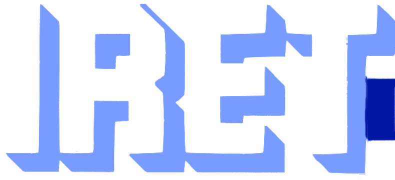

POLICY BULLETIN

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FINANCIAL PRIVACY AND INDIVIDUAL LIBERTY

Introduction

Well before the September 11 attacks, a major European-led international effort was underway to promote greater intergovernmental information sharing and to effectively end financial privacy. Although there was some interest in the law enforcement aspects of this program by the Financial Crimes Enforcement Network of the U.S. Treasury Department (FinCEN) and, internationally, by the Financial Action Task Force on Money Laundering (FATF), it was clear that the primary motivation of the governments leading the effort was tax administration.

The Organization for Economic Cooperation and Development (OECD) launched a major initiative in 1996 designed to abolish financial privacy and limit tax competition by blacklisting low-tax jurisdictions or so-called tax havens (the OECD Harmful Tax Competition initiative). In 2000, the United Nations (UN) commenced a campaign to enable the UN to share financial information among UN member states through the proposed United Nations International Tax Organization (UNITO). The United States government made important contributions to the effort with the proposed bank deposit interest reporting regulations, the qualified intermediary (QI) rules, the effective incorporation of "know your customer" (KYC) banking regulations into the U.S. QI rules and support for the OECD and other initiatives. The European Union also launched its Savings Tax Directive designed to share information among EU member states and other key financial centers, including the U.S. and Switzerland.

Law enforcement officials need reliable information to combat serious crimes, prevent terrorism and protect national security. Congressional testimony and reports in the U.S. and European news media made it clear very soon after the attacks, however, that the current information sharing framework both within the U.S. government and internationally is simply inadequate and misdirected for purposes of addressing the threat that terrorism poses to the United States and allied countries. The approach that has been adopted so far is largely to do more of what has been ineffective. Moreover, many of the "innovations" or "new initiatives" inaugurated since the attacks will actually make the situation worse.

The political situation since the attacks has changed dramatically. There has been an acceleration in the demands to share information and a further degradation in privacy concerns. This was demonstrated, most notably, by the enactment in October, 2001 of the International

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Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.[1] Numerous regulations have been issued under the authority granted by this Act.[2] Databases were created at Interpol and countless interagency task forces were created. Recent calls for a second "Patriot Act" show that the government's appetite for even greater information flow is not sated.

Many OECD governments appear to be exploiting the political climate in the aftermath of September 11 to promote information exchange policies that have more to do with limiting tax competition than enhancing international efforts to apprehend terrorists and criminals.

This paper is divided into five major parts. The first examines current practice and major proposals for change with respect to information gathering and exchange. This discussion separately treats issues relating to national security, terrorism and law enforcement on the one hand, and tax administration on the other. The second discusses the relationship between financial privacy and individual liberty. The third analyzes current practice and various reform proposals in light of the importance of financial privacy to individual freedom. The fourth discusses recommendations for reform that will enable the federal government actually to enhance its ability to protect the lives, liberty and property of the American people while enhancing the privacy of law-abiding citizens. The fifth sets forth a proposed international Convention on Privacy and Information Exchange that would impose for the first time enforceable limits on the uses to which governments can put the information obtained.

Information Exchange: Current Practice and Proposals

There are a wide variety of U.S. and foreign government agencies and international agencies involved in the collection and dissemination of information about private persons and organizations. This paper divides the discussion into two basic areas: (1) National Security, Terrorism and Law Enforcement, and (2) Tax Administration. The lines between these areas are not bright, and various agencies are involved in collecting information for more than one purpose. The priorities, the methods and the policy choices in each area are, or at least should be, different.

National Security, Terrorism and Law Enforcement

The major agencies involved in collecting and disseminating information about private persons for national security, anti-terrorism and law enforcement purposes in the United States are the Federal Bureau of Investigation (FBI), the Criminal Division of the Justice Department,

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[1] Enacted as a component part of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (H.R. 3162; Public Law No: 107-56, October 26, 2001).

[2] For a description of the regulations promulgated, see A Report to the Congress in Accordance with §356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT ACT) submitted by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission, December 31, 2002.

the Central Intelligence Agency (CIA), the National Security Agency (NSA)[3] and the Financial Crimes Enforcement Network of the U.S. Treasury Department (FinCEN). Internationally, the primary organizations involved are the Financial Action Task Force on Money Laundering (FATF) and the International Criminal Police Organization (Interpol). FATF is housed at the Organization for Economic Cooperation and Development (OECD) in Paris but is independent of the OECD. Interpol is headquartered in Lyons, France. FinCEN, FATF and Interpol are the primary agencies involved in monitoring financial transactions and enforcing laws against money laundering.

FinCEN was created in 1990. Its Money Laundering working group is composed of representatives from many other agencies including the Internal Revenue Service, the Customs Service, the Secret Service, the Federal Law Enforcement Training Center, the Department of Justice, the Federal Bureau of Investigation, the Drug Enforcement Agency, the United States Postal Inspection Service, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

The primary source material for FinCEN investigations are suspicious activity reports (SARs) and currency transaction reports (CTRs) provided by U.S. financial institutions. SARs are filed when a financial institution detects activity that it believes may constitute unlawful activity. CTRs are filed with respect to cash transactions of $10,000 or more.[4]

Suspicious Activity Reports Filed (1996-2002)[5]
(in thousands)

Year	1996	1997	1998	1999	2000	2001	2002
Total Filings	52.0	81.2	96.5	120.5	162.7	203.5	224.2

Note: 2002 data is through October 31, 2002 only. Estimated 2002 total is approximately 280,000.

Between 12,000,000 and 13,000,000 CTRs have been processed by FinCEN every year since fiscal year 1995. 12.3 million were processed in fiscal year 2002.[6]

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[3] The NSA routinely monitors electronic communications abroad and communications between U.S. residents and persons abroad.

[4] Internal Revenue Code section 6050I and the Bank Secrecy Act, Pub. L. 91-508, title II, Oct. 26, 1970, 84 Stat. 1118 and Currency and Foreign Transactions Reporting Act, Pub. L. 97-258, Sec. 5(b), Sept. 13, 1982, 96 Stat. 1068, especially at 31 USC 5313.

[5] The SAR Activity Review, Trends, Tips and Issues, February 2003, p. 5.

[6] FinCEN Report to the Congress on the Use of Currency Transaction Reports, October 2002.

FATF was established in 1989 by an agreement reached at a G-7 summit. FATF is a very informal group working under minimal formal restrictions or guidelines. Twenty-eight countries now participate in FATF. FATF's primary role has been to establish standards relating to money laundering laws and practices and work to implement these standards around the world. Its basic standards are outlined in its "40 recommendations." Those recommendations include (1) the criminalization of the laundering of the proceeds of serious crimes, (2) the enactment of laws to seize and confiscate the proceeds of crime, (3) the imposition of obligations for financial institutions to identify all clients, including any beneficial owners of property, and to keep appropriate records, (4) the imposition of a requirement for financial institutions to report suspicious transactions to the competent national authorities, and the implementation of a comprehensive range of internal control measures at financial institutions, (5) the creation of adequate systems for the control and supervision of financial institutions, (6) the entering into force of international treaties or agreements relating to money laundering, and (7) the enactment of national legislation which will allow countries to provide prompt and effective international co-operation. FATF periodically publishes a report listing non-cooperating countries and territories (NCCTs).[7] These countries and financial institutions located in these countries are subject to greater review and countries that do not comply with FATF's recommendations may be subjected to potentially severe sanctions by FATF member countries.

In the aftermath of the September 11th attacks, Interpol established a September 11th Task Force. On December 11th, 2001, Interpol and the U.S. Treasury announced the creation of a new partnership that would, most notably, establish an international terrorist financing database. The Interpol database is designed to consolidate international and national lists of terrorist financiers and make it available to police around the world to prevent the flow of funds to terrorist groups and to assist in criminal investigations. Participants would include all 179 members of Interpol.

Tax Administration

The United States imposes income taxes on U.S. persons (including corporations, citizens and resident aliens) on their income from throughout the world.[8] Accordingly, the United States Internal Revenue Service has a strong interest in obtaining financial information from abroad. To assist the IRS in obtaining this information, the United States has entered into a wide array of bilateral income tax treaties and information sharing arrangements. In addition, the United States requires its financial institutions to report interest and dividends paid to U.S. residents and information related to certain other financial transactions. With the advent of the recent qualified intermediary (QI) rules and the proposed interest reporting regulation (both discussed below), the

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[7] In its February 13, 2003 report, the Cook Islands, Egypt, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, Philippines, St. Vincent and the Grenadines, and the Ukraine were listed as NCCTs. Dominica, Hungary, Lebanon, the Marshall Island, Niue, St. Kitts and Nevis were recently dropped. Ukraine was a new addition.

[8] Those interested in a relatively brief introduction to U.S. taxation of international income may wish to examine *International Taxation*, 3rd Edition, Richard L. Doernberg (West Publishing, 1997).

U.S. has become increasingly aggressive in requiring foreign financial institutions to make similar reports. Finally, under the Clinton administration, the U.S. supported the OECD harmful tax competition initiative, which would impose severe sanctions on non-OECD low tax countries that do not disclose financial information with respect to customers doing business in those countries. The Bush administration position is more ambiguous. In addition, Robert Rubin, former U.S. Secretary of the Treasury in the Clinton administration, was instrumental in developing the proposal to create a UN International Tax Organization that would generalize the OECD initiative to apply to all countries, including the U.S.

OECD Harmful Tax Competition

The Organization for Economic Cooperation and Development (OECD) is an international organization with 30 member countries, including the U.S., Canada, Japan and most European countries. In May of 1996, Ministers instructed the OECD to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases." In April of 1998, the OECD Council adopted a Recommendation to the Governments of Member Countries[9] and issued a report entitled "Harmful Tax Competition: An Emerging Global Issue." In that report, the OECD adopted the position that it was necessary to engage in a collective international effort to stop harmful tax competition by harmful tax regimes. The OECD is worried that low tax countries will attract too much capital from high tax countries.[10] The OECD considers a country a harmful tax regime if the country (1) has low or zero income taxes, (2) allows foreigners investing in the country to do so at favorable rates, and (3) affords financial privacy to its investors or citizens. The OECD identified 41 countries (mostly developing countries) as "harmful tax regimes."

The OECD demanded that the low tax countries sign a Memorandum of Understanding (MOU). Originally, the deadline for compliance was July 31, 2001 and then November 2001. Now, a jurisdiction must have made a "commitment" by February 28, 2002 to eliminate "harmful tax practices" to avoid being blacklisted as a "non-cooperating jurisdiction." A commitment involves agreeing to an "implementation plan." By the expedient of broadening what constitutes a "commitment," the OECD has persuaded over 30 jurisdictions to become "committed jurisdictions." Seven jurisdictions have been blacklisted.[11] As a result of the fluidity of the process and the lack of any governing rule or principle in the process, it is now far from clear what being a "committed jurisdiction" actually means. The target date for the elimination of

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[9] Luxembourg and Switzerland abstained. The Clinton Administration supported the OECD initiative.

