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The Tax Cheaters' Lobby Is Wrong about IRS Proposed Regulations

In late January every year, mailboxes around the country start to fill up with copies of all those forms that your bank, your employer, and your brokerage firm send to the Internal Revenue Service to report the income paid to you last year.

This type of third-party information reporting is critical to our tax system. A GAO report[1] found that when income is subject to a high level of third-party reporting (e.g. wages), the income is reported correctly on the tax returns of the recipients 98.8 percent of the time. But when the amount of third-party reporting on certain types of income is low (e.g. rents), the income is reported correctly only 46 percent of the time.

Banks are required to report the amount of interest paid on deposit accounts. Right now, they are only required to file those reports on U.S. and Canadian account holders.

On January 6, the IRS announced that it was proposing new rules[2] requiring banks to report interest paid to nonresident foreign individuals just as they report interest on U.S. citizens and residents. The IRS will use this information to respond to foreign governments' requests for information about their citizens' U.S. income.

As the IRS stated in its notice, we have seen in the last few years "a growing global consensus" about how important it is for countries to cooperate in exchanging tax information to protect their tax revenues and catch tax cheats. Many significant agreements have been reached recently, including eliminating the use of bank secrecy laws as a reason for refusing to share information.

The new reporting rules will also help the IRS catch U.S. tax cheats that are currently avoiding the reporting rules by posing as foreigners.

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[1] United States Government Accountability Office Report to the Committee on Finance, U.S. Senate, "Tax Administration: Costs and Uses of Third-Party Information Returns," GAO-08-266, November 2007, available at http://www.gao.gov/new.items/d08266.pdf.

[2] Internal Revenue Service , Guidance on Reporting Deposit Interest Paid to Nonresident Aliens, Reg-146097-09, January 7, 2011, available at http://www.federalregister.gov/articles/2011/01/07/2011-82/guidance-on-reporting-interest-paid-to-nonresident-aliens.

On the same day the proposed regulations were announced, the Center for Freedom and Prosperity, which CTJ long ago dubbed[3] the "Tax Cheaters' Lobby," came out against the new rules[4] and promised to lead the fight to "derail or kill this misguided regulation." The Tax Cheaters' Lobby works hard to preserve tax havens and the ability of wealthy people to hide their assets and avoid paying their taxes.

In a Forbes.com blog, Tax Cheaters' Lobby (TCL) Chairman and Cato Institute Senior Fellow Daniel Mitchell attacked the IRS for proposing the new regulations.[5] Let's look at the arguments he makes.

TCL: "On January 7, the tax-collection bureaucracy proposed a regulation that, if implemented, would force American financial institutions to put foreign tax law above US tax law."

CTJ: Where the heck does he get that? All the regulation requires is that the bank report interest paid to foreign customers as well as its U.S. and Canadian customers. The proposed rule has nothing to say about foreign tax law nor would it elevate that foreign law above U.S. tax law.

TCL: "Banks would be required to report to the IRS any interest they pay to foreigners, but not so the US government can collect tax, but in order to let foreign governments tax this US-source income."

CTJ: That's true and we applaud the effort. The interest income paid by the bank is not subject to U.S. tax if it is earned by a nonresident alien. The IRS wants to collect this information so that they can respond to requests under Tax Information Exchange Agreements (TIEAs) that have been in place for a long time. The United States should not be a tax haven that allows citizens of other countries to evade their legal obligation to pay tax.

TCL: "**The IRS is flouting the law, using regulatory dictates to overturn laws enacted through the democratic process**. Ever since 1921, and most recently reconfirmed by legislation in 1976 and 1986, Congress specifically has chosen not to tax interest paid to non-resident foreigners…. Yet rogue IRS bureaucrats want to impose a regulation to overturn the outcome of the democratic process."

CTJ: Mitchell is really out on a limb here. The regulation would not in any way make this income subject to U.S. tax. It would only collect information that the IRS could turn over to the tax authorities in other jurisdictions. We believe he is being deliberately misleading in order to bolster his very weak case against the regulations.

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[3] Robert S. McIntyre, "Tax Cheaters' Lobby," The Taxonomist, June 2001, available at http://www.ctj.org/taxonomists/taxonomist20010600.pdf.

[4] Center for Freedom and Prosperity Press Release, "Obama's Revival of Clinton-Era Interest-Reporting Regulation Threatens U.S. Economy," January 6, 2011, available at http://www.freedomandprosperity.org/press/p01-06-11/p01-06-11.shtml.

