4

Residence Taxation for Portfolio Investment Income

The old capital export neutrality (CEN) view surmised that the most important role for US multinational enterprises (MNEs) in the world economy was to allocate capital among national economies (see chapter 3). This premise may have been correct in the decades immediately after World War II, when barriers to capital mobility were so severe that only large US companies could surmount them. But international capital markets are now both huge and efficient. US investors can earn capital income overseas easily, and foreign investors readily earn capital income in the United States, without MNEs' assistance.

The Rise of Portfolio Capital

In 1970 US direct investment income accounted for three-quarters of total US private receipts from investments abroad. By 2005, however, reported portfolio income was about the same as direct investment income, $218 billion versus $251 billion.[1] Those numbers reflect worldwide trends in

1. Bureau of Economic Analysis, *Survey of Current Business,* August 2006, US International Transactions, table E.2, D-3, available at www.bea.gov. Foreign portfolio investment is defined as all private foreign investment other than FDI. FDI in the United States is defined by the Bureau of Economic Analysis as occurring whenever a single foreign business, person, or associated group of persons owns 10 percent or more of a US business enterprise. Portfolio investment income flows may be underestimated owing to underreporting. Moreover, in 2005 direct investment dividends enjoyed a one-time boost on account of the partial tax holiday under the American Jobs Creation Act (AJCA) of 2004.

Peterson Institute for International Economics | www.petersoninstitute.org

the flow of new investment: World portfolio investment flows amounted to $2.3 trillion in 2005, while direct investment flows amounted to $0.7 trillion in that year, according to the International Monetary Fund (IMF 2006).[2] The rising importance of portfolio income does not, however, mean that earnings on direct investment are becoming less important to US corporations. On the contrary, whereas in 1970 earnings on direct investment amounted to 11 percent of US corporate profits, in 2005 their share was 19 percent.[3]

At the end of 2005 the stock of US portfolio investment abroad was $7,289 billion, while the stock of foreign portfolio investment in the United States was $8,612 billion. Comparable figures for the stock of foreign direct investment (FDI) at market value were $3,524 billion and $2,800 billion, respectively.[4] Thus, by the mid-2000s, the stock of US portfolio investment abroad and foreign portfolio investment in the United States both exceeded their counterparts' direct-investment magnitudes by factors of around two to one—as opposed to the early 1960s, when US direct investment abroad exceeded portfolio investment by more than six to one. When the US international tax system was designed, portfolio investment was a relatively small phenomenon compared to FDI. Today portfolio investment has become more important than FDI in shifting savings around the world.

The existence of large international portfolio flows implies that investors can allocate capital efficiently on a global scale without the aid of MNEs.[5] The logical corollary seems straightforward: If policymakers want the tax system to influence the global allocation of capital, they should look first to taxes that affect comparative financial yields, not to taxes on earnings of foreign subsidiaries and branches.

---

2. Eight countries are not covered by the reported figures: Australia, Cyprus, Denmark, Iceland, New Zealand, Norway, Sweden, and Switzerland.

3. Bureau of Economic Analysis, *Survey of Current Business,* August 2006, US International Transactions, tables 1.14 and E.2, D-3.

4. Bureau of Economic Analysis, *Survey of Current Business,* August 2006, US International Transactions, table F.1. Portfolio investment for this purpose includes corporate bonds, corporate stock (holdings of less than 10 percent), and US claims on unaffiliated foreigners (or US liabilities to unaffiliated foreigners).

5. The National Foreign Trade Council (NFTC 1999, paragraphs 43, 46) drew a similar conclusion, noting that: "In the current economic environment, however, it is far from clear that imposing current U.S. tax on U.S. CFCs [controlled foreign corporations] is necessary or sufficient to achieve an efficient worldwide allocation of investment. If foreign subsidiaries fund incremental investment through securities sold to portfolio investors, then efficiency in the allocation of capital rests on the taxation of portfolio investment . . . the eclipsing of foreign direct investment by portfolio investment calls into question the importance of tax policy focused on foreign direct investment for purposes of achieving an efficient global allocation of capital."

Peterson Institute for International Economics | www.petersoninstitute.org

Applying Capital Export Neutrality Logic to Portfolio Income

Apart from the temporary use of withholding taxes as a means of regulating international capital flows to promote financial stability (discussed below), from the point of view of worldwide efficiency, there is no reason for taxes to distort the decisions of portfolio investors. If equity or debt investments abroad offer higher returns or better diversification than do investments at home, the money should be used abroad. The best tax regime on a global basis taxes investors the same whether they choose foreign or domestic securities. Hence, the CEN approach is a solid foundation for taxing income from portfolio investments.