[10] For example, the report states, "Globalization has, however, also had the negative effects of opening up new ways by which companies and individuals can minimize and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital," Harmful Tax Competition: An Emerging Global Issue (1998), p. 14, section 23.

[11] They are Andorra, the Principality of Liechtenstein, Liberia, the Principality of Monaco, the Republic of the Marshall Islands, the Republic of Nauru and the Republic of Vanuatu.

"harmful tax practices" is April 2003. It is quite possible, if not probable, that the OECD and the "committed jurisdictions" will have a falling out in the Spring as the OECD starts to demand binding agreements that would effectively abolish financial privacy. Alternatively, the OECD could compromise its aims. The OECD has been forced to be less aggressive because the Bush administration support for the initiative has been more qualified, in contrast to the Clinton administration's strong support.[12]

Once the process has evolved a bit further, the OECD can be expected to work to ensure that OECD member states impose sanctions on the blacklisted countries. Sanctions proposed by the OECD for imposition on the targeted low tax countries include the termination of tax treaties, denying income tax deductions for business purchases made from targeted countries (thereby dramatically raising the cost of buying materials, parts, and services from suppliers in that country), imposing withholding taxes on payments to residents of targeted countries, and denying the foreign tax credit for taxes paid to the targeted government. The OECD also proposes to explore measures designed to disrupt normal banking and business operations.

United Nations International Tax Organization

On June 25, 2001 UN Secretary-General Kofi Annan provided the report of the High Level Panel on Financing for Development to the General Assembly of the UN. He appointed the panel in December of 2000.[13] Annan described the report as a "solid piece of work" and commended the panel for the "energy, imagination and effort that they brought to their task." The recommendations of the report were considered at the Conference on Financing for Development, which took place in Monterrey, Mexico in March 2002. The continued promotion

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[12] See, Statement of Paul H. O'Neill before the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, OECD Harmful Tax Practices Initiative, July 18, 2001. See also, "U.S. to Abandon Crackdown on Tax Havens, OECD Effort Is Too Broad and Could Raise U.S. Taxes, Treasury's O'Neill Says," Washington Post, By Dana Milbank, Washington Post Staff Writer, Friday, May 11, 2001; Page A29.

[13] The U.N. report is available at http://www.un.org/esa/ffd/a55-1000.pdf. The members of the panel were:
Abdulatif Al-Hammad, President, Arab Fund for Economic Development, Kuwait;
David Bryer, Director of OXFAM, United Kingdom;
Mary Chinery-Hesse, Former Deputy Director-General of the International Labor Organization, Ghana;
Jacques Delors, former Finance Minister of France and President of the European Commission;
Rebeca Grynspan, former Vice-President, Costa Rica;
Aleksander Livshitz, Chairman of the Board of the Russian Credit Bank;
Majid Osman, former Finance Minister of Mozambique, who now heads a commercial bank;
Robert Rubin, former Secretary of the Treasury, United States;
Manmohan Singh, former Minister of Finance, India; and
Masayoshi Son, President and Chief Executive Officer of Softbank Corporation in Japan.

of cooperation in tax matters was one of the few concrete recommendations to emerge from the Monterrey conference.[14]

The report recommends the creation of an International Tax Organization (ITO).[15] The proposed ITO would "sponsor a mechanism for multilateral sharing of tax information, like that already in place with OECD, so as to curb the scope for evasion of taxes on investment income earned abroad."[16] The proposed UNITO would result in every UN member government having routine unqualified access to the financial information of the citizens of all UN member states.

The primary purpose of the UNITO would be to limit tax competition. The report states:

> The taxes that one country can impose are often constrained by the tax rates of others: this is true of sales taxes on easily transportable goods, of income taxes on mobile factors (in practice, capital and highly qualified personnel) and corporate taxes on activities where the company has a choice of location. Countries are increasingly competing not by tariff policy or devaluing their currencies but by offering low tax rates and other tax incentives, in a process sometimes called "tax degradation".[17]
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> It [the ITO] might engage in negotiations with tax havens to persuade them to desist from harmful tax competition. It could take a lead role in restraining the tax competition designed to attract multinationals – competition that, as noted earlier, often results in the lion's share of the benefits of foreign direct investment accruing to the foreign investor.[18]
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> Another task that might fall to an ITO would be the development, negotiation and operation of international arrangement for the taxation of emigrants. At present most emigrants pay taxes only to their host country, an arrangement that exposes source countries to the risk of economic loss when many of their most able citizens emigrate.[19]

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[14] See, Report of the Secretary-General, Follow-up Efforts to the International Conference on Financing and Development, August 16, 2002, especially sections 27-29 and 60.

[15] Report of the High Level Panel on Financing for Development to the General Assembly, pp. 27-28, 64-66.

[16] Ibid, p. 28.

[17] Ibid, p. 65.

[18] Ibid, p. 65.

[19] Ibid, p. 66.

The report recommends that a currency transactions tax or carbon (CO_2) tax be imposed to finance the various spending programs it recommends.[20] The report recommends that foreign aid from developed countries be 0.7 percent of GDP (or roughly $75 billion for the U.S., a nearly 8 fold increase).[21] The report endorsed steps to create a global council to promote global governance because "modern globalization calls for global governance."[22]

U.S. Qualified Intermediary Rules

Payments from the U.S. to foreigners are often subjected to a withholding tax. Fixed or determinable annual or periodical (FDAP) income (i.e. rents, royalties, interest, dividends, and the like but not capital gains) paid from U.S. sources is subject to a 30 percent withholding tax, unless a treaty between the U.S. and the country of the foreign payee reduces the rate.[23] Treaties generally reduce the withholding tax rate to the five to fifteen percent range.[24] However, if the interest is portfolio or bank deposit interest, Internal Revenue Code sections 871(h), 871(i) and 881(c) exempt most interest paid to foreigners.

The "qualified intermediary" rules, effective January 24, 2000, are designed to enforce the withholding taxes on U.S. source income paid to foreigners and to ensure that income paid to foreign financial institutions with respect to assets beneficially owned by U.S. persons is taxed.[25] They are quite complex.[26]

A "qualified intermediary" is defined as (1) a foreign financial institution, (2) a foreign branch or office of a U.S. financial institution or (3) a foreign corporation presenting claims

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[20] Ibid, pp. 26-27.

[21] Ibid, p. 21.

[22] Ibid, pp. 24, 26.

[23] IRC §1441 (regarding individual payees) and IRC §1442 (regarding corporate payees); also see IRC §871 and §881.

[24] See IRS Publication No. 515, Withholding of Tax on Non-resident Aliens and Foreign Corporations.

[25] See generally IRC §§1441-1443.

[26] The QI rules are primarily set forth in Treasury Regs. §1.1441-1(e)(5), Rev. Proc. 2000-12 (2000-4 Internal Revenue Bulletin 387) effective January 24, 2000 and Notice 2001-4 (Internal Revenue Bulletin 2001-8, January 8, 2001). See also Announcement 2000-48. It is, at some level, remarkable that such a short statutory provision can give rise to so many hundreds of pages of rules, including the regulations under section 1441, the various information reporting requirements related to withholding, Revenue Procedure 2000-12 relating to QIs, and the many country specific attachments and approved KYC rules.

under a tax treaty that has entered into a withholding agreement with the Internal Revenue Service.[27]

In order to become a qualified intermediary (a "QI"), an institution must apply. The application requires dozens of lists, statements and documents.[28] In addition, the QI is required to fully inform the IRS about the details of its home country know your customer rules.[29]

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[27] §1.1441-1(e)(5)(ii). The agreement that the qualified intermediary must sign is set forth in Rev. Proc. 2000-12. This agreement establishes the "QI's rights and obligations regarding documentation, withholding, information reporting, tax return filing, deposits, and refund procedures under sections 1441, 1442, 1443, 1461, 3406, 6041, 6042, 6045, 6049, 6050N, 6302, 6402, and 6414 of the Internal Revenue Code with respect to certain types of payments." See Preamble, QI Agreement, Rev. Proc. 2000-12.

[28] A prospective QI must submit an application to become a QI. The application must establish to the satisfaction of the IRS that the applicant has adequate resources and procedures to comply with the terms of the QI withholding agreement. An application must include the information specified in the Revenue Procedure and any additional information and documentation requested by the IRS. The information required includes:
(1) A statement that the applicant is an eligible person and that it requests to enter into a QI withholding agreement with the IRS.
(2) The applicant's name, address, and employer identification number (EIN), if any.
(3) The country in which the applicant was created or organized and a description of the applicant's business.
(4) A list of the position titles of those persons who will be the responsible parties for performance under the Agreement and the names, addresses, and telephone numbers of those persons as of the date the application is submitted.
(5) An explanation and sample of the account opening agreements and other documents used to open and maintain the accounts at each location covered by the Agreement.
(6) A list describing the type of account holders (e.g., U.S., foreign, treaty benefit claimant, or intermediary), the approximate number of account holders within each type, and the estimated value of U.S. investments that the QI agreement will cover.
(7) A general description of U.S. assets by type (e.g., U.S. securities, U.S. real estate), including assets held by U.S. custodians, and their approximate aggregate value by type. The applicant should provide separate information for assets beneficially owned by the applicant and for assets it holds for others.
(8) A completed Form SS-4 (Application for Employer Identification Number) to apply for a QI Employer Identification Number (QI-EIN) to be used solely for QI reporting and filing purposes. An applicant must apply for a QI-EIN even if it already has another EIN. Each legal entity governed by the QI withholding agreement must complete a Form SS-4.
(9) Completed appendices and attachments that appear at the end of the QI agreement.

[29] The IRS will not enter into a QI withholding agreement that provides for the use of documentary evidence obtained under a country's know-your-customer rules if it has not received the "know-your-customer" practices and procedures for opening accounts and responses to the 18 specific items presented below. If the information has already been provided to the IRS, it is not necessary for a particular prospective QI to submit the information. The IRS may publish lists of countries for which it has received know-your-customer information and for which the know-your-customer rules are acceptable. The 18 items are as follows:

1. An English translation of the laws and regulations ("know-your-customer" rules) governing the requirements of a QI to obtain documentation confirming the identity of QI's account holders. The translation must include the name of the law, and the appropriate citations to the law and regulations.

(continued...)