[5] Daniel J. Mitchell, "IRS Run Amok: Agency Illegally Helping Foreign Governments Collect Taxes?" January 18, 2011, http://blogs.forbes.com/beltway/2011/01/18/irs-run-amok-agency-illegally-helping-foreign-governments-collect-taxes.

TCL: "The IRS has failed to perform a cost-benefit analysis, as required by executive order 12866 which requires that regulations be accompanied by 'An assessment of the potential costs and benefits of the regulatory action' for any regulation that will, 'Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities.'

Yet the IRS blithely asserts that this interest-reporting proposal is 'not a significant regulatory action.' Amazing, we have trillions of dollars of foreign capital invested in our economy, perhaps $1 trillion of which is deposited in banks, and we know some of which definitely will be withdrawn if this regulation is implemented, but the bureaucrats unilaterally decided the regulation doesn't require a cost-benefit analysis."

CTJ: We think the IRS is right. The regulation only applies to accounts owned by nonresident alien individuals. Much of the "trillions of dollars of foreign capital" is, first of all, invested by foreign legal entities (not individuals) that would not be covered by this regulation. Second, the regulations only apply to bank deposits – not stock ownership, not private equity funds, not real estate – not anything else.

Banks, both large and small, are already required to collect the information on all their customers. They already must report this information to the IRS for their U.S. and Canadian customers. The new rule only expands the number of customers who are covered by the third-party reporting rules.

Mitchell goes on to cite a Small Business Administration comment on the earlier regulation that has nothing to do with the cost-benefit analysis but with the separate Regulatory Flexibility Act which deals with the impact of regulations on small business. The IRS, quite correctly we believe, states that the new rules will have a limited impact on small businesses (see the previous paragraph).

TCL: "The IRS is imposing a regulation that puts America's economy at risk. According to the Commerce Department, foreigners have invested more than $10 trillion in the U.S. economy. And according to the Treasury Department, foreigners have more than $4 trillion in American banks and brokerage accounts."

CTJ: Again, Mitchell deliberately muddies the facts to make his case. The regulations only apply to deposits in U.S. banks by foreign individuals. We think that's a pretty small fraction of those big numbers Mitchell is throwing around. In fact, the federal reserve reports that three-fourths of the $4 trillion foreigners have in American banks are accounts held by foreign governments, official institutions, international and regional organizations, and foreign banks.[6] Of the less than $1 trillion left, only the amount held in the name of individuals would be subject to reporting under the new rules.

[6] Federal Reserve Board, Liabilities to Foreigners Reported by Banks in the United States, available at http://www.federalreserve.gov/econresdata/releases/statbanksus/liabfor20110131.htm#fn11r

TLC: "**The IRS is destabilizing America's already shaky financial system**. Five years ago, when the banking industry was strong, the IRS regulation would have been bad news. Now, with many banks still weakened by the financial crisis, the regulation could be a death knell. Not only would it drive capital to banks in other nations, it also would impose a heavy regulatory burden."

CTJ: This claim is completely unsupported. Mitchell's argument relies on an assumption that the American banking system doesn't thrive on the many legitimate uses of financial institutions by law-abiding citizens of the U.S. and other countries, but depends upon the business of tax evaders and money launderers.

TLC: "**The IRS is endangering the lives of foreigners who deposit funds in America because of persecution, discrimination, abuse, crime, and instability in their home countries**. If you're from Mexico you don't want to put money in local banks or declare it to the tax authorities. Corruption is rampant and that information might be sold to criminal gangs who then kidnap one of your children. If you're from Venezuela, you have the same desire to have your money in the United States, but perhaps you're more worried about persecution or expropriation by a brutal dictatorship. There are people all over the world who have good reasons to protect their private financial information. Yet this regulation would put them and their families at risk."

CTJ: The regulation requires financial institutions to report the information to the IRS. It does not require the IRS to turn the information over to anyone else. It only allows the information to be available to respond to TIEA requests from countries we have agreements with.

Information is not exchanged under a TIEA automatically, but only as a response to a specific, carefully limited request which identifies the nature of the information and describes the specific evidence being sought. The U.S. has the right to refuse to provide the information requested by the foreign government.

TCL: "Under current law, America is a safe haven for international investors."

CTJ: Mitchell meant that under current law, American is a safe haven for international tax cheats. CTJ applauds the IRS for taking this important step against tax evasion by citizens of all countries.