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Treasury's Qualified Intermediary Regulations And The OECD Tax Haven Initiative: Threats To International Capital Mobility And Investment

The United States Treasury is taking or considering action on two fronts in the international arena to shore up enforcement of the current individual income tax system. In the process, it needs to be careful not to harm the U.S. economy by driving away badly needed investment money. Some of the proposals under review could have the unfortunate side effect of interfering with prospects for fundamental tax reform and may encourage greater growth of government here and abroad.

The current tax system.

The U.S. employs a so-called "broad-based" individual income tax which favors consumption over saving. In addition, it attempts to impose that tax on a global rather than a territorial basis. Many other developed nations employ the same type of tax system, at least vis-a-vis the United States.

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Such an income tax system has two main drawbacks. First, the "broad-based" feature of the tax means that it generally taxes income used for ordinary saving and investment in the year it is earned, and also taxes the subsequent returns on the saving and investment. (Saving done in an IRA or tax-deferred pension arrangements escapes this double taxation.) By contrast, income used for consumption is also taxed when earned, but the subsequent purchase and use of the consumption item is generally not taxed again under the federal income tax. (A few goods face federal excise taxes.) This arrangement generally places a higher tax on income used for ordinary saving and investment than on income used for consumption. The resulting tax bias against saving and investment holds capital formation, productivity, wages, and employment below levels that would be possible under an unbiased tax regime.

Second, the income tax is imposed on the global earnings of U.S. residents, not just on the income they earn in the United States, with much of the tax on foreign income offset by a complex foreign tax credit to avoid double taxation. The global definition of taxable income requires the U.S. Treasury to gather information on economic activity outside the jurisdiction of the United States to enforce U.S. tax law. Both features of the tax code result in enormous complexity for the taxpayer and enforcement problems for the Treasury.

U.S. treatment of foreign investors.

Foreign savers owning U.S. financial assets receive different tax treatment from U.S. residents.

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Like many other nations, the United States does not impose withholding on interest paid to foreign holders of U.S. bank deposits or bonds. In effect, the foreign savers get tax treatment on U.S. interest income that is available to U.S. residents only on tax exempt bonds or in a Roth IRA. This tax treatment attracts foreign funds to the U.S. financial industry and broadens the market for U.S. government securities. Dividends paid to foreign owners of U.S. stocks are taxable. The foreign dividend recipients normally face a 30 percent withholding tax on their dividends in lieu of having to file a U.S. tax return. If they are residents of a country which has a tax treaty with the U.S., they may be allowed a lower withholding rate of 5 percent to 15 percent on dividends, depending upon what reciprocal tax reductions were negotiated with the country in question. If the savers wish to remain anonymous and not claim tax treaty benefits, they are subject to the 30 percent default withholding rate. The 30 percent rate is lower than the marginal tax rates faced by U.S. taxpayers in upper income brackets, and lower than the top tax rates in many foreign countries.

The Treasury has recently imposed ... Qualified Intermediary (QI) regulations ... [that] would require foreign financial institutions to enter into agreements with the IRS ... to provide personal and financial information on their customers, including their names and countries of residence for tax purposes, whether they are involved with the United States tax system or not.

Two steps toward trouble.

The Treasury has recently imposed new reporting regulations on foreign financial institutions to discourage the use of off-shore accounts by U.S. residents to obtain the favorable tax treatment given foreigners on U.S. investment income, or for other tax avoidance purposes. Treasury is also participating in discussions about (although it has not endorsed, and has been somewhat critical of) an initiative by the Organization for Economic Cooperation and Development (OECD) to impose global regulations to rein in what the OECD calls "harmful tax competition" and to force so-called "tax shelter" countries to share financial information about foreign investors with OECD tax authorities on a virtually unlimited basis.

The Qualified Intermediary Regulations.

In January, 2001, the Treasury issued a notice revising Revenue Procedure 2000-12 (issued in 2000) that was designed to implement the controversial Qualified Intermediary (QI) regulations relating to withholding of tax on U.S. source income. These rules establish highly invasive requirements with which foreign financial institutions must comply to avoid 30 percent withholding on portfolio interest that would otherwise be exempt from any U.S. tax.