Once an institution has become a QI, the institution becomes a withholding agent within the meaning of Internal Revenue Code §3406 for amounts it pays to its account holders.[30] The withholding agent must withhold 30 percent of any payment amount subject to non-resident alien (NRA) withholding made to an account holder that is a foreign person. It must withhold this 30

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[29](...continued)
2. The name of the organization (whether a governmental entity or private association) responsible for enforcing the know-your-customer rules. Specify how those rules are enforced (e.g., through audit) and the frequency of compliance checks.
3. The penalties that apply for failure to obtain, or evaluate, documentation under the know-your-customer rules.
4. The definition of customer or account holder that is used under the know-your-customer rules. Specify whether the definition encompasses direct and indirect beneficiaries of an account if the activity in the account involves the receipt or disbursal of funds. Specify whether the definition of customer or account holder includes a trust beneficiary, a company whose assets are managed by an asset manager, a controlling shareholder of a closely held corporation or the grantor of a trust.
5. A statement regarding whether the documentation required under the know-your-customer rules requires a financial institution to determine if its account holder is acting as an intermediary for another person.
6. A statement regarding whether the documentation required under the know-your-customer rules requires a financial institution to identify the account holder as a beneficial owner of income credited to an account.
7. A list of the specific documentation required to be used under the know-your-customer rules, or if those rules do not require use of specific documentation, the documentation that is generally accepted by the authorities responsible for enforcing those rules. Generally, the IRS will not permit a QI to establish the identity of an account holder without obtaining documentation directly from the account holder.
8. A statement regarding whether the know-your-customer rules require that an account holder provide a permanent residence address.
9. A summary of the rules that apply if an account is not opened in person (e.g., correspondence, telephone, Internet).
10. Whether an account holder's identity may be established, in whole or in part, by introductions or referrals.
11. The circumstances under which new documentation must be obtained, or existing documentation verified, under the know-your-customer rules.
12. A list of all the exceptions, if any, to the documentation requirements under the know-your-customer rules.
13. A statement regarding whether the know-your-customer rules do not require documentation from an account holder if a payment to or from that account holder is cleared by another financial institution.
14. A statement regarding how long the documentation remains valid under the know-your-customer rules.
15. A statement regarding how long the documentation obtained under the know-your-customer rules must be retained and the manner for maintaining that documentation.
16. Specify whether the rules require the maintenance of wire transfer records, the form of the wire transfer records and how long those records must be maintained. State whether the wire transfer records require information as to both the original source of the funds and the final destination of the funds.
17. A list of any payments or types of accounts that are not subject to the know-your-customer rules.
18. Specify whether there are special rules that apply for purposes of private banking activities.

[30] QI's may, but need not, assume primary responsibility for non-resident alien withholding under IRC §1441. (QI Agreement, sections 3.02-3.03, Rev. Proc. 2000-12.) A QI does have the primary responsibility to issue Form 1099s, although it can designate another payor to undertake this function. (QI Agreement, section 3.05, Rev. Proc 2000-12. See also section 4.01.)

percent tax unless it has reliable documentation to prove that the payee is either a U.S. person or a beneficial owner that is a foreign person entitled by tax treaty to a reduced rate of withholding.[31]

QIs agree to collect and maintain information on their account holders in accordance with the specified "know-your-customer" requirements and to withhold the appropriate amount of tax.[32] A QI may not reduce the rate of withholding based on a beneficial owner's claim of treaty benefits unless the QI obtains specified documentation that the owner is eligible for the benefits.[33]

The QI agreement establishes the presumption that amounts subject to withholding paid to an account that is maintained outside the United States is presumed made to an undocumented foreign account holder. Therefore, the QI must treat the amount as subject to withholding at a rate of 30 percent on the gross amount paid and report the payment to an unknown account

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[31] See QI Agreement, section 3.01, Rev. Proc. 2000-12. In general, the QI is a payor under section 3406 and is required to deduct and withhold 31 percent from the payment of a reportable payment to a U.S. non-exempt recipient if the U.S. non-exempt recipient has not provided its TIN in the manner required by U.S. law. (QI Agreement, section 3.04, Rev. Proc. 2000-12.) The QI can, however, avoid this responsibility by avoiding primary Form 1099 responsibility and by providing Forms W-9 for its U.S. non-exempt recipient account holders together with the withholding rate pools attributable to those account holders. (QI Agreement, section 3.06, Rev. Proc. 2000-12.)

[32] See QI Agreement, section 5.01, Rev. Proc. 2000-12. A QI may generally treat an account holder (including an account holder that is a collective investment vehicle) as a foreign beneficial owner of an amount if the account holder provides a valid Form W-8 (other than Form W-8IMY) or other valid documentary evidence. A QI may treat a documented foreign beneficial owner account holder as entitled to a reduced (or zero) rate of non-resident alien (NRA) withholding if all the requirements to a reduced rate are met and the documentation provided by the account holder supports entitlement to a reduced (or zero) rate. In addition, the QI may not treat an account holder that provides documentation indicating that it is a bank, broker, intermediary, or agent (such as an attorney) as a beneficial owner unless the QI receives a statement, in writing and signed by a person with authority to sign such a statement, stating that such account holder is the beneficial owner of the income. (QI Agreement, section 5.02, Rev. Proc. 2000-12.)

[33] The documentation is that required by section 5.03 of the QI Agreement. That section requires, among other things, that the account holder properly complete Form W-8BEN, the account holder has provided know-your-customer compliant documentation and the account holder has provided a statement to the effect that the account holder has met all of the legal requirements entitling the account holder to the benefit of the treaty, provided however, that the QI is excused from the statement requirement if the account holder is an individual resident of an applicable treaty country. The QI must comply with a variety of rules concerning what is and is not valid documentation. (QI Agreement, section 5.10, Rev. Proc. 2000-12.)

holder on Form 1042-S.[34] The QI may presume that foreign source income paid outside the U.S. is not subject to withholding or reporting.[35]

In general, the IRS agrees not to audit QIs but to accept instead the audit conducted by an approved external auditor.[36] These auditors verify that the QI's employees are properly trained, that the QI's withholding responsibilities have been properly discharged, that the reporting pools rules have been properly complied with, that the proper forms have been filed, and so forth. The external auditor provides a report to the IRS.

The IRS has taken some steps to streamline this cumbersome process. It has issued a list of countries with approved KYC rules, so that each institution within that jurisdiction does not have to individually satisfy the IRS with respect to its country's KYC rules.[37] The QI withholding agreement permits a qualified intermediary to use documentary evidence of the same type as that obtained under the KYC rules applicable to the QI, but only if the documentation is listed in an attachment to the QI withholding agreement. The IRS is developing country-specific attachments for countries that have approved KYC rules.[38]

U.S. Interest Reporting Regulations

As noted, payments from the U.S. to foreigners are often subjected to a withholding tax. FDAP income (i.e. rents, royalties, interest, dividends, and the like) is subject to a 30 percent withholding tax, unless a treaty between the U.S. and the country of the foreign payee reduces

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[34] The QI agreement obligates the QI to file Form 1042-S for each pool of income. (QI Agreement, sections 6.03 and 8.01, Rev. Proc. 2000-12.) The QI, however, must file separate 1042-S Forms in the case of non-qualified intermediary account holders, unknown recipients and each QI or foreign partnership account holder that receives amounts subject to non-resident agent withholding. (QI Agreement, section 8.02, Rev. Proc. 2000-12.) The QI must file Form 1099s, in general, for unknown owners and U.S. non-exempt recipients. (QI Agreement, section 8.04, Rev. Proc. 2000-12.)

[35] QI Agreement, section 5.11, Rev. Proc. 2000-12.

[36] QI Agreement, section 10.01, Rev. Proc. 2000-12.

[37] Jurisdictions with approved Know-Your-Customer rules include Andorra, Argentina, Aruba, Australia, Austria, Bahamas, Barbados, Belgium, Bermuda, British Virgin Islands, Canada, Cayman Islands, Chile, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Gibraltar, Greece, Guernsey, Hong Kong, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Korea, Luxembourg, Liechtenstein, Malta, Monaco, Netherlands, Netherlands Antilles, Norway, Panama, Portugal, Singapore, Spain, St. Lucia, Sweden, Switzerland, Turks and Caicos Islands, Uruguay and the United Kingdom. Jurisdictions awaiting approval of Know-Your-Customer Rules include Antigua, Bahrain, Colombia, Iceland, Lebanon, Saudi Arabia, Slovenia and the United Arab Emirates.

[38] Approved country specific attachments are available for these countries: Austria, Barbados, Belgium, Bermuda, Canada, Cayman Islands, Denmark, Finland, France, Germany, Gibraltar, Guernsey, Hong Kong, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Korea, Luxembourg, Monaco, Netherlands, Netherlands Antilles, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

the rate.[39] Treaties generally reduce the withholding tax rate to the five to fifteen percent range.[40] FDAP income includes interest and dividends but not capital gains. To attract foreign capital to the United States, in 1984 Congress enacted the portfolio interest exception, which repealed this tax on interest received by non-resident aliens on most portfolio debt instruments (including interest on bank deposits and bonds).[41] This exception only applies to unrelated borrowers and lenders and is otherwise restricted but is quantitatively very important.[42] Although it is difficult to know for certain, analysts generally believe that this provision has attracted somewhat over $1 trillion in foreign capital to the United States.

On January 17, 2001, immediately prior to the change in U.S. administrations, the U.S. Internal Revenue Service (IRS) issued a proposed regulation entitled "Guidance on Reporting of Deposit Interest Paid to Nonresident Aliens."[43] The IRS previously had issued a regulation concerning information relating to interest paid on deposits from U.S. bank accounts to nonresident alien individuals who are residents of Canada, saying that these regulations would significantly further, in unspecified ways, its compliance efforts. Reg. §1.6049-8(a) requires the reporting of such interest on a Form 1042-S.

The regulations proposed in January 2001 would have extended the information reporting requirement for bank deposit interest paid to nonresident alien individuals who are residents of foreign countries. The regulations would require all payors of interest to non-resident aliens to file a Form 1042-S. This form, among other things, would require the reporting of the payee's name and address, tax numbers and the amount paid. Under current rules, once a foreigner has filed a W-8 establishing foreign status, there is no need to file a Form 1042-S with respect to interest payments since there is no U.S. tax imposed. The IRS regards this extension as appropriate for two reasons. First, requiring routine reporting to the IRS of all bank deposit interest paid within the United States would minimize the possibility of avoidance of the U.S. information reporting system (such as through false claims of foreign status). Second, several countries that have tax treaties or other agreements that provide for the exchange of tax information with the United States have requested information concerning bank deposits of individual residents of their countries. Treasury and the IRS believe it is important for the United States to facilitate, wherever possible, the effective exchange of all relevant tax information with our treaty partners because of the importance that the United States government attaches to exchanging tax information pursuant to income tax treaties or tax information exchange agreements as a way of encouraging voluntary compliance and furthering transparency.

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[39] IRC §1441 (regarding individual payees) and IRC §1442 (regarding corporate payees); also see IRC §871 and §881.

[40] See IRS Publication No. 515, Withholding of Tax on Non-resident Aliens and Foreign Corporations.

[41] PL 98-369 (July 18, 1984), The Deficit Reduction Act of 1984.

[42] IRC §881(c)(3).

[43] REG-126100-00.

In August, 2002, the Bush administration withdrew the Clinton regulation and proposed a new rule.[44] Although the new rulemaking would withdraw the widely and strongly criticized January 17th proposal, it only slightly narrows its scope.[45] This new rule would require reporting of interest paid to residents of Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden and the United Kingdom. The reporting requirements would mandate that copies of Forms 1042-S be furnished to the Service and to NRAs who are residents of these countries with a copy to the Service. The rule would permit payors to choose to report bank deposit interest paid to all NRAs. As a prelude of things to come, the Treasury presages it may expand upon this list of countries. The Service intends to collect this information in a central repository, so that it can be made available to unspecified authorities in the enumerated foreign nations. If the payor has not filed valid Forms W-8 or W-9, a payment made to a U.S. non-exempt recipient is generally subject to backup withholding.

