IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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IRET TESTIMONY

Proposed IRS Regulation a Threat to Foreign Investment, U.S. Banks, the Dollar, and the Economy

A proposed Internal Revenue Service Regulation would scare away foreign investors from developed nations by requiring U.S. banks to report to the IRS the interest they pay to such depositors even though the interest is not subject to U.S. tax. The information on the interest payments could then be transferred to the depositors' home countries' tax authorities. Hundreds of billions of dollars of foreign-owned deposits would probably flee the U.S. for friendlier tax havens, losing business for U.S. banks and making it harder to fund U.S. budget deficits and a strong level of U.S. business investment. The regulation is good for foreign governments, but not good for the U.S. economy. There would be no gain for U.S. tax enforcement. Weaker investment in the United States would actually reduce U.S. jobs and tax revenue. The regulation also flies in the face of Congressional intent to exempt the earnings of such deposits from tax to attract the funds to the United States.

IRET's President, Stephen J. Entin, submitted the attached comments on the proposed regulation to the IRS, and spoke at the IRS public hearing held on December 5th.

November 12, 2002

Comments on IRS REG-133254-02
To Require U.S. Banks to Report to the IRS
Interest Paid to Depositors from Selected Developed Countries
Even Though It Is Not Subject to U.S. Tax

My name is Stephen J. Entin. I am President and Executive Director of the Institute for Research on the Economics of Taxation. Before joining IRET, I served as Deputy Assistant Secretary for Economic Policy, Department of the Treasury, from 1981 to 1988. Before that, I was a staff economist with the Joint Economic Committee of the Congress. My areas of specialization include macroeconomics, international economics, and taxation.

I offer the following comments on REG-133254-02, a regulation proposed by the Internal Revenue Service to provide guidance on the reporting requirements for interest on deposits maintained at U.S. offices of certain financial institutions and paid to nonresident alien individuals that are residents of certain specified countries.

My conclusion is that the proposed regulation would be detrimental to the economy of the United States, and would provide little or no benefit to the U.S. Treasury, either in terms of administrative advantages or additional revenue. As such, it should not be adopted.

Current law tax treatment makes deposit interest paid to nonresident aliens not reportable.

Like many other nations, the United States does not impose tax and does not engage in withholding on interest paid to foreign holders of U.S. bank deposits or government bonds. In effect, the foreign savers get tax treatment on U.S. interest income from these sources 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.

Because the interest income is tax exempt in the United States if the recipient is a nonresident alien, there is currently no requirement that the payer or the recipient report the interest to the IRS (except for interest paid to residents of Canada that is reportable pursuant to an information exchange agreement). Consequently, most foreign depositors enjoy strict financial

privacy with respect to their U.S. deposit accounts. In particular, the IRS does not have the capability of informing foreign tax authorities of the U.S. interest payments received by their nationals, and those nationals may, if they choose, avoid foreign taxes.

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. 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 regulation would make such deposit interest reportable.

The proposed regulation would alter the non-reportable status of deposit interest paid to nonresident aliens who are residents of certain foreign countries. Payers of interest on deposits maintained at U.S. offices of certain financial institutions would be required to issue a copy of Form 1042-S to the interest recipient, and report that information to the IRS. That information would then be available for the IRS to share with the listed countries' tax authorities under income tax treaties or tax information exchange agreements (TIEAs). This would end the financial privacy enjoyed in the United States by nonresident alien depositors from such countries.

The authority for imposing the regulation is unclear, as it benefits foreign tax authorities more than the IRS.

The IRS has argued that these regulations will help to enforce U.S. tax law, which gives the IRS the authority to impose them. That argument is not convincing. In reality, the regulation will chiefly help foreign countries enforce their tax laws, to the detriment of investment in the United States, and will do little or nothing to help the IRS enforce U.S. tax law.

The regulation is, in the first instance, aimed squarely at nonresident aliens who do not owe U.S. tax. It does not apply to U.S. residents. Its only connection with enforcement of U.S. tax law, a very round-about and tenuous connection, is that it might turn up information on nonresidents that could be exchanged, pursuant to income tax treaties or tax information exchange agreements (TIEAs) with foreign tax authorities, for information they might possess on U.S. residents who are avoiding U.S. taxes on interest earned abroad.

Savers will shift assets in response to the regulation, and the expected revenues to foreign and U.S. tax authorities will not materialize.

