OECD Model states that:
Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination ... This means that the requested State has to collect the information the other State needs in the same way as if its own taxation was involved, under the proviso mentioned in paragraph 15…(emphasis added).

It cannot be the case that information exchange articles of U.S. income tax treaties impose a legal obligation to change U.S. internal law to accommodate the needs of a treaty partner. Such an obligation would be in derogation of state sovereignty because it would in effect allow one treaty partner to write the law of another nation notwithstanding the existence of contrary domestic law. Moreover, our treaty partners would have the right to impose enormous regulatory costs on the U.S. government, U.S. financial institutions, and the economy in general to gather information that they believe is necessary better to collect their taxes.

Paragraph 3 of the Model U.S. Treaty requires treaty partners - which includes the United States - to respond to specific requests for information held by financial institutions even if the information is not needed for the administration of domestic tax law. This means the IRS can obtain information held by financial institutions in order to respond to a specific request, but this does not mean the IRS must change information collection requirements applicable to all U.S. financial institutions or mandate additional routine collection of such information. It, therefore, does not affect the issue under consideration and it does not require the U.S. or its treaty partners to collect information they do not otherwise collect for the administration of their tax laws.

Finally, it is worth noting that the provisions of paragraph 3 of Article 26 is in effect with only one of the countries covered by the nonresident alien proposal. The treaties with all of the other countries involved do not even have this provision. This indicates that the other treaty partners do not want to be subject to its conditions even in the case of specific requests.

BY: Dan R. Mastromarco, Esq.