European Union Savings Tax Directive

The European Union proposed a new Savings Tax Directive at the European Council meeting in Feira, Portugal in June 2000 which was approved by the EU's Council of Finance Ministers in November 2000. Under this Directive, nations would automatically exchange information on the investment earnings of foreign investors.[46] This pact would apply to all EU member nations as well as six non-EU nations (the United States, Switzerland, Liechtenstein, Andorra, Monaco, and San Marino). In order to go into effect, the Directive was required to have received unanimous support from all EU member nations, and all six non-EU jurisdictions were to have agreed to participate by the end of 2002.

The EU openly acknowledges that the Savings Tax Directive would fail without the participation of non-member nations, since "the proposal could incite paying agent operations to relocate outside the EU."[47] The Savings Tax Directive seeks to overturn existing international practices. Nations would have no choice but to collect information on foreign investors, even if there was no need to amass that data for purposes of domestic laws or administrative practices.[48]

On January 21, 2003 a deal was struck in the EU Council of Ministers. Under the proposed Directive, twelve EU Member States would implement automatic exchange of information

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[44] Available at http://www.treasury.gov/press/releases/reports/po33011.pdf.

[45] REG-133254-02 (2002).

[46] The European Union is a Brussels-based international organization representing the 15-member European Community. A description of the European Union's "Savings Tax Directive" can be found at http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip011026/memo0 1266_en.pdf.

[47] Ibid, p. 2.

[48] Ibid, p. 3.

concerning interest income derived from savings in another Member State from the date of application of the Directive, while Austria, Belgium and Luxembourg would apply a withholding tax on savings held by residents of other Member States (15% for the first three years, 20% for the following three and thereafter 35%) and share the revenue with the country of residence (handing over 75% and keeping 25%). These three would implement automatic exchange of information if and when certain third countries (including Switzerland, Liechtenstein, Monaco, Andorra and San Marino) agree to exchange of information upon request with respect to savings income in accordance with the principles of the OECD Agreement on Exchange of Information on Tax Matters. Switzerland is evidently willing to participate by imposing withholding taxes at the same rate as Austria, Belgium and Luxembourg. The Swiss have made it clear they are not willing to exchange information. The EU considers the United States to have complied, presumably because of the proposed interest reporting regulation discussed above. The dependent and associated territories of EU Member States would apply the same arrangements as Member States.

The situation remains somewhat tenuous because adoption of the Directive is predicated on the participation of the non-EU states. The results of the Council of Economics and Finance Ministers meeting, held in Brussels, March 19-20 indicates that the EU will adopt the position that all of the non-EU states will have complied with EU demands.

Financial Privacy and Liberty

In free or liberal societies, elected governments possess limited powers and their primary role — indeed their very reason for existing — is to protect the life, liberty and property of the people they govern.[49] In free societies, there is a small public space and a large private space. People are free to do as they please, free of any interference from government, provided they do not interfere with the equal rights of others. Notably, citizens of a free republic are free to go where they please, talk with whom they please, meet with whom they please, say what they please, trade with whom they please, work at what they please, and so on without any legal requirement to explain anything to the state, the church or to others.[50] To the extent these things are not so, a society is less free.

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[49] See, for example, the U.S. Declaration of Independence, "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. —That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed" or Articles I and II of the Virginia Declaration of Rights: I That all men are by nature equally free and independent, and have certain inherent rights, of which, when they enter into a state of society, they cannot, by any compact, deprive or divest their posterity; namely, the enjoyment of life and liberty, with the means of acquiring and possessing property, and pursuing and obtaining happiness and safety. II That all power is vested in, and consequently derived from, the people; that magistrates are their trustees and servants, and at all times amenable to them. [June 12, 1776]

[50] Obviously, a person can alienate (i.e. compromise or give up) these rights contractually.

Free people are not required to report their whereabouts or their actions to government. Governments in free societies do not monitor law-abiding citizens unless they are suspected of criminal acts and then can do so only under strict safeguards because all citizens are presumed innocent until the state has proven otherwise in a court of law. Invading private spaces requires authority from an independent judiciary that enforces legal restrictions on police action.[51] To the extent these things are not so, a society is less free.

In contrast to liberal governments, totalitarian governments constantly monitor their citizens and, in most spheres of life, actions are presumed to be prohibited unless explicitly permitted or licensed. The state encourages or requires citizens to monitor their fellow citizens. Citizens are obligated to report their whereabouts to the authorities. Contacts with foreigners, or out-of-towners or those holding unacceptable political or religious opinions must be reported. Virtually all aspects on one's life is known and controlled by the state. The only work available is for the state, homes are owned and controlled by the state, financial transactions must be conducted through state financial institutions, and the media and educational institutions are controlled by the state. Thus, the state knows a great deal about what is going on within its jurisdiction and can, therefore, control what goes on. The state aggressively monitors citizens out of fear that they may engage in activities of which the state does not approve or which may represent an actual threat to the government (organizing politically, for example). Systems are established to systematically collect, analyze and act on information about individuals. The information collected enhances the power of the state to control the lives of those living under its control.

Clearly, governments needs to collect information on those it suspects of criminal wrong-doing. Clearly, governments also need to collect information on non-citizens who may represent a threat, most notably agents of foreign states or hostile non-state actors. But they must do so in a way that honors the private space of its law abiding citizens. Otherwise, they are doing nothing less than sacrificing their liberality and the freedom of their citizens and adopting instead the methods of totalitarian states.

It should be evident from the discussion relating to information exchange above that the United States in particular and the world in general are moving rapidly away from the principles of a free society. This is not, however, only because more and more information is being collected. It is also because that the information is being collected without any basis for believing that wrongdoing has taken place and because there are very limited restrictions on the use to which the information can be put by the U.S. or foreign governments.

That U.S. citizens are being required to report so much information to the federal government, whether for tax, regulatory or simply monitoring purposes would shock the founding generation. We have come a long way from the limited government envisioned by the framers. Even relatively responsible governments, such as our own, can be expected to misuse and abuse

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[51] In the case of businesses and other places of employment in the U.S., this requirement has eroded under the weight of the regulatory state to the point where virtually does not exist.

information collected from time to time. The fact that the information exists and can be used and that people are not saints virtually guarantees that. However, we, in the U.S., still maintain some degree of governmental accountability and some legal protections that most people around the world do not enjoy.

Unfortunately, the United States government is participating in international efforts that will enable governments around the world to suppress freedom ever more efficiently. The idea of sharing banking, credit card and tax information relating to American citizens or benign foreigners with most governments on the planet should be rejected on principle. Many governments are corrupt. Many governments are not interested in preserving freedom. Many governments are more than willing to use such information to oppress their political opponents or disfavored ethnic or religious minorities. Many governments are more than willing to confiscate the property of their opponents. Few governments have meaningful controls on information, so unscrupulous government employees can misuse information even if it is not a matter of state policy. For example, banking information has routinely been used in Columbia to identify potentially profitable kidnap victims.

The remainder of this paper addresses the specifics of the various international and domestic initiatives relating to financial privacy. It does not address various other federal initiatives such as internet use monitoring, enhanced wiretap authority and the like. When considered in their entirety, the scope of these initiatives is quite breath-taking. The world will be a vastly different place if these initiatives are allowed to bear fruit and no legal limits are placed on the use to which the information can be put. In a very important sense, these initiatives will make Orwell's fictional Big Brother quite real quite soon.

The Assault on Financial Privacy and a Better Approach to Law Enforcement

National Security, Terrorism and Law Enforcement

The current international information exchange system is inadequate for national security, terrorism and law enforcement purposes. It is ad hoc and relatively undeveloped. It has only been since the attack on September 11 that attempts to systematize the international exchange of information have begun. Interpol, for example, has undertaken to establish an international terrorism database.

The Interpol database, however, will not be successful in accomplishing its aims for two primary reasons. First, Western agencies will not be able to fully share information through this mechanism because Interpol includes many governments that are either known sponsors of terrorism or are otherwise hostile to the U.S. and its allies. It would be foolhardy to trust sensitive information to such a system, knowing that officials in certain governments would have free access to it and may provide it to terrorists or otherwise abuse the information.

Interpol has made it clear in its public pronouncements that all of its members will participate in the database. Interpol members, for example, include Algeria, Belarus, Bosnia-

Herzegovina, Bulgaria, Chad, China, Colombia, Cuba, Iran, Iraq, Kazakhstan, Libya, Mozambique, Myanmar, Nigeria, Pakistan, Somalia, Sudan, Syria, Tanzania, Vietnam, Yemen and Yugoslavia. These countries have or have recently had one or more of the following characteristics: major corruption problems, hostility to the United States, sponsorship of terrorism in the recent past, or important factions within their governments that are friendly to groups that support terrorism.

Second, there is every reason to believe that many Interpol member governments may use, to the extent that they can, the financial and other information obtained by means of the database for other purposes, particularly if it is as wide-ranging and comprehensive as it should be to be effective. They are likely to use the database to obtain information on political opponents or problematic religious or ethnic minorities in order to oppress them. It is not difficult to imagine member governments or persons within certain governments using the information to assist terrorists.

The Financial Action Task Force (FATF) faces similar problems. FATF membership and observers, while somewhat more restricted than Interpol, include many governments that are not democratic and others that are highly problematic.[52] Western agencies cannot engage in a full and free exchange of information in this environment. As with Interpol, there is no enforceable restriction on the use to which member governments can put the information. In fact, FATF, as an informal group with virtually no oversight that faces few restrictions on its activities and little accountability.

There is the need to restrict the information shared to national security, law enforcement and anti-terrorism purposes. This restriction is important even in the case of formally allied governments to ensure that the information is not used for inappropriate purposes (e.g. commercial espionage, political oppression, tax administration or civil purposes). Only by imposing these restrictions will participants' confidence in the system be high enough that they will freely provide information. It is important to restrict the information to reliable friendly governments so the information is not used against the United States or its citizens or to thwart its foreign or law enforcement policies. There is the need to make these restrictions legally enforceable and to monitor that they are being honored in practice.

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[52] Current FATF members are Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, European Commission, Finland, France, Germany, Greece, Gulf Co-operation Council, Hong Kong, China, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Kingdom of the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States. Member states of the Gulf Co-operation Council include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Observers include the Asia / Pacific Group on Money Laundering (APG), Caribbean Financial Action Task Force (CFATF), Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), Financial Action Task Force on Money Laundering in South America (GAFISUD) and by extension their member states which include, for example, Mozambique, the Seychelles, Tanzania, and Pakistan.

A system that does not allow the U.S. and its close allies to freely exchange relevant information will not be effective in preventing terrorism or enhancing national security. Yet the FATF and Interpol systems are so inclusive and free of meaningful restrictions that it would not be prudent to provide full information to these databases for fear that some government or some official in a corrupt or potentially hostile government will use the information to thwart the anti-terrorism or national security purposes of the database.