What are the implications of CEN for taxing portfolio income?[6] The basic recommendation is that a country should tax its residents on their income from foreign portfolio investments the same as it taxes their income from domestic portfolio investments. The recommendation that follows is more surprising: To advance its own welfare, the foreign country in which the portfolio capital is invested should not tax the interest income paid to nonresidents.[7]

An extended example illustrates the two recommendations. Suppose the world interest rate on dollar-denominated triple-A 10-year bonds is 5 percent. A country that wishes to tax the interest income of its residents might impose a tax of 20 percent on it, whether it is received from investments at home or abroad. The tax does not cause residents to shift their portfolios to raise domestic interest rates: Wherever they put their money, their after-tax return is now 4 percent rather than 5 percent. Hence the tax exerts the least possible distortion on domestic activity. But like any tax

6. Appendix C2 examines the taxation of world portfolio capital in more detail. The argument in this chapter applies generally to all types of portfolio income for which the investor has no control over the operation of the property—interest, dividends, rents, and royalties—even though the examples offered are cast in terms of interest income, as interest payments are by far the dominant form of international portfolio income.

7. In support, see Reich (1998, paragraph 19): "One important policy consideration would seem to favor having the source country forgo the taxation of passive income, particularly portfolio investment income. Investment capital is highly mobile, and investors often can choose from among alternative investment opportunities around the world. The ease with which capital can be invested in the international capital markets and the volume of such cross-border investments have increased dramatically in recent years. Taxation of portfolio investments by the source country is a disincentive to [inward] foreign investment and may induce investors to seek comparable returns from countries with more hospitable tax rules. Thus, in today's global capital markets, countries seeking to attract foreign capital investments have an incentive to forgo the taxation of portfolio investment income earned by foreign investors." Brean, Bird, and Krauss (1991) likewise favor CEN for taxing portfolio investment. However, they rely on the foreign tax credit to achieve CEN objectives, and unlike us, do not reject source-based taxation.

Peterson Institute for International Economics | www.petersoninstitute.org

on capital income, it distorts the long-run choice between present consumption and future consumption and thus might well discourage domestic saving (Boskin 1988b, Muten 1994), but it will not deter domestic investment because, in short, the interest rate remains at 5 percent.

It would be a mistake, however, to apply the same 20 percent tax on interest paid to foreigners. Many important foreign investors—pension funds, life insurance companies, and firms with net operating loss carryovers—legitimately pay little or no tax to their home governments, even on their domestic income. In the United States, for example, life insurance companies pay no tax on investment income allocated to policyholders; they pay the regular corporate tax on the remaining investment income. Some countries exempt their investors from taxation on portfolio income received from abroad. These various legitimate investors, together with those who simply evade their home-country tax, have little or no use for foreign tax credits and will not accept the lower net rate of return brought about by a source-country tax because they can place their portfolio investments elsewhere. A tax on interest paid to foreigners will prompt such tax-sensitive investors to withdraw funds until market forces push the domestic interest rate up by enough to offset the tax. The end result is a loss for the capital-importing country because profitable investment opportunities are forgone.

To illustrate, if the 20 percent tax were imposed on interest paid to foreigners, and if an important segment of foreign investors had no use for the foreign tax credit, the domestic interest rate would need to rise to 6.25 percent on all triple-A 10-year bonds, as financial assets are highly fungible. The net return to foreign investors would then remain at 5 percent, while the other 1.25 percent would be paid as tax (20 percent tax rate $\times$ a 6.25 percent yield $=$ 1.25 percent). Foreign portfolio investors would be no better off and no worse off.[8] But all domestic investments that would have been profitable at interest rates between 5 percent and 6.25 percent would simply not be made.[9]

---

8. Domestic portfolio investors would earn higher returns on their new savings, but that benefit is more than offset by the associated penalty on new domestic capital formation.

9. Corden (1974, 335–47), Gersovitz (1987, 616–17), and Slemrod (1988, 121) discuss this result in more detail. If the capital-importing country is very large, so that foreign investors do not have unlimited investment opportunities elsewhere, the borrowing country can derive some benefit from a tax on foreign investment income. The reasoning is akin to optimum tariff analysis in trade theory. In the text example, the interest rate might only rise to 6 percent rather than 6.25 percent, and the after-tax yield to foreign investors might be cut to 4.8 percent rather than remain at 5 percent. By itself, the drop in after-tax yield to foreign investors helps the taxing country. However, it is difficult to know exactly which tax rate produces an overall gain when the reduction in domestic investment because of higher interest rates is also taken into account. Choosing the wrong tax rate could easily harm the borrowing country. Readers familiar with trade theory will note the parallels to the practical problems encountered in setting an optimal tariff.

