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Clinton-Era IRS Regulation Threatens Economy and Financial Markets

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Three days before President Bill Clinton left office, the Internal Revenue Service (IRS) proposed a regulation (No. 126100-00) that would have forced American banks to report the interest they pay on the deposits of nonresident aliens. The IRS openly admitted that the information collected would be forwarded to foreign governments and that the regulation was designed solely to help those governments tax income from accounts in the United States.

This midnight rule generated considerable controversy. The financial services industry said that the proposed regulation would drive funds from U.S. banks and undermine the industry's global competitiveness. Taxpayer organizations opposed the rule because it would create an obstacle to tax reform and undermine fiscal competition between nations. In effect, the regulation would have put the enforcement of foreign tax law ahead of America's economic interests.

Faced with strong opposition, the IRS was forced to withdraw the rule in the summer of 2002. Unfortunately, that was a hollow gesture. After a few cosmetic modifications, the IRS quickly reissued the Clinton-era regulation (with a new number, 133254-02) and now the agency is pushing to finalize the proposed regulation.

The IRS scheme would cause serious damage to the U.S. economy, driving away funds from the economy and weakening financial markets. Equally troubling, the IRS is abusing the regulatory process. In its zeal to impose an ideological agenda, the Service is flouting the law and running roughshod over important procedural safeguards. The proposed regulation should be permanently withdrawn.

Harm to the U.S. Economy. Investment capital from overseas helps finance growth and boost financial markets, but the proposed regulation would make America less attractive to the world's investors. If the regulation is implemented:

- **Capital will flee the American economy.** According to private-sector estimates and government data, nonresident aliens have deposited approximately $1 trillion in U.S. banks. This money helps finance car loans, home mortgages, and small business expansion for Americans. This influx of capital has been a direct result of very favorable tax and privacy laws for nonresident aliens, but these policies will be overturned if the IRS regulation is approved. According to a study commissioned

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by the Florida Bankers Association, it is likely that at least one-third of affected deposits will shift to foreign banks in places such as London and Hong Kong.

- **U.S. banks will become less competitive.** Bank deposits can travel around the world at the click of a computer keyboard, as investers seek better returns and more security. Although American banks traditionally have been successful in this competitive environment, their ability to attract deposits from overseas almost surely will shrink if banks are forced to act as deputy tax collectors for foreign governments. U.S. banks will then find it harder to meet the challenge of foreign competition.
- **Banks will suffer a paperwork burden.** Although the IRS claims that financial institutions will need only 500 hours to comply with this new regulation, this is an absurdly low estimate. Banks will need to read the rule, analyze its meaning, get appropriate legal and accounting advice, and report on thousands of accounts.
- **Tax reform will be undermined.** Tax reform is based on common-sense principles, including the premises that funds should not be double taxed and that taxation should be limited to national borders (territorial taxation). The IRS regulation violates both of these principles of tax reform.
- **Fiscal competition will be hindered.** The IRS rule will make it much harder for foreigners to take advantage of better tax laws in other nations. It will make it much easier for high-tax governments to impose levies on income earned outside their borders and will encourage foreign governments to increase marginal tax rates on mobile capital.

Procedural Concerns. The IRS clearly is attempting to usurp the role of the legislative branch by replacing existing law with a regulatory edict, and it is flouting proper procedural guidelines. Specifically:

- **The proposed regulation would overturn existing law.** Because they wanted to attract capital to the American economy, legislators chose not to tax bank deposit interest paid to nonresident aliens and have consistently decided against requiring that such income be reported. The proposed IRS regulation would overturn the outcome of this democratic process.
- **The IRS is misusing its regulatory authority.** The IRS is supposed to issue regulations that help enforce U.S. tax law. Since the U.S. government does not tax bank deposit interest paid to nonresident aliens, there is no need to collect this information. The IRS admits that the purpose of the proposed regulation is to help foreign governments tax U.S.-source income.
- **The IRS has not performed a required cost/benefit analysis.** The IRS is trying to dodge the legal requirement to review the costs and benefits of its actions. It has arbitrarily declared that most of its regulations are either "interpretative" under the Administrative Procedure Act or not "major" for purposes of Executive Order 12866. For all intents and purposes, this means that the Internal Revenue Service has effectively exempted itself from regulatory oversight.

Conclusion. The IRS regulation requiring that interest on foreign bank deposits must be reported is bad tax policy and bad regulatory policy. It will hinder President Bush's tax reform agenda and it will damage the U.S. economy by reducing the amount of capital that will be available for America's workers, consumers, homeowners, and entrepreneurs. Treasury Secretary O'Neill should immediately withdraw this regulation.

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