An International Convention on Privacy and Information Exchange - a Better Route to Law Enforcement in a Free World

Establishing a new Privacy and Information Exchange Convention subject to meaningful, enforceable restrictions on membership and the use to which information can be put would promote the kind of free exchange of information necessary to effectively combat terrorism. The new convention would internationalize traditional U.S. legal principles such as protections against unreasonable search and seizures and due process of law. It would provide for enforceable restrictions on the use to which information can be put and provide persons within adhering states a private right of action to enforce the Convention.

The United States, and its international partners through the new Privacy and Information Exchange Convention, should aggressively work with banking secrecy jurisdictions to obtain information related to crime and terrorism. The dual criminality principle should be honored. In other words, the person about whom information is sought or provided should be reasonably suspected of an act that is a crime in both jurisdictions. Countries that honor requests for information about criminals and terrorists should not be harassed or sanctioned because they honor financial privacy in civil controversies or matters that are not a crime in their jurisdictions. Misguided anti-competitive efforts like the OECD initiative against harmful tax competition should not be allowed to impede efforts to obtain information about terrorists or criminals.

U.S. domestic law also must be revised. Existing money laundering rules currently generate so many "suspicious activity reports" (SARs) (over a quarter million) and "currency transaction reports" (roughly 12,000,000 annually) that reports about the activities of criminals and terrorists are lost in a mountain of useless reports about law-abiding citizens. The Currency Transaction Report system is particularly ineffective because of the sheer volume of reports generated and because the system is so simple to evade by even moderately sophisticated criminals.[53] Recent changes in the law enacted as part of the Patriot Act have led to a dramatic increase in the number of SARs.[54]

Generating still more untargeted reports by reducing the reporting threshold or broadening the reporting network will hinder rather than aid law enforcement efforts. To make the system

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[53] This evasion may be accomplished by either making transactions under the $10,000 reporting threshold or by inflating the cash receipts of an otherwise legitimate business.

[54] See discussion above. The number of SARs filed have virtually doubled since 2000.

more effective, the current CTR and SAR system should be replaced. Instead, the authorities should generate a confidential "watch list" consisting of individuals and organizations (and their known aliases, identifying numbers and addresses) suspected of involvement in terrorism, other threats to national security, or serious crimes. The law should provide that persons could only be placed on the watch list if there was a reasonable and significant suspicion that the person was a threat to national security or was involved in terrorist activities or serious ordinary law crimes. It is possible that the approval of magistrates outside of the agency asking for a person or organization to be placed on the list should be required before placing a person or organization on the watch list to ensure that the suspicious was objectively reasonable and significant.

The federal government should employ computer technology to compare this watch list with the accounts maintained in financial institutions in the U.S. and abroad (by means of the proposed Privacy and Information Exchange Convention and otherwise) and if a match is made, the government would obtain a report of the financial transactions involving the accounts in question.

To effect such a system, financial institutions and government would need to cooperate to establish systems that allow an automated matching of the financial institution account databases and the watch list database. The matching program should examine names, identifying numbers and addresses.

The current adversarial approach taken by regulators towards financial institutions regarding the money laundering requirements has been counterproductive. Subjective and ever-changing requirements — coupled with disproportionately heavy and arbitrary fines — have instituted an economic incentive to over-report, even in cases where there is no reasonable suspicion of wrong-doing. Current practice in effect institutes a "report to protect yourself from fines" approach rather than a "report transactions which should be investigated" one.

FinCen, following the passage of the USA PATRIOT Act, has suggested a somewhat greater emphasis on minimizing burdens on financial institutions primarily out of concern that they are received too many reports that are not useful for investigative purposes. In fact, however, the small steps that have been taken have done almost nothing to alleviate either the burden on financial institutions, reporting private transactions of law-abiding persons or to promote law enforcement.

Penalties for non-compliance of money laundering requirements are often more severe than requirements for maintaining the safety and soundness of the financial institutions and should be reduced. Such a change would result in the reporting of better information, rather than just more information, for law enforcement and intelligence purposes.

Where the Drive for Enhanced Tax Administration Goes Astray

OECD Harmful Tax Competition Initiative

Tax competition is a highly desirable limit on the degree to which governments can tax and a check on the inefficiency and corruption of government. Countries that wish to attract investment from abroad by providing low taxes have every right to do so and neither the OECD nor the UN should dictate tax levels to sovereign states.

When evaluating the appropriateness of support for the OECD Harmful Tax Competition initiative, it is important to note that the United States, the United Kingdom and Switzerland would also be on the OECD blacklist except that OECD members were excluded. The U.S., for example, has relatively low taxes. Moreover, the U.S. allows foreigners to invest confidentially in the U.S. free of tax and provides those foreigners with a preferential tax regime when compared to the taxation that U.S. nationals have to bear.[55] This kind of preference designed to attract capital from abroad, is precisely the kind of "harmful" tax provision that the OECD decries.[56]

In time, however, the U.S. can expect the high-tax European Union to bring pressure to bear through the OECD, the WTO, the UN and otherwise (as has been done by the EU in the past with respect to U.S. Domestic International Sales Corporation law and, more recently, the U.S. Foreign Sales Corporation law). This process has, in fact, already begun and the proposed interest reporting regulations represent an effort by the U.S. Treasury to accede to that pressure. If the U.S. has been a party to bringing extreme pressure to bear on small countries that do nothing more than the U.S. does, resisting that pressure will be intellectually and politically difficult. It is wrong for the U.S. to be demanding that the small targeted countries live by tax and financial privacy rules by which the U.S. itself is not willing to abide.

The OECD initiative targets certain countries while exempting the U.S. and others. It is therefore inconsistent with our national treatment and most favored nation treaty commitments as a member of the World Trade Organization (WTO). By virtue of its membership in the WTO, the U.S. will soon be forced to choose between the OECD initiative and its own privacy and tax policies. If the Bush administration follows the Clinton administration's lead in pressuring small countries to accept the OECD initiative, it is quite possible that the U.S. will bend to European pressure and comply with the OECD initiative itself. This would sacrifice U.S. taxpayer privacy, as U.S. taxpayer information started flowing to other governments. It would also result in a massive capital outflow because many foreigners invest here to take advantage of the tax-free investment environment.

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[55] See the discussion of the portfolio interest exemption in the Tax Administration section above.

[56] In OECD parlance, it is often called "ring-fencing."

The OECD MOU provides for the total abolition of any financial privacy in the 41 targeted countries as it relates to the 30 OECD member countries. The targeted countries would be under an obligation to routinely share banking, tax and other financial information with OECD member countries. There would be no requirement for the recipient country to show probable cause for belief that a crime had been committed in either country. There would not even be a requirement to show that some civil wrong had been committed or was even suspected. The information would simply be routinely sent to any OECD country that asked for it. There are absolutely no restrictions on the use to which the information may be put.

Once that step has been taken, there will be no principled reason for the exchange of information not to be generalized so that any government in the world will be entitled to the information. The logic of the OECD proposal is the total abolition of financial privacy and a world where all governments can access the financial information, including banking, tax and credit card information, of any individual living anywhere in the world. That, in fact, is exactly what the proposed UNITO would do.

Even within the OECD, some countries have questionable human rights records and may use the information against political opponents and to further their foreign policy goals. Outside of the OECD, such abuse of the information is a virtual certainty.– European intelligence services routinely help their large firms engage in commercial espionage, and there is nothing to prevent OECD countries' intelligence services from sharing this kind of information with private companies because there are no restrictions in the OECD proposal to ensure that this does not happen.

United Nations International Tax Organization

One of the proposed purposes of the proposed UNITO would be to enable a government to tax people on their wages or investment *even after* they have emigrated from the country. The idea that a government should be able to impose taxes on the future income of those that have emigrated from its jurisdiction is repugnant and a violation of fundamental human rights. It rests of the premise that the state retains a right to the fruits of its former national's future labor and investment income even after they have emigrated.[57] The UNITO proposal should be viewed as a violation of Article 13 of the Universal Declaration of Human Rights, adopted by the UN General Assembly in 1948, which states in relevant part that "[e]veryone has the right to leave any country."

The proposed UNITO would result in every UN member government having routine unqualified access to the financial information of the citizens of all U.N. member states. It would undoubtedly result in governments that receive this information using it not only for tax purposes but for intelligence purposes and to oppress minorities and political opposition. It is

[57] This premise is, of course, false even with respect to a state's own nationals and with respect to current income. However, in that case, at least, in principle, the state is providing some service in return.

extraordinarily naive to believe that governments, particularly those known to systematically violate human rights, will not use sensitive information provided to them by the UN to achieve political objectives within their own countries. If the UN enables them to track the financial activities of their political opponents, then it will make it much easier for oppressive governments to identify and oppress their opposition. And most UN member states are controlled by tyrants of varying degrees of ruthlessness.

Providing the United Nations itself with the ability to tax directly the nationals of its several states would effectively create the first global government — a government heavily influenced by undemocratic and despotic member states. It would begin a process of centralization similar to that currently being undertaken by the European Union and would necessarily exact a steep price in terms of reduced freedom and limits on U.S. national sovereignty.

Information is power. Given the propensity for harm, including extended and systematic mass murder, that the modern state has demonstrated time and again during the last century, it is not prudent to trust governments across the globe with that much unbridled power. It would be unwise and foolhardy to give governments the means to identify, defund and cripple their political opponents, to suppress religious freedom and to control the lives of their citizens. The OECD and UNITO initiatives should give pause to anyone who attaches even the slightest value to financial privacy and individual freedom.

U.S. Qualified Intermediary Rules

The United States qualified intermediary (QI) rules are overbroad. They contain provisions that other countries find objectionable because they represent an invasion of privacy or because they would require a violation of the foreign country's domestic law. Furthermore, these rules are not necessary to enforce U.S. law. For example, the QI rules allow the IRS to impose country by country reporting on the QI.[58] Such reporting is objectionable to many QIs because it constitutes an invasion of privacy (by potentially allowing the identification of clients) and may constitute a violation of a foreign country's domestic law. Yet, if a QI client is receiving dividends for residents of non-treaty countries, there is no need to break the clients down by country since all non-treaty country payees are subject to the same withholding rates and no withholding tax rate could be higher. By way of further example, all non-resident alien or foreign corporation recipients of U.S. source portfolio interest income are exempt from tax. There is also no need to segregate these recipients by country or, for that matter, to report the amount received.

The QI rules should not require QIs to do administrative work that is unnecessary to enforce U.S. law and that may require them to violate their own laws or the privacy of their clients. This is particularly true since QIs are subject to independent third-party audits to ensure that their

[58] Rev. Proc. 2000-12, at section 8.03 of the QI Agreement, with respect to QIs entering into agreements after December 31, 2001 or whose agreements expire or otherwise, if the IRS so decides.

characterizations of their clients' nationalities are accurate.[59] Country by country analysis (although not reporting) is required only in those cases where the income is subject to tax and the client wishes to take advantage of treaty provisions to achieve a lower withholding tax rate. It would be sufficient for U.S. purposes to report by withholding rate pools rather than by country.