Peterson Institute for International Economics | www.petersoninstitute.org

Residence-Only Taxation of Portfolio Income

In short, if countries are going to tax portfolio income at all, there are strong reasons for them to fully tax the income received by their own residents from international portfolio investments. At the same time, they should not tax interest income paid to foreign investors. Only combining the two tax rules exerts the least possible effect on local interest rates.[10] Industrial countries appear to have absorbed this lesson, as taxation of portfolio interest income solely by the resident country has come to be the generally accepted approach.[11] Such countries tax their residents fully on portfolio interest income without deferral or exemption and often tax portfolio interest income paid out to foreign investors at zero or low rates. The United States repealed its withholding tax on interest from debt obligations, including Treasury debt, issued to foreign persons after July 18, 1984,[12] and on all interest paid by banks and insurance firms.[13]

The changes to the tax code and the many treaties that exempt residents of signatory countries from US tax on all interest income—except interest income attributable to US permanent establishments—means that the effective tax that foreigners pay on US-source interest income has been almost eliminated in the past two decades. As table 4.1 shows, in 2006 US entities paid approximately $457 billion of interest to foreign persons, including corporations, partnerships, trusts, governments, and individuals. Of this amount, about $145 billion was paid on US Treasury debt free of US withholding tax, and about $311 billion was paid to foreign persons by various private entities, including tax-free interest paid by banks and insurance companies. Out of the total $457 billion interest

10. If a country wishes to use tax policy to promote domestic saving by ensuring high after-tax interest rates, the straightforward approach is to simply not tax interest income at all. The taxation of domestic interest income paid to foreigners is a backdoor method to achieve the same policy result, but with an associated penalty on real investment, as the before-tax interest rate must rise when this backdoor method is used.

11. Other countries, especially in Latin America, have historically followed the source principle, so that income that their residents earn from foreign investments is exempt from tax while foreign investors are taxed on portfolio income earned locally. Williamson and Lessard (1987, 40–43) discuss the troublesome role taxation has played in the problem of capital flight from Latin America and other developing countries. They conclude that the source principle has not served the countries well, and that they should move to a residence approach. See also McLure (1988).

12. See Internal Revenue Code (IRC) sections 871(h), 881(c); Reg. Section 1.871-14(a). This exemption, commonly called the portfolio interest exemption, generally applies to interest (or original issue discount) on obligations in registered or bearer forms, excepting interest received from related persons and banks.

13. Interest income on bank deposits, deposits with domestic savings and loan associations, and "amounts held by an insurance company under an agreement to pay interest thereon" are exempt from the withholding tax; IRC sections 871(i)(2)(A), 871(i)(3), 881(d).

Peterson Institute for International Economics | www.petersoninstitute.org

Table 4.1 US interest and portfolio dividends paid to foreign persons and withholding taxes collected by the Internal Revenue Service, 2005 and 2006 (billions of dollars)

Type of interest payment	2005	2006
FDI-related interest payments		
Paid by US parent firms to their foreign affiliates	3.4	4.0
Paid by US subsidiary firms to their foreign parents	18.2	22.6
Other private interest payments		
Bond interest payments	81.0	109.4
Bank interest payments	62.0	109.9
Interest paid by nonbank financial firms	42.5	65.5
US government interest payments	113.6	145.1
Portfolio dividend payments to foreign persons	38.1	44.4
Royalties and license fees	4.1	5.4
Total payments	362.9	506.3
Total interest paid	320.7	456.5
Total interest payments reported for US withholding tax purposes[a]	134.1	190.9
Total US withholding tax collected on interest payments[b]	2.1	3.1
Effective withholding tax rates (percent)		
On reported interest	1.6	1.6
On total interest	0.6	0.6

a. Based on the ratio between total interest payments in 2000 and the interest reported for withholding tax purposes in 2000.
b. Based on withholding tax rate in 2000 and total interest reported for withholding tax in 2005 and 2006.

Notes: The term "person" includes corporations, partnerships, governments, trusts, as well as individuals. All withholding taxes collected are attributed to interest payments (i.e., no withholding tax is attributed to dividends, rents, or royalties). Hence on reported interest, the effective rate represents an upper bound. The effective rate of withholding tax on all reported US-source portfolio dividends, interest, Social Security, rents and royalties, and other payments to foreigners was 1.6 percent in 2000.

Sources: Bureau of Economic Analysis, *Survey of Current Business,* April 2007 and April 2001, 41–57; Internal Revenue Service, *Statistics of Income,* Summer 2003, 183.

paid to foreign persons, only $191 billion was reported to the Internal Revenue Service (IRS). On this amount, $3.1 billion was paid in US withholding taxes. Hence the effective US tax rate on reported interest paid to foreigners was 1.6 percent in 2006. The effective US tax rate on total interest paid to foreigners was less than half that level, 0.6 percent. In other words, more than half of US interest payments to foreign persons are legally exempt from US withholding tax. The United States taxes the other half at the low effective rate of 1.6 percent.