The QI rules would require foreign financial institutions to enter into agreements with the IRS obligating them to provide personal and financial information on their customers, including their names and countries of residence for tax purposes, whether they are involved with the United States tax system or not.

The Treasury has a plausible requirement for such information in certain cases, but not in others. The Treasury needs to be able to identify U.S. residents who might have moved funds off-shore, invested them in U.S. or foreign assets through foreign brokerage accounts, banks, or mutual funds, and failed to report the resulting income to the Treasury for tax purposes. By appearing falsely to be foreign investors, such individuals might then receive interest tax free or dividends taxed at a withholding rate below what they would owe if they reported the income on their U.S. tax returns. The Treasury also needs to verify the nationality of foreign participants in such investment vehicles if

those participants elect to claim the special low tax treaty withholding rates on dividend income that the U.S. has negotiated with their home countries.

However, the Treasury does not need to know the nationality of participants in such investments who are non-U.S. residents and whose U.S. source income is non-taxable interest or who are not claiming reduced tax withholding on U.S. source dividend income under the tax treaties. Such non-residents may accept normal dividend withholding either because their home country has no tax treaty with the United States or because they wish to waive their rights to a lower treaty withholding rate rather than reveal their personal data. Their personal information is not needed to enforce U.S. tax law or to comply with any tax treaties. Such individuals have a right to retain their financial privacy.

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If the Treasury tries to collect personal information on non-residents who clearly owe no further U.S. tax, the foreign investors may fear that the Treasury is collecting the information about them on behalf of their home country tax agencies. They may then want to withdraw their funds from any investment vehicles containing U.S. assets. To forestall the loss of that business, foreign-based banks and mutual funds may choose to exclude U.S. assets from some of their investment portfolios and mutual fund offerings. There is anecdotal evidence that foreign mutual funds, banks, and other investors are already moving to withdraw money from the United States so as not to run afoul of the QI regulations.

Some critics of the QI regulations have suggested that they be withdrawn, and that Treasury not seek any information from financial intermediaries about offshore savers. That would require Treasury to abandon the attempt to enforce a portion of current U.S. law. Treasury staff might reasonably ask if they have the authority to choose what part of U.S. law to enforce and what part to ignore. They would have a valid point. If the broad-based global income tax system is the law of the land, the Treasury is obligated to take steps to enforce it.

However, it is also incumbent on the Treasury to warn the Congress and the Administration when the tax law is creating serious problems. This the Treasury has notably failed to do. In fact, the Treasury has been an eager and long-time advocate of the broad-based global income tax. It has shown little or no concern for the economic, diplomatic, compliance, or enforcement costs of the system, nor to the damage that the current system does to privacy and personal freedom. Only occasionally, when pressed, has Treasury made any effort to acquaint the public or the Congress with alternative tax systems, and Treasury invariably argues for strengthening the current regime. Consequently, Treasury's moral authority and intellectual leadership in this area have been compromised.

<u>OECD sanctions and sovereignty.</u>

The OECD initiative has two parts. One is a campaign for international "tax harmonization" in which low tax rate countries would be pressured into raising their tax rates so as not to attract saving and investment from high tax rate nations. The other part of the OECD initiative is an information sharing requirement. Absent higher tax withholding on foreign investors, forty-one small nations deemed to be low tax rate "havens" would be required to repeal their financial privacy laws and share information about the capital earnings of foreign investors with OECD nations' tax authorities. The

OECD nations would have the right to audit the information for accuracy, which means examining the books of the financial institutions of the targeted countries and obtaining information on all the institutions' customers, whatever their country of residence.

Treasury Secretary Paul O'Neill has stated that each nation has the right to have the tax regime of its choice, and has voiced skepticism of any measures to infringe on national sovereignty. He recently reiterated this point in a May 10th commentary in the Washington Times, saying, "The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any effort to harmonize world tax systems." This is absolutely the correct position on the sovereignty issue.