Neither QIs nor non-QIs should be required to file Form 1042-S with respect to foreign beneficial owners that are either receiving income exempt from U.S. tax or are paying the maximum U.S. tax.[60] In neither case does receipt of the form further a U.S. interest. In the former case, the U.S. has disclaimed any interest in taxing the income and therefore no information relating to that person is necessary, other than establishing the foreign nationality of the recipient (which is accomplished otherwise under the QI rules). In the latter case, the recipient would be paying the maximum amount allowed by law, so there is no need to report any information relating to that person since no such information could result in greater tax liability.

The QI rules should be narrowed to –require only information and administrative tasks necessary to enforce U.S. law. The current QI provisions unnecessarily intrude on financial privacy, unnecessarily violate the national sovereignty of foreign states, unnecessarily place foreign financial institutions in the untenable position of being asked to violate their domestic law, and will cause an unnecessary and undesirable flight of capital from the United States.[61]

U.S. Interest Reporting Regulations

The proposed IRS regulation on deposit interest paid to nonresident aliens is unnecessary to enforce U.S. law. For nearly two decades, U.S. law has encouraged foreigners to invest in U.S. banks and debt securities by imposing no tax on interest earned by foreigners, except in very narrow circumstances.[62] Accordingly, there is no need for the U.S. government to track the amounts paid to these persons to enforce U.S. law. All that needs to be established is that the payments are indeed being made to foreigners.[63]

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[59] See QI Agreement, section 10.01, Rev. Proc. 2000-12 and the discussion above related to QI audits and KYC rules.

[60] Pursuant to sections 8.01 through 8.03 of the QI Agreement, QIs generally need not do so but must in certain instances. Non QIs, however, must generally do so.

[61] As is more fully discussed below with respect to the proposed interest reporting regulation, the provisions of the QI rules that are unnecessary to enforce U.S. law may be challengeable in court and should be reviewed by the Office of Management and Budget.

[62] Capital gains on portfolio securities held by foreigners are also generally exempt from tax.

[63] For a detailed legal discussion of this and other issues see, Written Comments on Guidance on Reporting of Deposit Interest, Southeastern Legal Foundation, available at http://www.freedomandprosperity.org/slf-irs.pdf.

It is axiomatic that the executive branch has no authority to issue regulations except pursuant to law.[64] The regulation should, therefore, be void as being unauthorized by statute. It is also void as arbitrary and unreasonable since it is not "reasonably related to the purposes of the enabling legislation."[65]

The regulation is also bad policy. It imposes an unnecessary major compliance burden on U.S. financial institutions. This compliance burden imposes a needless burden on the U.S. economy and impedes the competitiveness of U.S. financial institutions. Moreover, the regulation operates at cross purposes with the successful Congressional policy inaugurated in 1984 of attracting foreign capital to the United States. The regulation, if implemented, will have a substantial adverse impact on U.S. capital markets and the U.S. economy by encouraging a significant portion of the estimated one trillion dollars attracted by the portfolio interest exception to be withdrawn from U.S. capital markets. Many foreign investors will no longer find U.S. debt securities an attractive investment if their interest income is reported to their government by the IRS. Former U.S. Treasury official Stephen J. Entin estimates that the regulation could cause $400 billion to leave the United States and reduce GDP by as much as $80 billion annually.[66]

The IRS is abrogating a host of due process requirements as set forth in statute and Executive Orders (EOs). The Congressional Review Act and Executive Order 12866 clearly apply to this regulation. This IRS regulation would impose a significant cost on the economy and should be subject to the regulatory review process. Although the Internal Revenue Service, by a combination of declaring most of its regulations "interpretive" within the meaning of the Administrative Procedure Act and not "major" within the meaning of Executive Order 12866, has effectively exempted itself from regulatory oversight, this regulation is an appropriate case for the Office of Management and Budget (OMB) to exercise its lawful powers. OMB should review this regulation and stop it if the Treasury does not withdraw it. The Service is also patently violating the Regulatory Procedure Act (RFA) (5 U.S.C. 603), the Administrative Procedure Act (APA Section 553(b)), OMB Circular 94-A and certain other procedural protections designed to ensure protections against such faulty rulemakings.[67]

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[64] "The exercise of quasi-legislative authority by government departments and agencies must be rooted in a grant of such power by the Congress," *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 (1979). See also *Morrill v. Jones*, 106 U.S. 466, 467 (1883).

[65] See, e.g., *Mourning v. Family Publication Serv.*, 411 U.S. 356, 369 (1973), *Bowen v. American Hosp. Assn.*, 476 U.S. 610, 626 (1986).

[66] Proposed IRS Regulation A Threat To Foreign Investment, U.S. Banks, The Dollar, And The Economy, Stephen J. Entin, Institute for Research on the Economics of Taxation, Advisory No. 142, 2002.

[67] For a detailed discussion of how the regulation violates existing procedural protections, see, Written Comments on Guidance on Reporting of Deposit Interest, Southeastern Legal Foundation, available at http://www.freedomandprosperity.org/slf-irs.pdf and Statement of the Office of Advocacy of the Small Business Administration available at http://www.sba.gov/advo/laws/comments/irs02_1114.html.

The real reason the proposed regulation was released is that the IRS bureaucracy and the Clinton and Bush Treasury Departments want the United States to become a full player in a global tax information exchange network such as those proposed by the OECD and UN designed to thwart tax competition.[68] The proposed regulation is almost certainly the reason why the EU regards the U.S. as being in compliance with the EU Savings Tax Directive.[69] In the Background and Explanation section of the regulation, the IRS very nearly comes out and says as much. They want to help enforce foreign government tax systems to prevent tax competition.[70] Tax competition, as explained in the OECD discussion above, however, is a very positive force globally and especially positive for the United States since the U.S. has relatively low taxes compared to most industrialized countries.

European Union Savings Tax Directive

The European Union Savings Tax Directive is perhaps even more aggressive than the OECD's so-called harmful tax competition initiative. The EU wants automatic exchange of all earnings by foreign investors. There would be no due-process legal protections.

Advocates of the European Union Savings Tax Directive understand that the proposed cartel will not work so long as there are jurisdictions hospitable to foreign investment. As such, they would require that six non-EU nations – including the United States – participate before the Directive can take effect. In addition to the other five nations, the Directive assumes participation by British and Dutch possessions in the Caribbean.[71]

As the world's biggest beneficiary of foreign investment, the United States would suffer significant capital flight. The larger concern is that U.S. legal protections guaranteeing taxpayer confidentiality would be undermined by the automatic information exchange that is the EUs ultimate goal. The United States is in a position to derail the entire EU Savings Tax Directive process if it withdraws the proposed bank deposit interest regulation. If it did so, other non-EU countries whose participation is a predicate to the Directive taking effect may be encouraged to withdraw from participation with the EU.

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[68] This would not even be arguably desirable or required were the U.S. to adopt a territorial tax system, whether an origin principle tax such as the flat tax or destination principle taxes such as a sales tax or value added tax.

[69] To the author's knowledge, the EU has simply said the U.S. is in compliance but not said why. The proposed regulation is the only reason why the EU would have said so other than simply side-stepping its own requirement that the U.S. participate.

[70] This desire is a function of a sense of solidarity among international tax bureaucrats and, perhaps, adherence to a flawed policy of capital export neutrality (a policy rejected by the Congress in this area of the law).

[71] http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip011026/memo01266_en.pdf.

Conclusions and Recommendations

1. Form an Effective International Convention for Information Exchange Composed of Democratic Governments that Respect the Rule of Law

It has become apparent that the current international framework for information sharing is inadequate to achieve the needs of law enforcement and national security. This is true of FATF, Interpol, EU and U.S. efforts (most notably FinCEN). Moreover, the current framework does not adequately protect information to ensure that it does not fall into hostile hands, that the information is used appropriately and that legitimate privacy concerns are honored.

The United States should take the lead in forming an effective international convention composed of democratic governments that respect the rule of law to enable the United States to obtain and routinely share information about the financial and other activities of terrorists and criminals.

Specifically, the U.S. should enter into a Convention on Privacy and Information Exchange to (1) make information exchange for national security, anti-terrorism and law enforcement purposes more effective, (2) prevent the information obtained and shared from falling into hostile hands, and (3) protect, in a legally enforceable manner, the privacy of innocent persons. A draft Convention is set forth in an appendix.

The membership in this Convention should be restricted to governments that:

1. are democratic;
2. respect free markets, private property and the rule of law;
3. can be expected to always use the information in a manner consistent with U.S. national security interests;
4. have in place (in law and in practice) adequate safeguards to prevent the information from being obtained by hostile parties or used for inappropriate commercial, political or other purposes.

Examples of governments that would appear to meet these requirements would include the governments of Australia, Canada, Germany, Japan, South Korea, Taiwan, and the United Kingdom (and its dependencies). Certain NATO allies, most notably Greece and Turkey, do not currently provide adequate safeguards with respect to information and also have inordinate difficulties with corruption and protecting civil rights. Certain countries (e.g. Switzerland, Liechtenstein and Austria) that are financial centers but have not been involved in the Western Security network may be candidates for involvement.

The activities of the Convention's adherents should be limited to obtaining and sharing information for national security, law enforcement and anti-terrorism purposes. The Convention should develop and enforce protocols to ensure the information is not provided to hostile parties or used for inappropriate commercial or political purposes or for other purposes unrelated to law

enforcement or anti-terrorism efforts. Protocols should ensure that private information of innocent persons is protected. The Convention should provide a private right of action for persons in member states to enforce their legal rights under the Convention in member state courts.

2. Better Target Money Laundering Laws

Existing money laundering rules currently generate so many "suspicious activity reports" and "currency transaction reports" that reports about the activities of criminals and terrorists are lost in a mountain of useless reports about citizens going about their law-abiding activities. The Currency Transaction Report system is particularly ineffective because of the sheer volume of reports generated and because the system is so simple to evade by even moderately sophisticated criminals. Suspicious Activity Reports are problematic because of the necessary lack of clear and objective guidelines and the severity of the penalties for failing to report. Unfortunately, the U.S. Congress recently made the situation worse with the passage of the USA PATRIOT Act which further expands the reporting system and, in effect, increases the size of the haystack which the law enforcement community must search for the terrorist and criminal "needle."[72] The number of SARs filed is growing rapidly.

The last thing that would be constructive in the effort to apprehend terrorists and criminals would be to generate even more untargeted reports by, as has been proposed by some, reducing the reporting threshold or broadening the reporting network. To rationalize the effort to apprehend terrorists and criminals, the current CTR and SAR system should be replaced. Instead, the authorities should generate a confidential "watch list" consisting of individuals and organizations (and their known aliases, identifying numbers and addresses) about which there is reasonable and significant suspicion of involvement in terrorism, other threats to national security or serious crimes. It may prove desirable to have third party magistrates determine whether placing a person on the watch list is warranted.

A mechanism should be established whereby the government can employ computer technology to compare this watch list with the accounts maintained in financial institutions in the U.S. and abroad (by means of the proposed Privacy and Information Exchange Convention and otherwise) and if a match is made, the government would obtain a report of the financial transactions involving the accounts in question.