Peterson Institute for International Economics | www.petersoninstitute.org

The European Union has taken the US residence-only approach a step further, adding a mechanism to combat tax evasion. In June 2003 the European Union adopted Directive 2003/48/EC on taxation of savings income in the form of interest payments, or the Savings Directive, which entered into force on July 1, 2005.[14] The ultimate aim of the Savings Directive is to ensure that interest payments made by one member state to individual residents in another member state are subject to effective taxation according to the laws of the second member state. Under the terms of the Directive, member states have agreed to automatically exchange information on interest payments made by paying agents established in their own territory to individual residents located in other member states. In return, interest income that agents located in another member state pay to individual EU residents is not subject to withholding tax by the source country. Instead the payments are taxed only in the investor's member state of residence.[15] The European Union has adopted a similar proposal regarding portfolio interest and royalty payments for companies based in EU member states.[16]

It can be argued that, as a matter of international tax equity, residence countries should share their revenue on portfolio income with the countries where the income was paid (the source countries), or put another

14. Within the framework of the directive, EU member states have entered into bilateral agreements with certain tax havens, offshore financial centers, and other jurisdictions that maintain bank secrecy. The agreements contain provisions broadly equivalent to those laid down in the directive. See Council Directive 2003/48/EC on Taxation of Savings Income in the Form of Interest Payments, as draft published by the Council at its meeting of June 3, 2003, available at http://eur-lex.europa.eu.

15. The original 1998 proposal was based on a compromise solution known as the coexistence model, which would have allowed each member state to choose between applying a withholding tax of at least 20 percent on interest payments made by paying agents within its territory to individual beneficial owners residing within the European Union, or providing information to the investor's member state of residence. The ultimate language of the directive, which eliminates the withholding tax choice completely, permits a seven-year transition period for three member states—Belgium, Luxembourg, and Austria—during which time they can continue to apply their withholding tax systems. The transition period will end if, among other things, the United States commits to exchange of information upon request, under the provisions of the 2002 Organization for Economic Cooperation and Development (OECD) Model Agreement.

16. See Proposal for a European Directive Concerning a Common Tax System Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, March 6, 1998. The proposal, last amended on March 19, 2003, exempts from withholding tax both royalty and interest payments made between associated companies of member states. The exemption applies mainly to payments made by a subsidiary company to its parent company when the parent holds not less than 25 percent of the subsidiary's capital. It also applies to payments made by a parent company to its subsidiary, again with a 25 percent ownership requirement.

Peterson Institute for International Economics | www.petersoninstitute.org

way, that a tax should be imposed at residence-country rates, but that some part of the revenue should be paid over to (or collected by) the source country. We disagree with this suggestion. The only role we see for source-country collection is to help defeat tax avoidance, a point discussed later and drawing on EU experience. In our view, a residence country that establishes an economic climate favorable to portfolio capital creation by combining public fiscal virtue with private thrift should be rewarded for its contribution to the world economic system by garnering the tax revenue. The source country derives ample benefit simply from using capital from abroad to finance investments that pay a higher return than the interest cost.

On the grounds of both self-interest (source countries stand to benefit from more investment) and tax equity (residence countries deserve to benefit from more tax revenue), the rule of residence-only taxation of interest income should become the international norm. This can be accomplished if important countries, such as the United States, eventually deny a foreign tax credit for foreign withholding taxes on interest income. To be consistent with existing treaties, the new policy could be phased in gradually, giving long termination notices for treaty credits on foreign withholding taxes on portfolio interest and other forms of portfolio income. In the credits' place, the United States and other countries should apply the national neutrality (NN) prescription to portfolio interest, allowing a deduction only for foreign withholding taxes.

Retaliation against such a move is certainly possible, but it would be welcomed, not feared. As no investor could claim the benefit of a foreign tax credit, all investors would be prompted to withdraw funds from countries that imposed withholding taxes on interest income. Local interest rates would rise in those jurisdictions, and eventually political pressures would work to repeal their withholding taxes. Over time, withholding taxes on portfolio income would disappear from the fiscal landscape.

Cooperation Against Tax Avoidance

As the EU Savings Directive demonstrates, the real issue with residence-only taxation is the need for international cooperation in administering the tax system. The residence-only approach is vulnerable to abuse: If investors can evade their own home-country taxes on foreign interest income, the income is not taxed anywhere,[17] and when such evasion is

17. Without international cooperation, the other side of the coin is greater potential for double taxation. If the United States taxes portfolio interest based exclusively on residence while other countries practice source taxation, double taxation is inevitable unless a treaty solution is available. If the United States adopts a residence-based approach for taxing portfolio income, as we recommend, the US treaty network must be modified accordingly.

Peterson Institute for International Economics | www.petersoninstitute.org

possible, residents shift their capital to untaxed foreign investments (Reich 1998). Domestic interest rates then tend to rise until they equal the world interest rate plus the domestic tax rate, which in turn prompts some investors to invest in their home-country securities covertly, through foreign intermediaries. For example, US investors might invest in US Treasury bonds through numbered accounts in Macau banks.[18] Such a prospect prompted the United States, under its old withholding regulations, effective until 2000, to require a negative certification by foreign institutional investors that they were not acting on behalf of US residents when they held US securities.