Secretary O'Neill has been more supportive of the concept of sharing tax information among national revenue agencies, but he has put it in the context of specific cases where tax evasion is suspected. In his commentary, he wrote, "If the United States believes a particular U.S. taxpayer is illegally evading the U.S. tax laws through the use of offshore entities or secret bank accounts, the United States must make every effort on our own to obtain the necessary information to enforce the U.S. tax laws. In addition, the United States has negotiated individual treaties or agreements with more than 60 countries so it can obtain needed information in cases of tax evasion."

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He stated, "The work of this particular OECD initiative... must be refocused on the core element that is our common goal: the need for countries to be able to obtain specific information from other countries upon request in order to prevent the illegal evasion of their tax laws by the dishonest few. In its current form, the project is too broad and it is not in line with the administrations's tax and economic priorities."

Agreements are voluntary, and, as Treasury views them, can provide the limited information needed in suspected cases of wrong-doing. The OECD initiative, however, would force a very broad form of information sharing on unwilling low tax countries and their businesses by means of protectionist sanctions against those countries' financial institutions. Such sanctions and forced compliance would be a clear infringement on the sovereignty of the small victim nations. They would also be a clear violation of the World Trade Organization rules against discriminatory treatment of businesses based on their country of origin.

The U.S. must be cautious about these initiatives. Tax competition is a healthy thing for world taxpayers. Governments that can raise taxes with impunity usually do, with bad outcomes for their economies, their citizens, and their trading partners. Also, excessive infringement on financial privacy could interfere with the free flow of international capital and deprive the United States of beneficial investment.

Although the United States has an interest in reducing tax evasion by its citizens, encouraging information sharing has some adverse consequences. If the United States insists on bilateral information sharing with foreign tax authorities, it is not in a position to object if other nations do the same. But if high tax foreign nations succeed in curbing capital flight to tax haven nations, the result may be less investment in the United States. We may lose more than we gain.

Low tax rates help underdeveloped countries make real progress fighting poverty by encouraging saving and capital formation. If they wish to offer low tax rates to foreign investors as well as to their own people, then those foreign savers should be able to share in the benefits without being thwarted by their home country tax authorities. Ironically, the OECD nations have generally insisted that any special business tax incentives that a country enacts be available to companies from all nations, not just those from the country in question. That is, there should be no tax discrimination against subsidiaries or branches of foreign businesses in favor of domestic companies. Yet by taxing the world-wide income of their citizens, these same nations would impose higher taxes on the income their individual citizens earn in low tax countries than are imposed on the income earned by the local savers.

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Furthermore, the OECD assault on the tax systems and privacy laws of the small nations could be a prelude to an attack on the laws of the United States. We have been a relatively low tax country (although recent tax rate cuts in Germany, Italy and France are partially closing the gap), and there are similar financial privacy laws in the United States at the federal and state levels. Erosion of U.S. financial privacy rules and forced sharing of tax information with foreign governments could reduce the attractiveness of the United States as a place in which to invest.

Unintended economic consequences.

The total private sector capital stock of produced assets (plant, equipment, structures, and inventories, but not land) stood at just over $25 trillion at the end of 1998, and probably exceeds $27 trillion today. Private foreign investment in the United States probably exceeds $8 trillion (extrapolating from year-end 1999 data). This sum includes direct investment in U.S. production facilities and real estate, and holdings of financial assets such as stocks, bonds, mortgages, bank accounts and U.S. currency. The financial assets should exceed $5 trillion. Bank deposits of foreign individuals in U.S. banks exceed $1 trillion. Many of the foreign-owned assets constitute long term investment in the United States that is not primarily motivated by tax considerations.

Some of the foreign money invested here, however, is flight capital. It would be sensitive to reporting requirements that could, if shared among national tax agencies, provide information to the savers' home countries' tax authorities. Alternatively, it could be completely legal money belonging to residents of countries that do not tax their citizens' income from foreign investments. Such savers might face no tax consequences from the regulations, but they may wish to avoid the unnecessary expense of irrelevant reporting requirements. In either case, the QI regulations, or other reporting requirements that might flow from an expanded version of the "tax haven" elements of the OECD initiative, might

affect foreigners' willingness to invest in U.S. assets.