To effect such a system, financial institutions and government would need to cooperate to establish high legal standards and practices, and systems that allow an automated matching of

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[72] The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (which includes the *International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, the First Responders Assistance Act, the Crimes Against Charitable Americans Act of 2001, and the Critical Infrastructures Protection Act of 2001*) (H.R. 3162; Public Law No: 107-56).

the financial institution account databases and the watch list database. The matching program should examine names, identifying numbers and addresses.

3. Prioritize National Security, Anti-Terrorism and Crime

The United States should aggressively work with banking secrecy jurisdictions to obtain information related to crime and terrorism. The dual criminality principle should be honored. In other words, the person about whom information is sought or provided should be suspected of an act that is a crime in both jurisdictions. Countries that honor requests for information about criminals and terrorists should not be harassed or sanctioned because they honor financial privacy in civil controversies or matters that are not a crime in their jurisdictions. Misguided efforts like the OECD initiative against harmful tax competition should not be allowed to impede efforts to obtain information about terrorists.

4. The United States Must Prevent Sensitive Information From Reaching Hostile Hands

Proposals such as the proposal by the United Nations High Level Panel on Financing for Development to create a UN International Tax Organization, which would provide sensitive U.S. private financial information (including banking, credit card and tax information) to hostile states or states without adequate privacy safeguards, should be opposed. Interpol, for example, includes countries known to sponsor terrorism (e.g. Iran, Iraq, Libya, Somalia, Syria, Sudan), other countries that may be hostile to the West (e.g. the People's Republic of China, Cuba, Yugoslavia) and countries with major corruption problems (e.g. Bulgaria, Colombia, Nigeria). Financial Action Task Force members (particularly its regional and observer status participants) also pose unacceptable security risks.[73]

Accordingly, no existing international organization has both the breadth to be effective and the standards to ensure that both our national security and the privacy of our citizens are protected. It is impossible for any of these organizations to serve as a genuine clearing house for information since the security threat posed by member countries is simply too high. A more restrictive organization is necessary in order for the project to work effectively.

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[73] Current FATF members are Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, European Commission, Finland, France, Germany, Greece, Gulf Co-operation Council, Hong Kong, China, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Kingdom of the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States. Member states of the Gulf Co-operation Council include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Observers include the Asia / Pacific Group on Money Laundering (APG), Caribbean Financial Action Task Force (CFATF), Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), Financial Action Task Force on Money Laundering in South America (GAFISUD) and by extension their member states which include, for example, Mozambique, the Seychelles, Tanzania, and Pakistan.

5. The United States Should Withdraw Its Proposed Interest Reporting Regulation

This regulation would cause large amounts of foreign capital to leave the United States, impose large compliance costs on U.S. financial institutions that are unnecessary to enforce U.S. law, and reduce the competitiveness of U.S. financial institutions. The regulations are not authorized by statute and should be found arbitrary and unreasonable within the meaning of the applicable Supreme Court jurisprudence.

If the Treasury Department does not withdraw this regulation on its own initiative, the Office of Management and Budget should exercise its authority under the Congressional Review Act and Executive Order 12866 to stop the regulation.

6. The United States Should Oppose the Creation of a United Nations International Tax Organization

The proposed UNITO would be destructive. It would impede tax competition and it may lead to a dramatic reduction in U.S. sovereignty. The proposal to allow the UN to directly tax persons in UN member states would be a significant step toward an oppressive and unaccountable world government and would inevitably have an adverse economic impact on relatively free countries like the United States. The proposal to use the UNITO to enable governments to tax people on future earnings even after they have emigrated would violate fundamental human rights and would be fundamentally against the interest of a nation of immigrants such as the United States. Finally, and perhaps most importantly, the proposal to share routinely all financial information, including banking, credit card and tax return information, among all UN member governments would constitute a gross violation of U.S. citizens' privacy rights and would aid the most repressive regimes on the planet by enabling them to more fully track the activities of their political opponents and oppressed minorities.

7. The United States Should Oppose the OECD Harmful Tax Competition Initiative

The United States should oppose the OECD Harmful Tax Competition initiative. It represents an attempt by high tax European countries to extraterritorially enforce their high tax rates. The United States itself would qualify as engaging in harmful tax competition under the rules laid out by the OECD. Were the OECD rules also applied to OECD countries, the U.S. would be subject to draconian international sanctions. The U.S. should not be a party to applying rules against small countries that it is not willing to abide by itself. Countries that honor financial privacy and maintain low tax rates should not be sanctioned merely for doing so.

The United States, as a low tax country and as a country that has attracted approximately a trillion dollars capital by offering foreign investors the opportunity to invest in the U.S. free of tax, would be severely harmed by a generalization of the proposed OECD rules.

Moreover, the OECD initiative represents a major step toward the unrestricted disclosure of private financial and tax information, including from the U.S. and other OECD countries, to a

wide array of countries that can be expected to misuse the information for commercial, political or intelligence purposes.

8. The United States Should Modify its Qualified Intermediary Rules

The qualified intermediary (QI) rules should not impose burdens on foreign financial institutions that are unnecessary to enforce U.S. law. To do so unnecessarily limits financial privacy, intrudes on the national sovereignty of other states and will result in unnecessary and undesirable flight of capital from U.S. markets.

The QI rules should be amended so reporting pools are by withholding tax rate (including a pool for the maximum rate and for income exempt from U.S. tax (most notably portfolio interest)).

Neither QIs nor non-QIs should be required to file Form 1042-S with respect to foreign beneficial owners that are either receiving income exempt from U.S. tax or are paying the maximum U.S. tax. In neither case does receipt of the form further a U.S. interest. In the former case, the U.S. has disclaimed any interest in taxing the income and therefore no information relating to that person is necessary, other than establishing the foreign nationality of the recipient (which is accomplished otherwise under the QI rules). In the latter case, the recipient would be paying the maximum amount allowed by law, so there is no need to report information relating to that person since no such information could result in greater tax liability.

9. The United States Should Reject the European Union's Savings Tax Directive

For the same reasons outlined above in the section on the OECD's "harmful tax competition" initiative, the United States should decline to participate in the European Union's Savings Tax Directive by withdrawing the proposed interest reporting regulation and by declining to participate otherwise. The United States is a capital-inflow country. It is not in America's interest to facilitate foreign taxation of U.S.-source income.

In General

If this set of recommendations for reform were adopted, they would actually enhance the ability of the federal government to protect the lives, liberty and property of the American people and enhance the privacy of law abiding citizens.

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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.

Appendix: Convention on Privacy and Information Exchange

General Explanation

The current patchwork of international information exchange treaties, organizations and networks has two important flaws. First, the current system is not nearly as effective as it could and should be in aiding law enforcement and anti-terrorism efforts. Second, it imposes little or no legally cognizable restrictions on the use to which governments can put the information obtained and insufficiently protects individuals' privacy.

The proposed Convention would address both problems by making the international information exchange system much more effective and, for the first time, legally commit leading countries to the respect of individual privacy and provide enforceable restrictions on the use to which obtained information can be put.

The Convention would facilitate the exchange of information among Member States for national security, anti-terrorism and law enforcement purposes and only these purposes. In stark contrast to present practice, the Convention would establish legally enforceable rules to ensure this information is adequately protected and to prevent that information from being obtained by hostile parties, potentially hostile parties, parties that do not have adequate safeguards under domestic law or parties that in practice do not observe those safeguards. It would ensure that the information is not used for inappropriate commercial, political or other purposes.

The Convention would establish a private right of action, enforceable in Member State courts, with respect to the legal rights afforded to individuals under the Convention.

The Convention was developed by the Prosperity Institute's Task Force on Information Exchange and Financial Privacy. The Chairman of this task force was former U.S. Sen. Mack Mattingly. It was composed of leading former law enforcement officials, tax attorneys and economists. The author was the Executive Director of the task force.[74] The proposed text is set forth below.

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[74] The Task Force included former U.S. Sen. Mack F. Mattingly, Chairman, former Rep. and V.P. nominee Jack F. Kemp, former attorney general Edwin Meese, III, David R. Burton, Dr. Veronique de Rugy (Cato Institute), Stephen J. Entin (Institute for Research on the Economics of Taxation), James W. Harper, Esq. (PolicyCounsel.com, Privacilla.org) ,Dr. Lawrence A. Hunter (Empower America), J. Bradley Jansen (Free Congress Foundation), Dan Mastromarco (Prosperity Institute, Argus Group), Dr. Daniel Mitchell (Heritage Foundation), Andrew Quinlan (Center for Freedom and Prosperity), Dr. Richard W. Rahn (Discovery Institute), Solveig Singleton, Esq. (Competitive Enterprise Institute), Mark A. A. Warner, (Hughes, Hubbard & Reed), and the Hon. John Yoder, Esq. (Burch and Cronauer).

Convention on Privacy and Information Exchange

PREAMBLE

Whereas, the individual right to life, to liberty and to possess property are fundamental human rights and governments have an obligation to protect these rights;

Whereas, to better protect these rights, there is a need for greater cooperation among democratic states to obtain information and to facilitate the exchange of information for national security, law enforcement and anti-terrorism purposes;

Whereas, there is a need to protect individual privacy under international law;

Whereas, there is a need to ensure that sensitive private, national security, law enforcement and terrorism-related information is safeguarded,

Therefore, the States party to this Convention have agreed as follows:

Article I

ESTABLISHMENT OF CONVENTION

The Contracting States undertake to respect and to ensure respect for the present Convention on Privacy and Information Exchange in all circumstances.

Article II

PURPOSE

The purpose of this Convention shall be:

(1) to facilitate the exchange of information among Member States for national security purposes;
(2) to facilitate the exchange of information among Member States to detect, prevent or defend against terrorism and to apprehend persons who have committed acts of terrorism;
(3) to facilitate the exchange of information among Member States to detect, prevent or defend against serious ordinary law crimes and to apprehend persons who have committed serious ordinary law crimes;
(4) to protect the privacy of citizens of Member States and other innocent persons;
(5) to ensure that information obtained by Member States or exchanged among the Member States by means of the Convention is adequately protected and to prevent that information from being obtained by hostile parties, potentially hostile parties, parties that do not have adequate safeguards under domestic law or parties that in practice do not observe those safeguards;

(6) to ensure that information obtained by Member States or exchanged among the Member States by means of the Convention is used solely for purposes set forth in subparts (1) through (3) of this Article; and
(7) to ensure that information obtained by Member States or exchanged among the Member States by means of the Convention is not used for inappropriate commercial, political or other purposes.

Article III

PRINCIPLES

The Member States reaffirm the following principles:

(1) The right to life, to liberty and to possess property are fundamental human rights;
(2) The governments of the Member States have an obligation to protect the national security of the Member States and to protect the lives, liberty and property of the citizens of the Member States from attack from hostile parties;
(3) The governments of the Member States have an obligation to detect, prevent or defend against terrorism and to apprehend persons who have committed or planned acts of terrorism;
(4) The governments of the Member States have an obligation to detect, prevent or defend against serious ordinary law crimes and to apprehend persons who have committed serious ordinary law crimes;
(5) The governments of the Member States have an obligation to respect and protect the privacy of citizens of Member States and other innocent persons.

The Convention shall be guided by these principles.

Article IV

DEFINITIONS

For purposes of this Convention the following terms shall be defined as follows.