IRS and industry participants acknowledged that the old withholding regulations were unworkably complex, resulting in poor compliance from US and foreign financial intermediaries (Reich 1998). The certification system was porous to tax abuse, especially in identifying sophisticated US investors who acquired either US securities through shell corporations organized in tax haven jurisdictions or non-US securities through accounts with offshore branches of non-US financial institutions. The absence of a universal taxpayer identification number (UTIN), together with financial institutions' haphazard disclosure of customer information to tax authorities, greatly facilitated tax avoidance.[19] However, new measures enacted since the terrorist attacks of September 11, 2001 to combat money laundering and terrorist financing could be adapted to sharply reduce tax avoidance.

Prior to legislation in the wake of September 11, US withholding-tax regulations were drawn up in 1997 and effective in 2001 (see appendix A5). They tried to deal with abuse by identifying the ultimate beneficiary owner through the establishment of a special qualified intermediary (QI) regime.[20] Under this regime, the burden of certifying residence information from

18. Liberalization of financial markets during the last decade has given investors access, at little or no cost, to banking systems around the globe through which they may conduct both legitimate and illegitimate transactions. This freedom has made it easier for investors to place money in jurisdictions that limit tax authorities' access to bank information. It also makes it harder for tax administrations to detect noncompliance, unless they have robust exchange of information systems with the relevant jurisdictions; see OECD (2000a, 22–23).

19. Because there is no world-wide system of tax identification numbers, most tax administrations are unable to match the information received from their treaty partners with domestic taxpayers (Avi-Yonah 1998a, 1821).

20. The QI status typically extends to a foreign financial institution (or a US financial institution with respect to its foreign branches) that enters into an agreement with the IRS. An institution that does not sign an agreement with the IRS remains a nonqualified intermediary (non-QI) with regard to securities it holds on behalf of customers. The main difference between a QI and a non-QI is that the QI makes deposits of withholding tax directly to the US Treasury Department whereas a non-QI will use a US withholding agent to perform this role (McGill 2000, 2823).

Peterson Institute for International Economics | www.petersoninstitute.org

investors fell explicitly on the QI, which had to cooperate with the IRS and adhere to so-called know-your-customer rules regarding its account holders. In return, the QI generally was permitted to certify the status of its customers without having to disclose their identities to US tax authorities.[21] However, the 1997 withholding regulations are at best a halfway solution, without a satisfactory answer to the problem of cooperative tax administration. In particular, they do not enable tax authorities to match interest payments with individual tax returns.

The basic point is that countries where interest is earned—the source countries—have much better access to information about who is receiving interest income because the corporate payers are located in the source country. Under a residence-only system, however, the source countries are not directly concerned with making sure that foreign receivers of interest income pay taxes on it. Indeed, countries that borrow large amounts of foreign money are tempted to go easy on tax enforcement where foreign investors are concerned: By so doing, their banks, industrial firms, and finance ministries all enjoy continued access to the world pool of capital at the lowest possible interest rates, which reflect zero tax whether or not such tax is due legitimately in the resident country.

OECD Project on Harmful Tax Competition

After an awkward, "one step forward, two steps back" attempt at dealing with harmful tax competition at the end of the 1980s, EU officials have concluded, correctly, that nothing should be attempted short of full international cooperation, involving the United States, Canada, Japan, and countries in the European Free Trade Association as well as the European Union itself.[22] Local financial intermediaries, especially banks, lose sig-

21. Under the old withholding regulations, there was no practical way for a US withholding agent to collect documentation from a foreign beneficial recipient of income who held securities through a foreign financial institution. The new withholding regulations address this problem by placing the burden of establishing beneficial ownership on foreign financial institutions rather than on US custodians and by specifying the obligation to withhold tax in the absence of documentation (Shay, Fleming, and Peroni 2002, 124).

22. Germany instituted a withholding tax on interest in January 1989, partly to ensure that foreign depositors would not avoid their home-country tax; the tax was repealed three months later after objections from domestic bankers, who experienced a massive departure of foreign capital as investors scurried to friendlier tax climates in Luxembourg and Switzerland. This failure scuttled the European Commission's proposal that all EC countries adopt a uniform withholding tax upon the full opening of European capital markets in June 1990 (*Financial Times,* May 22, 1989, 4). In 1992 Germany reintroduced the withholding tax after a decision by the German Federal Constitutional Court in 1991. The court concluded that withholding taxes on wages and not on interest violated the constitutional obligation to

Peterson Institute for International Economics | www.petersoninstitute.org

nificant business if only one country helps resident countries collect their tax on interest payments.[23] Thus despite the hesitation, the last decade has seen significant cooperation against tax avoidance, including improvements in the exchange of information. These developments open new opportunities to implement our proposal to shift toward a residence-only system of taxing for portfolio capital flows.