A reduction in the willingness of foreign savers to hold U.S. assets could result in the withdrawal of substantial sums from the United States that are currently invested here and a reduction in future investment from abroad. There is no way to know in advance what the magnitude of such a shift in the allocation of world saving might be.

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Although the quantitative extent of the economic fallout may be unpredictable, the qualitative results are readily apparent. 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, for example, that erosion of financial privacy rules causes a modest shift of $400 billion in foreign saving out of the United States. Some, but not all, of the capital withdrawn would be replaced by other capital, either from a reduced outflow of some domestic saving that had been headed abroad, or an inflow of other foreign saving replacing the flight capital. Assume that half of the flight capital is replaced. The resulting $200 billion net capital outflow is equal to about 0.8 percent of the private sector U.S. capital stock. We might therefore 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 lower capital stock would reduce labor productivity, wages and employment. 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. The rest would be a small net reduction, about $4 billion, in the after-tax returns to capital. The $4 billion net figure would consist of a loss of perhaps $12 billion after taxes to foreign savers, and a gain of about $8 billion to U.S. owners of capital who would benefit from the higher returns on the shrunken capital stock.

The reduction in federal tax collections due to the reduced national income might well exceed the additional taxes collected by means of the QI regulations from U.S. tax evaders attempting to utilize foreign accounts to hide either U.S. source or foreign source income from the Internal Revenue Service. U.S. residents hold something in excess of $3 trillion in foreign stocks and bonds, and dutifully report much of the income they earn on those assets to the IRS. They also claim significant foreign tax credits for the taxes paid on that income to foreign jurisdictions, greatly reducing their residual U.S. tax liability. They can owe no more than a few billions of dollars in U.S. tax, most of which they pay.

What about tax evasion on U.S. assets held abroad by U.S. residents? In 1997, the Treasury's

Statistics of Income 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 non-interest portion of that income, assuming the interest was largely tax exempt if earned by foreign depositors. 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 QI regulations? 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. Since most of this income is actually going to genuine non-U.S. residents, this is not a plausible scenario.

However one analyzes the figures, it is not clear that much revenue owed to the Treasury remains to be collected by vigorous application of the QI regulations. Furthermore, taxpayers determined to dodge U.S. taxes could avoid the QI regulations by shifting their investments to financial institutions not aspiring to qualified intermediary status.

Other adverse affects would be felt abroad if the OECD initiative were to restrict international capital flows. The low tax nations would grow more slowly than otherwise, and would be forced to buy less from the developed world. The higher taxed nations would be under less pressure to curtail government spending or to provide better tax treatment of saving and investment, reducing the chance for pro-growth policy initiatives.

Ultimate solution: fix the tax system.

It is hard to enforce our broad-based income tax on world-wide income in an integrated global economy. Efforts to do so have the potential to reduce our access to world saving, but failure to do so could encourage tax evasion. Shifting from an income-based to a consumption-based tax system collected on a territorial (non-global) basis would eliminate all these difficulties.

Under a territorial tax system, each nation would tax the income earned on its own territory, and not tax income earned abroad. In particular, any income earned by U.S. savers abroad would not be subject to federal tax, and there would be no need for the Treasury to seek any foreign financial information. Income earned by foreigners in the United States would be taxed here and not in their home countries.

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Simply shifting to a territorial tax system would not solve the whole international tax problem, however. If the United States continued its current biased tax treatment of on-shore saving (taxing interest, dividends, and capital gains even when the saver had received no deduction for the saving), and if other nations taxed saving less heavily, U.S. residents would still be encouraged to move their saving offshore to avoid U.S. taxes — only it would be legal. To remain competitive, the United State would have to adopt a more saving-friendly tax system. Providing neutral tax treatment of saving in the U.S. would accomplish this goal and would end the incentive for capital to emigrate.

A consumption-based (saving-consumption neutral) tax system would tax either the income used for saving or the returns, but not both. Either income used for saving would be tax deferred and the earnings and principal would be taxed when they are withdrawn for consumption (akin to the treatment given to deductible IRAs or 401(k) plans), or the income would be taxed before it is saved but the subsequent earnings on the after-tax savings

would not be taxed (as with a Roth IRA or tax exempt bond). The cash flow tax, the USA (Nunn-Domenici) tax, VATs, and the national retail sales tax are examples of saving-deferred taxes; the personal side of the Armey/Hall-Rabushka Flat Tax is an example of the latter.

