



Testimony of

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Before the

United States Department of Treasury

Internal Revenue Service

Hearing on Proposed Regulation 26 CFR Parts 1 and 31

Guidance on Reporting Interest Paid to Nonresident Aliens  
[REG-146097-09]

May 18, 2011

Ladies and Gentleman:

Thank you for the opportunity to testify at this hearing regarding the proposed regulation providing “Guidance on Reporting Interest Paid to Nonresident Aliens” (the Proposal).<sup>1</sup>

My name is John Berlau, and I am the director of the Center for Investors and Entrepreneurs at the Competitive Enterprise Institute. The Competitive Enterprise Institute (CEI) is a non-profit public policy organization dedicated to advancing the principles of limited government, free enterprise, and individual liberty. Founded in 1984, our mission is to promote both freedom and opportunity. We make the principled case for economic freedom because we believe it is essential for entrepreneurship, innovation, and prosperity to flourish.

We also have serious concerns about privacy rights and civil liberties. We have joined bipartisan coalitions with liberal groups such as the American Civil Liberties Union to express concerns about anti-drug and anti-terrorism policies that we believe give law enforcement too much latitude to intrude on individual privacy without probable cause or reasonable suspicion.

Our strong concerns about both economic opportunity and civil liberties prompt us to strongly object to the IRS’s proposed rule that would force banks and credit unions to report information on foreign bank account holders to facilitate what has been described as “automatic information exchange” with their home countries. This proposed rule is simply amazing in the simultaneous, divergent harms it would cause to the U.S. economy and to human rights throughout the world. All at once, if implemented, the rule would:

- A. Reduce U.S. competitiveness in attracting foreign capital.
- B. Harm the safety and soundness of U.S. banks and credit unions and probably cause more financial institutions to fail in areas already hard hit by souring real estate loans.
- C. Threaten the privacy and safety interests of individuals throughout the world by putting sensitive financial information in the hands of governments with lax data security systems, in which criminal gangs could access the data to target victims for kidnapping.

And:

- D. Empower corrupt dictators by giving them direct access to financial information of dissidents who may hold U.S. accounts. If this rule were in place now, U.S. banks would have to

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<sup>1</sup> Internal Revenue Bulletin: 2011-8 (February 22, 2011)

report the sensitive financial information of Libyan rebels fighting the regime of Moammar Gadhafi, if any of these rebels or their families held accounts here.

### Proposed Rule Violates President Obama's Executive Order 13563

In January, President Obama issued Executive Order 13563, intended to reemphasize the principles of Executive Order 12866 that govern the regulatory development and review process. Regarding his new Executive Order, the President wrote:

"...We are seeking more affordable, less intrusive means to achieve the same ends—giving careful consideration to benefits and costs. This means writing rules with more input from experts, businesses and ordinary citizens.... I am directing federal agencies to do more to account for—and reduce—the burdens regulations may place on small businesses."<sup>2</sup>

Unfortunately, the proposed regulation – which effective would designate the U.S. as tax collector for the world -- fails to meet any of these objectives. Not only does the proposal fail to give "careful consideration to benefits and costs," it ignores the requirement of Executive Order 12866 issued under President Clinton that requires a cost-benefit analysis for "significant regulatory action," which it defines as having "an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy."

Most estimates say this rule's cost to the economy would easily exceed \$100 million. In fact, the Mercatus Center of George Mason University estimated in 2004 that even a scaled back variant of this rule would drive \$87 billion out of the economy. The rule also fails to address global bipartisan concerns regarding privacy and human rights.

### Proposed Rule Would Harm U.S. Competitiveness and Safety and Soundness of Banking System

Since 1921, with the goal of attracting capital to the U.S. economy, Congress has exempted from U.S. taxation the interest earned on deposits of nonresident aliens. According to the Department of Commerce, nonresident aliens hold more almost \$4 trillion in U.S. banks. And they have been estimated to represent as much as one-third of all bank deposits in Florida.

These deposits enable banks and credit unions to make more loans to consumers, homeowners, and small businesses – generating economic activity that produces billions in state and federal tax revenues. But this rule threatens to bring much of this economic activity to a screeching halt, and may even take some financial institutions – particularly smaller ones -- under.

Financial institutions of all sizes have opposed this rule. Among the comments the IRS has received are letters from both the Independent Community Bankers of America and the Credit

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<sup>2</sup> "Toward a 21-st Century Regulatory System," President Barack Obama, The Wall Street Journal, January 18, 2011.

Union National Association, who say their member institutions will be hit hard by the costly upgrades in technology forced by this rule, as well as the loss of deposits.

All this burden for a rule that would raise no revenue for the U.S. coffers. In fact, ironically, if Congress were to change its policy and start taxing foreign interest, it would probably have less effect on movement of deposits than this rule would. But by scaring away current depositors and potential depositors from U.S. financial institutions, the IRS has effectively foreclosed this as a viable revenue method for Congress to explore.

### The Biggest Cost: Loss of Privacy and Human Rights

Taxes are one of many reasons, and in many cases probably not the most important, nonresident aliens patronize U.S. banks. As the Independent Community Bankers Association of America noted in its comments to the IRS last month, “Foreign deposits in U.S. banks are largely a function of the confidentiality, privacy, and stability of our banking system.”

In the past, the U.S. has negotiated tax treaties taking account, as with all treaties, levels of corruption, civil liberties, and just plain stability of the countries in question. But now by requiring U.S. banks to report the financial information of – in the proposal’s words – “any nonresident alien individual” from any country, and by not specifying criteria for limits to information sharing, the IRS would subject the world’s citizens in suspect regimes to uncertain fates and may promote interests contrary to U.S. foreign policy.

For instance, the U.S. is providing support to rebels trying to take down dictator Moammar Gadhafi. But under this rule, if any of these rebels had accounts in a U.S. bank, that bank would have to report this info to the IRS. Would the IRS then hand this info to the Gadhafi government? I would certainly hope not! But this proposal doesn’t specify any limits to the information sharing. And this very uncertainty is what would likely cause a mass exodus of foreign accounts from the U.S. So the issues of economic opportunity, civil liberties, and human right are all uniquely linked together in this destructive proposal.

Finally, a word about the argument that it is only fair that the U.S. impose automatic exchange of information on itself since it is effectively requiring other nations to do so through FATCA, or the Foreign Account Tax Compliance Act of 2010. It is indeed true that FATCA is imposing an incredible burden on citizens of other countries, as well as American diplomats, students and retirees who have legitimate business in other nations. Publications like the Wall Street Journal have documented horror stories such as individuals having to fill out three different forms for the same item.

Yet what these countries and individuals want is not for the U.S. to shoot itself in the foot by imposing a similar requirement on itself. They want Congress to grant them relief from FATCA. And Americans want the IRS to follow the letter and spirit of the Fourth Amendment, conducting reasonable searches and not asking for broad data dumps of sensitive information. This proposal does not achieve that, and is detrimental to growth, and it should be scrapped.