The first coordinated international effort to cooperate effectively against tax avoidance was the Convention on Mutual Assistance in Tax Matters, developed jointly by the OECD and the Council of Europe,[24] signed in 1988, and entered into force in 1995.[25] Not until May 1996, however, was an active approach to deal with harmful tax competition endorsed, as national ministers instructed the OECD to "develop measures to counter the distorting effects of Harmful Tax Competition on investment and financing decisions and the consequences of national bases" (OECD 1998, paragraph 1). This resulted in the 1998 report entitled *Harmful Tax Competition, An Emerging Global Issue* (OECD 1998)—with Luxembourg and Switzerland abstaining—authorizing further work on 19

---

make taxation just and equitable. However, this time nonresident recipients of interest income were excluded, and even for resident taxpayers, an extremely high threshold was used to ensure that only a small number of wealthy investors would be affected (see Muten 1994).

23. In 2001 the US Treasury Department issued proposed regulations (REG 126100-00, 66 Federal Regulations (FR) 3925) to impose reporting requirements on US banks for interest paid on US bank deposits to all nonresident alien individuals and require the sharing of the information with other countries. The Treasury defended the regulations "because of the importance that the United States attaches to exchanging tax information as a way of encouraging voluntary compliance and furthering transparency" (66 FR 3925). However, the financial industry severely criticized the proposed regulations, contending that they would trigger massive withdrawals of foreign deposits from US banks, particularly from US banks with a deposit base that included a significant number of nonresident alien individuals living in jurisdictions that maintain stricter privacy standards (see, e.g., Mastromarco and Hunter 2003). Ultimately, the proposed regulations were replaced by another set of proposed regulations (see REG-133254-02, 67 FR 50386, July 30, 2002 not yet finalized as of July 2007) that limited the reporting requirements from US banks to cover nonresident alien individuals that reside in 15 designated treaty countries. Lawmakers also inveighed against the proposed regulations. For example, in a letter dated September 20, 2004, sent by House Ways and Means Committee member E. Clay Shaw (R-FL) to Treasury Secretary John Snow, Shaw urged Snow to withdraw the regulations, noting that they were "contrary to America's national interests" and could cause the flight of $87 billion of capital from the US economy.

24. The European Union has attempted to reduce tax regime differences among member states that potentially divert employment from one member state to another (Liebman 2002).

25. Article 4 of the convention states that the parties are obliged to exchange information that is foreseeably relevant assessing and recovering taxes correctly. Although the convention seeks to promote international cooperation for the better operation of national tax laws while respecting the fundamental rights of taxpayers, its effect is so far limited because only a few countries have ratified the convention (Belgium, Denmark, Finland, Iceland, the Netherlands, Norway, Poland, Sweden, and the United States).

Peterson Institute for International Economics | www.petersoninstitute.org

recommendations for actions against "harmful tax practices," including a timetable to identify and eliminate them.

A progress report tabled in June 2000 observed that "harmful tax competition is by its very nature a global phenomenon and therefore its solution requires a global endorsement and global participation" (OECD 2000b, 22). Follow-up progress reports were published in 2001 (OECD 2001c) and 2004 (OECD 2004c). The 1998 report states that a country maintains a harmful tax practice 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 report finds harmful tax practices in both island tax havens and the preferential tax regimes of other countries.

We are skeptical about the harmful tax competition project insofar as its goal is to harmonize corporate income taxes upward to the highest prevailing rate.[26] However, the OECD's project could be useful in furthering residence-only taxation of portfolio income. Information exchange is widely recognized as the most effective way to combat international tax evasion (OECD 2002c), and the OECD initiative provides a framework to exchange tax information effectively.

First, the OECD 1998 report enumerates factors to identify tax havens and harmful preferential tax regimes." Among those factors, the report identifies the absence of effective information exchange as a key feature.[27] A later OECD report (OECD 2000b) identified a number of harmful tax practices and offending jurisdictions,[28] including countries that granted businesses and individuals strict secrecy and other protections from tax authorities' scrutiny, as the OECD has worked to ensure that member states impose sanctions on blacklisted countries.[29] In 2004 the OECD unveiled a new study on harmful tax regimes (OECD 2004c), detailing significant progress in eliminating harmful preferential tax regimes in OECD member states and improving information exchange with tax havens.

---

26. See Conconi (2006), who argues that global tax harmonization leading to the complete elimination of tax competition is undesirable because it would prompt the adoption of higher than optimal capital taxes.

27. The OECD (1998, 29) noted that "the ability or willingness of a country to provide information to other countries is a key factor in deciding upon whether the effect of a regime operated by that country has the potential to cause harmful effects."

28. The OECD (2000b) identified 47 potentially harmful tax practices by member countries and listed 35 tax havens. The 2000 report excluded from its list those tax havens that made "a public political commitment at the highest level to eliminate their harmful tax practices and to comply with the principles of the 1998 Report" (OECD 2000b).

29. Sanctions proposed by the OECD for targeted countries include terminating tax treaties, denying income tax deductions for purchases made from firms in those countries, imposing withholding taxes on payments to residents of targeted countries, and denying foreign tax credit for taxes paid to the targeted government. See Prosperity Institute (2002).

Peterson Institute for International Economics | www.petersoninstitute.org

During the period 2001–04 the number of countries and jurisdictions outside the OECD that committed to the principles of effective exchange of information and transparency increased from 11 to 33.