(1) *Establishment* means any private:
    (a) place of employment,
    (b) office,
    (c) place of assembly, or
    (d) house of worship.
(2) *National Security Purposes* means action reasonably calculated to detect, prevent or defend against:
    (a) an attack by a hostile state or other hostile party on the territory of a Member State resulting in the loss of life or destruction of property;
    (b) an attack by a hostile state or other hostile party on the civilian or military personnel of a Member State government without the territory of a Member State;

(c) an attack by a hostile state or other hostile party on the citizens of a Member State without the territory of a Member State;
(d) an attack by a hostile state or other hostile party on the information systems infrastructure of a Member State; and
(e) espionage directed against a Member State or citizens of a Member State.

(3) *Party or Parties* means one or more international organizations, states, belligerents, private entities, individuals or other organization, entity or institution and their respective agents, employees, personnel, citizens or residents.

(4) *Person* means a natural person, a corporation, a private business entity or a private non governmental organization.

(5) *Protected Person* means any person that is a national of a Member State, a lawful resident of a Member State or domiciled in a Member State.

(6) *Serious Ordinary Law Crime* means conduct that (a) constitutes an offence in all Member States and (b) is punishable by a maximum deprivation of liberty of four years or more in all Member States.

(7) *Terrorism* means (a) any act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act, or (b) an act which constitutes an offence within the scope of and as defined in one of the following treaties:

1. Convention for the Suppression of Unlawful Seizure of Aircraft, done at The Hague on 16 December 1970.
2. Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation, done at Montreal on 23 September 1971.
3. Convention on the Prevention and Punishment of Crimes against Internationally Protected Persons, including Diplomatic Agents, adopted by the General Assembly of the United Nations on 14 December 1973.
4. International Convention against the Taking of Hostages, adopted by the General Assembly of the United Nations on 17 December 1979.
5. Convention on the Physical Protection of Nuclear Material, adopted at Vienna on 3 March 1980.
6. Protocol for the Suppression of Unlawful Acts of Violence at Airports Serving International Civil Aviation, supplementary to the Convention for the Suppression of Unlawful Acts against the Safety of Civil Aviation, done at Montreal on 24 February 1988.
7. Convention for the Suppression of Unlawful Acts against the Safety of Maritime Navigation, done at Rome on 10 March 1988.
8. Protocol for the Suppression of Unlawful Acts against the Safety of Fixed Platforms located on the Continental Shelf, done at Rome on 10 March 1988.
9. International Convention for the Suppression of Terrorist Bombings, adopted by the General Assembly of the United Nations on 15 December 1997.

Article V

MEMBERSHIP

(1) The Contracting States shall be Members of the Convention, subject to this Article.
(2) Each Member State is obligated to:
  (a) maintain a democratic form of government;
  (b) maintain adequate domestic laws against corruption in government;
  (c) maintain adequate domestic law protecting individuals against deprivation of life, liberty or property without due process of law;
  (d) maintain adequate domestic anti-terrorism laws;
  (e) maintain domestic law that allows for the extradition of persons to other Member States that stand accused of committing or conspiring to commit under the law of another Member State one or more acts of terrorism or one or more serious ordinary law crimes;
  (f) maintain domestic law that complies with Article VIII of this Convention relating to privacy;
  (g) maintain domestic law such that Article IX of this Convention is enforceable;
  (h) consistently and reliably comply in practice with the provisions of the Member State's domestic law referenced in this subpart (2);
  (i) be a party to a treaty or treaties that, with respect to other Member States, provides for adequate mutual legal assistance in criminal matters; and
  (j) consistently and reliably comply in practice with this Convention.
(3) The Members of the Convention may decide to invite any Government prepared to assume the obligations of membership to accede to this Convention. Such decisions shall be unanimous. Accession shall take effect upon the deposit of an instrument of accession with the depositary Government.
(4) Members of the Convention shall monitor the compliance or lack thereof of each Member with subpart (2) of this article. The Convention shall terminate the membership of any Member in the Convention that it finds is not in substantial compliance with subpart (2) of this article. Said termination shall be effective immediately upon the affirmative finding of two-thirds of the Members of the Convention at a meeting of the Convention and the terminated Member shall have no more standing in the Convention than any other non-member state. The terminated Member may be readmitted pursuant to subpart (3) of this article.

Article VI

GOVERNANCE

(1) Unless the Members of the Convention otherwise agree unanimously for special cases, decisions shall be taken and recommendations shall be made by mutual agreement of all the Members.

(2) Each Member shall have one vote. If a Member abstains from voting on a decision or recommendation, such abstention shall not invalidate the decision or recommendation, which shall be applicable to the other Members but not to the abstaining Member.
(3) No decision shall be binding on any Member until it has complied with the requirements of its own constitutional procedures. The other Members may agree that such a decision shall apply provisionally to them.
(4) A Convention Conference, to which all the Members shall be invited to send delegates, shall be the body from which all acts of the Convention derive. Each Member State shall designate a person or persons to participate in the Convention as delegates.Conference. Each Member shall have one vote in the Convention Conference. There shall be an annual Convention Conference. Special Convention Conferences may be called upon the request of a majority of the members. Each Member shall be responsible for its own expenses. Convention Conference expenses shall be borne by the host government.
(5) Members shall designate each year a Chairman, who shall preside at its session, and a Vice-Chairman.
(6) Members may establish an Executive Committee and such subsidiary bodies as may be required for the achievement of the aims of the Convention.
(7) Upon such terms and conditions as the Conference may determine, the Convention may:
    (a) address communications to non-member States or organizations;
    (b) address communications to individuals or private institutions;
    (c) establish and maintain relations with non-member States or organizations; and
    (d) invite non-member Governments or organizations to assist in activities of the Convention.
(8) The first annual Convention Conference shall be in ___. The time and place of subsequent Convention Conferences shall be as determined by the Members.
(9) Each year, the Chairman of the Convention Conference shall issue a report describing and analyzing the operation of the Convention. The report may also contain recommendations of the Convention Conference. The Chairman shall make the report publicly available, provided however, that the Members may vote to not disclose a portion of the report if it determines that doing so is reasonably necessary to further the purposes of the Convention.

Article VII

GENERAL OBLIGATIONS

In order to achieve the purposes set forth in Article II, the Members of the Convention and those acting under their authority, in a manner consistent with this Convention and subject to the restrictions of this Convention, may:

(1) obtain information,
(2) provide information to other Member governments,
(3) cooperate with law enforcement, intelligence and defense authorities of other Member governments,
(4) make recommendations to other Members, and

(5) enter into agreements with other Members, non-member States and international organizations.

In order to achieve the purposes set forth in Article II, the Members, in a manner consistent with this Convention and subject to the restrictions of this Convention, shall:

(1) cooperate with law enforcement, intelligence and defense authorities of other Member governments,
(2) enact and maintain domestic law to enforce Article VIII of this Convention, and take steps to ensure that information obtained by means of the Convention and provided to other Members is safeguarded.

Article VIII

PRIVACY

(1) No information obtained by means of the Convention shall be provided to any Member government and no Member government shall use information obtained by said Member government by means of the Convention except for the following purposes:
    (a) for national security purposes,
    (b) to detect, prevent or defend against terrorism and to apprehend persons who have committed acts of terrorism,
    (c) to detect, prevent or defend against serious ordinary law crimes and to apprehend persons who have committed serious ordinary law crimes.
(2) All Member Governments shall enact and maintain domestic law to enforce subpart (1) of this Article. Each Member shall ensure that individuals who act in contravention to subpart (1) of this Article shall be criminally liable such that said individual is (a) subject to deprivation of liberty of not less than four years, and (b) subject to dismissal if employed by the Member's government.
(3) All Member Governments shall ensure that information obtained by means of the Convention or exchanged among the Member States by means of the Convention is not used for commercial, or political or other purposes unrelated to achieving the purposes of the Convention set forth in subparts (1), (2) and (3) of Article II.
(4) Each Member Government shall respect the right of other Member Governments to respect and protect the privacy of citizens or other innocent persons in cases unrelated to achieving the purposes of the Convention set forth in subparts (1), (2) and (3) of Article II.
(5) All Member Governments shall ensure that citizens of the Member States shall be secure in their persons, houses, establishments, papers and effects against unreasonable searches and seizures.
(6) All Member Governments shall enact or maintain domestic law establishing adequate safeguards for the privacy of the citizens of the Member States. Said domestic law shall provide at least the following safeguards:
    (a) protect individuals and private establishments from warrantless searches and seizures and require that warrants not be issued but upon a showing of probable or reasonable cause;

(b) prohibit the disclosure of tax information about individuals or private establishments obtained by Member States to private parties and restrict~~ing~~ its use to national security, law enforcement, anti-terrorism or tax administration purposes;
(c) prohibit the disclosure of financial or personal information about individuals or private establishments that is (1) obtained by Member States by operation of law and (2) not in the public domain to private parties and restrict~~ing~~ its use to national security, law enforcement, anti-terrorism or tax administration purposes;
(d) such other safeguards as the Members may provide, subject to the provisions of this Convention.

Article IX

RIGHTS OF PROTECTED PERSONS

(1) Evidence obtained by a Member State by means of the Convention in deprivation of any rights, privileges, or immunities secured by this Convention, or other evidence obtained because of said evidence, shall not be admissible in a Court of Law of any Member State in a proceeding against a Protected Person or in an administrative proceeding of any Member State against a Protected Person.
(2) Every person who, under color of any treaty, statute, ordinance, regulation, custom, or usage, of any Member State subjects, or causes to be subjected, any Protected Person to the deprivation of any rights, privileges, or immunities secured by this Convention, shall be liable to the injured Protected Person in an action at law, suit in equity, or other proper proceeding for redress.
(3) To protect any rights, privileges, or immunities secured by this Convention, a Protected Person shall be entitled to injunctive relief in a Court of Law of competent jurisdiction of any Member State against:
    (a) any Member State, or
    (b) any person who under color of any treaty, statute, ordinance, regulation, custom, or usage, of any Member State,
    who subjects, or causes to be subjected, said Protected Person to deprivation of any rights, privileges, or immunities secured by this Convention.
(4) Each Member State shall take such steps as are necessary under its domestic law to ensure that Protected Persons' rights under this Article are secured.

Article X

RATIFICATION

(1) This Convention shall be ratified or accepted by the Signatories in accordance with their respective constitutional requirements.
(2) Instruments of ratification or acceptance shall be deposited with the Government of the United States, hereby designated as depositary Government.
(3) This Convention shall come into force on 30th September, 2003, if by that date three Signatories or more have deposited such instruments as regards those Signatories; and

thereafter as regards any other Signatory upon the deposit of its instrument of ratification or acceptance.

(4) Upon the receipt of any instrument of ratification, acceptance or accession, or of any notice of termination, the depositary Government shall give notice thereof to all the Contracting States and to the Secretary-General of the Organization.

Article XI

TERMINATION

Any Member State may terminate the application of this Convention to itself by giving three months' notice to that effect to the depositary Government.

IN WITNESS WHEREOF, the undersigned Plenipotentiaries, duly empowered, have appended their signatures to this Convention.