The scheme is unlikely to succeed unless all nations conform to the information exchange program. U.S. residents with foreign deposits and nonresidents with U.S. deposits who are determined to avoid home country taxes will not sit still for the change in regulations and

reporting requirements. Only the most careless of such foreign investors would continue to hold deposits in the United States once these regulations are adopted. Similarly, only the most careless of such American investors would continue to leave deposits in the information exchange nations once information sharing begins. Both sets of depositors would transfer their assets, not to their home countries, but to third nations that continue to offer financial privacy. Once these transfers of funds are made, the Treasury will have no information to offer the foreign tax authorities on their errant citizens, and the foreign tax authorities will have no information to offer the United States Treasury on its errant residents. Consequently, the United States will not collect additional taxes from such persons as a result of this information exchange. Therefore, even under the tenuous round-about reasoning relating to foreign information exchange, this arrangement cannot be construed as helping the United States to enforce U.S. tax law.

The regulation seems contrary to Congressional intent.

The tax exemption for deposit interest paid to nonresident aliens was enacted by the Congress to enable U.S. financial institutions to match the services being offered by banks in the Netherlands Antilles and other tax haven nations. Similarly, the tax exempt treatment of U.S. government bonds held by nonresident aliens has made these securities more attractive to foreign investors. This treatment has encouraged the accumulation of foreign deposits and the holding of U.S. securities. The exemptions have made the United States the world's largest tax haven. The Congress has reviewed this issue on a number of occasions, and has not voted to change this arrangement by subjecting the deposit interest and other tax exempt interest to tax. Consequently, effectively to destroy the arrangement would appear to go against original and ongoing Congressional intent.

The cost of the regulation would far exceed the paperwork burden estimated by the IRS. There would be potentially serious economic costs that the Service has not considered.

The IRS has suggested an unrealistically low reporting burden on the affected financial institutions. That is not the worst of the costs, however. There is more to the cost of a regulation than the paperwork burden. In this instance, there is the potential loss of business by the affected financial institutions, a point acknowledged in the IRS response to critics of the initial version of the proposed regulation issued in 2001. That cost is diminished but not eliminated by reducing the number of countries of residence whose citizens are targeted for disclosure.

Of greater concern, however, is the potential cost to the economy if a significant amount of flight capital should, in fact, flee the country and the dollar. There are roughly one trillion dollars of foreign-owned U.S. issued financial assets at the present time, and a significant portion of that investment may be here in response to the treatment they receive under current law and regulations. The funds so invested have helped to finance U.S. budget deficits without restricting U.S. business fixed investment, and have thereby aided the growth of the U.S. economy. That assistance would be lost if these regulations were adopted.

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.

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 highly sensitive to the after-tax rate of return, and could be regarded as short term lending or 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 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 maintain financial privacy for other reasons, such as fear of falling victim to kidnapping or other criminal activity. In either case, the proposed reporting requirements 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.

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, just for example, that erosion of financial privacy rules causes a 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.

Even if the assumed magnitude of the capital outflow in the illustration numbers is several times too high, it is highly implausible that any gains to the U.S. Treasury from the sharing of tax information on U.S. residents sheltering interest income abroad could make up for the costs of scaring foreign savings away from the United States.

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 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 proposed 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. 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.

However one analyzes the figures, it is not clear that much revenue owed to the Treasury remains to be collected by the information exchange effort that the proposed regulation aims to support. Furthermore, taxpayers determined to dodge U.S. taxes could avoid the information exchange regime by shifting their investments to financial institutions in countries not covered by the regulation. Indeed, given the high tax rates found in most of the listed countries covered by the proposed regulation, it is doubtful that many bona fide tax evaders are using these countries as shelters even now.

The Treasury is considering a major reform of the tax system. The regulation should wait for the outcome of the tax reform initiative.

The Treasury Department is studying proposals for a fundamental reform of the tax system. Depending on the choice of alternatives, and assuming favorable action by the Congress, the information sought by the proposed regulation may become moot. Many of the proposals for fundamental tax reform in the economic literature would replace the income tax with consumption-based or consumed-income taxes. In these systems, by one means or another, all interest income would receive the same tax treatment currently accorded regular IRAs and pensions, or Roth IRAs and tax exempt bonds. The tax systems also would be territorial rather than global in reach. Income earned outside the United States would not be taxable. In none of these systems would there be any income tax levied on interest earned abroad by U.S. taxpayers, nor, most likely, any U.S. tax on interest earned in the United States by foreigners. The IRS would have no need for the information exchange program that is driving the regulation. If even a portion of the shift to a consumption tax base were adopted by the Congress, the value of the proposed regulation would be rendered even less than under current law.

Conclusion

The proposed regulation would harm the economy of the United States, is only distantly related to enforcement of U.S. tax law, and would generate little or no additional tax revenue. Therefore, it should not be adopted.