The second avenue for improving information exchange stems from the 1998 Agreement on Exchange of Information on Tax Matters, released by the OECD Global Working Group on Effective Exchange of Information.[30] Although the agreement is not a binding convention, it sets standards on tax information exchanges for financial centers worldwide to deter the shift of business activity to noncooperative jurisdictions.[31] In July 2004 the OECD's Committee on Fiscal Affairs revised Article 26 of the OECD's Model Tax Convention, which covers information exchange on tax matters between national tax authorities as part of a drive toward improved cooperation in administering domestic tax laws and international tax treaties.

A model agreement is particularly important due to the fundamental weaknesses inherent in the information exchange mechanisms contained in most bilateral income-tax treaties. Tax treaties frequently allow contracting states to refuse to provide information in certain cases: if the countries do not collect the information for their own tax enforcement, or if the requesting state itself is unable to provide similar information. These exceptions mean that certain countries cannot exchange information on interest payments and that other countries are not required to provide information to these countries. In addition, tax treaties do not include common rules concerning the information to be reported, the format and frequency of information exchanges, or the mechanisms to carry out the information exchange. As a result, even when information is exchanged, it is not always usable (OECD 2000a).

Third, the OECD recommends that countries adopt common rules to identify taxpayers (e.g., through UTINs). Nonresident recipients of income would be required to disclose their UTINs.

Fourth, the OECD recommends that countries review their laws, regulations, and practices that govern access to banking information with a view to removing impediments that obstruct tax authorities. In 2000 the OECD released a report entitled *Improving Access to Bank Information for Tax Purposes* (OECD 2000a) that proposes better tax-administration access to bank information. The report, which was unanimously approved, calls

30. The working group consisted of representatives from OECD member countries and delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles, and San Marino.

31. The agreement is presented as both a multilateral instrument and a model for bilateral treaties. However, the multilateral instrument is not a multilateral agreement in the traditional sense. Instead, it provides a framework for an integrated bundle of bilateral treaties. A party to the multilateral agreement would only be bound with respect to specifically enumerated parties with which it agrees to be bound.

Peterson Institute for International Economics | www.petersoninstitute.org

for ending confidential bank accounts and requiring identification for bank customers and beneficial owners of accounts. A follow-up report (OECD 2003) noted positive developments in implementing the measures outlined in the OECD (2000a) report between the first and the second reports. Anonymous accounts can no longer be opened in any OECD country, customer identification numbers have been established in all OECD countries, and the requesting country's taxation of interest income is no longer a precondition to a treaty partner's providing information.[32]

A recent report released by the OECD Global Forum on Taxation (OECD 2006d) presents a survey of 82 OECD and non-OECD countries and jurisdictions, noting that in the past few years many of these economies have become more transparent. Most have entered into double taxation conventions and tax information exchange agreements, and many more are negotiating such agreements. Moreover, as the report points out, no OECD economy and few non-OECD countries currently require the prospect of domestic tax collections as a condition for responding to a treaty partner's request for information on a specific taxpayer. However, the report also notes that a few economies still constrain international cooperation in criminal tax cases, and a number continue to impose strict limits on access to bank information in civil tax cases.

The USA Patriot Act and Anti-Money Laundering Initiatives

Exchange of information systems came under a stronger spotlight after September 11, 2001 and associated anti-money laundering (AML) initiatives. As a side benefit, the new spotlight could facilitate residence-only taxation of portfolio income. Immediately after the September 11 attacks, the US Treasury and Interpol announced the creation of a partnership to establish an international terrorist-financing database.[33] On October 26, 2001 President George W. Bush signed into law a comprehensive set of antiterrorism and AML laws known as the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot) Act (PL 107-56), which paralleled a

32. The OECD (2003) report notes, however, that little progress has occurred in a few key areas. For example, the 30 OECD member countries have not agreed on a common definition of tax fraud, and few changes have been made to accessing bank information for civil tax purposes.

33. The Interpol database is designed to consolidate national and international lists of terrorist financiers and make the information available to police around the world to assist in criminal investigations. Participants are intended to include all 179 members of Interpol (Prosperity Institute 2002, 718).

Peterson Institute for International Economics | www.petersoninstitute.org

growing international campaign to combat money laundering led by the Paris-based Financial Action Task Force (FATF).[34]

Encompassed under title III of the USA Patriot Act is the International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001 (Implafa). Title III is the product not only of September 11, but also of an earlier congressional investigation into correspondent banks and their ties to international money laundering.[35] Implafa heightens the responsibility of US financial institutions to detect money laundering,[36] as financial institutions must comply with extensive requirements when creating new accounts and conducting transactions. The act mandates US-based financial institutions to determine whether potential foreign bank clients are involved in any law enforcement or regulatory actions related to money laundering, fraud, tax evasion, or drug trafficking.[37] Institutions must report suspicious activity to the US Treasury Department, cash transactions to the IRS, and the international transportation of monetary instruments to the Customs Service (Reuter and Truman 2004).[38]

The mechanisms in the USA Patriot Act readily lend themselves to enforcement of a residence-only system for portfolio capital flows. Due diligence requirements designed to combat money laundering and terrorist financing can be adapted to the universal reporting system needed to ensure that countries can collect taxes due on their residents' foreign portfolio investments. The G-7 argues that international action in this area would strengthen existing AML systems and increase the effectiveness of tax information exchange arrangements (OECD 2002a).