By allowing deferral of saving or exempting the returns, these neutral tax systems would afford savers in the United States as good a tax treatment as they could get by saving abroad, and as good a treatment as the U.S. currently gives to foreign savers investing in the United States. Consequently, U.S. residents would have no incentive to move funds offshore to get better U.S. or foreign tax treatment.

Furthermore, if Americans chose to invest abroad, it would not constitute a "loophole" or loss of revenue to the Treasury. A U.S. resident who moved funds offshore from a tax-deferred account would pay a tax on the amounts withdrawn from his or her U.S. savings. The funds would then become after-tax money. Other transfers from Roth-style accounts or wages would already have been taxed. As with a Roth IRA, the subsequent returns on the investment of any such after-tax income would not be taxable in the United States, no matter where in the world the funds were invested. There would be no need for the U.S. Treasury to seek any information about the returns on that income or the identity of the saver from any foreign financial intermediary or government revenue agency.

Funds brought into the United States for investment could be accorded either type of neutral tax treatment, but the simplest method would be to accord them the treatment currently applied to interest income. The saver would get no tax deduction for the incoming investment, but would pay no tax on the subsequent returns. (Alternatively, the individual or business could apply for a deduction for the incoming saving, and pay tax on the subsequent interest, dividends, and asset sales in accord with the tax treatment given to a regular IRA or pension. This is not a likely election for a new investment fund; unlike a U.S. wage-earner, the investor would not have sufficient U.S. income in the first year against which to take a deduction.)

A switch to a neutral tax system would provide tax simplification for taxpayers and greatly reduce enforcement burdens for the Treasury... National income would be as much as 10 percent higher, with annual family incomes rising by several thousand dollars... [O]ne of the hidden dangers of the OECD and Q.I. initiatives is that they make pro-growth tax reform less likely by entrenching the current system.

Either method of removing the tax bias against saving would end the international tax mess as far as the United States is concerned. If the U.S. tax system were not attempting to double tax saving and its returns, there would be no need for the IRS to try to track or tax savings income received abroad by U.S. residents.

If adopted world-wide, neutral territorial tax systems would not require any nation to collect tax information on its residents from any other nation. Such a system would allow every nation to set its own tax rates and have those rates apply to all activity within its borders regardless of who is conducting the activity. There would be no infringement on national sovereignty. Domestic residents and foreigners would be treated alike, with no discrimination. A poor nation desperate for capital would be able to establish a favorable tax climate not only for the saving of own residents but for that of foreigners as well. Any saver anywhere in the world would be free to share in the resulting saving and investment opportunities without being blocked by his own country's tax authorities.

OECD initiative and Q.I. regulations buttress status quo and threaten tax reform.

Fundamental tax reform would yield significant benefits for the United States and any other nation adopting it. A switch to a neutral tax system would provide tax simplification for taxpayers and greatly reduce enforcement burdens for the Treasury. It would also create a much stronger incentive to save and invest than exists under current law, leading to increased capital formation and a significant rise in productivity, employment, and wages. National income would be as much as 10 percent higher, with annual family incomes rising by several thousand dollars.

The current tax system is far less attractive. The United States Treasury is obligated to enforce current U.S. tax law. In doing so, it requires some information on foreign saving and investment activities of U.S. residents and some foreign citizens. This is difficult to obtain, and the Treasury is tempted to expand its access to information in ways that might damage our access to the international capital markets and interfere with financial privacy.

If a comprehensive international information-sharing arrangement were successfully imposed on the world, it would shore up the enforcement of the current, flawed income tax system. It would leave in place a biased, anti-saving, anti-investment tax system that really should be reformed. Consequently, one of the hidden dangers of the OECD and Q.I. initiatives is that they make pro-growth tax reform less likely by entrenching the current system. The OECD initiative should be rejected. The Q.I. rules should be enforced with great care. The Treasury should then turn as rapidly and forcefully as possible to the design of a fundamentally restructured and re-based tax system.

Stephen J. Entin
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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.