---

34. In May 1989 the G-7 finance ministers endorsed international action to enhance AML systems to combat tax-related crimes. The FATF was subsequently established in 1989 by 33 countries. However, the FATF parties stated that the new forum would not address tax issues; its primary role was to combat money laundering through name-and-shame tactics (Reuter and Truman 2004).

35. In February 2001 the US Senate Permanent Subcommittee on Investigations released a comprehensive report on money laundering and tax evasion abetted by the US banking system through correspondent accounts with high-risk foreign banks (Report on Correspondent Banking: A Gateway for Money Laundering, available at www.senate.gov). The report accused US banks of not enforcing AML safeguards and thereby acting as conduits for criminal proceeds. It called on US banks to shut their doors to high-risk foreign banks and eliminate abuses of the US correspondent banking system.

36. See section 312 of Implafa, which adds a new section, 5318(i), to title 31 USC.

37. See Fernando L. Aenlle-Rocha, "Correspondent Banking After September 11," *Los Angeles Lawyer Financial Times,* September 27, 2002.

38. Core financial institutions, such as banks, security firms, and insurance companies, are subject to the most stringent audit requirements. Less rigid rules apply to other financial institutions and nonfinancial businesses (Reuter and Truman 2004).

Peterson Institute for International Economics | www.petersoninstitute.org

Recommendations

At the beginning of 2005 the OECD identified at least five jurisdictions that had not yet committed to transparency and effective exchange of information.[39] As the OECD 2000 report indicates, "there is a significant risk that a failure to address these practices in parallel with the work in relation to Member countries will cause a shift of the targeted activities to economies outside the OECD area, giving them an unwarranted competitive advantage and limiting the effectiveness of the whole exercise" (OECD 2000b, 22).

In light of the competitive realities, some commentators have suggested that the current exemption for portfolio interest be limited to registered obligations and allowed only for residents of countries that exchange tax information with the United States.[40] Alternatively, the commentators suggest that the statutory withholding tax exemptions for portfolio interest and bank deposit interest be repealed—thereby reverting to a 30 percent withholding rate—and that exemptions should be provided only through bilateral tax treaties.

We do not agree with these suggestions. In our view, at the same time, they do too much and too little. On one hand, they deny the United States the benefits of inward investment flows attracted by unilateral relief from US withholding tax for law-abiding, taxpaying residents of non-treaty partner countries. On the other hand, they assume that all residents of treaty partner countries are law-abiding taxpayers. Further, we believe that the climate created by the OECD harmful tax competition project and the EU Savings Directive present a golden opportunity for the United States to cooperate with its closest partners in adopting a much stronger residence-only system of taxing portfolio income flows, without risking retaliation from key financial countries or facing significant withdrawals of foreign funds. The USA Patriot Act's groundbreaking due diligence requirements could be an important building block for a residence-only tax system.

From the narrow but important standpoint of US tax revenue, the central purpose of our recommendation is not to increase US tax collec-

39. The jurisdictions are Andorra, the Principality of Liechtenstein, Liberia, the Principality of Monaco, and the Republic of the Marshall Islands, which all appear on the OECD's list of uncooperative tax havens. In February 2005, however, Andorra accepted an OECD invitation to participate in the next meeting of the OECD Global Forum on Taxation.

40. These countries would consist of all of the current US treaty partners that cooperate in information exchange, regardless of the treaty withholding tax rate on interest payments, as well as countries party to tax information exchange agreements. See Shay, Fleming, and Peroni (2002, 145). The limitation to registered securities implies that tax would be withheld at source on bearer bonds.

Peterson Institute for International Economics | www.petersoninstitute.org

tion on outward flows of interest to foreign persons but rather to ensure that US taxpayers report all of their portfolio income to the IRS and pay whatever tax is owed to the US Treasury. To illustrate one example of massive tax avoidance, many tax-exempt US institutions such as pension plans, hospitals, and universities choose tax haven countries as a destination for their portfolio investments. A leading reason is to avoid US taxes that would otherwise be payable on unrelated business income. The Cayman Islands are particularly popular as a home for such investments, often made through hedge funds. According to an estimate by the Cayman Islands Monetary Authority, the Caymans are the corporate home for about three out of four of the world's hedge funds, owing to very low local taxes, light regulation, a cadre of legal and accounting professionals, and a reputation for honest governance.[41]

Given the nature of tax evasion, it is impossible to know how much additional revenue might be collected if our proposals were enacted. However, the reported stock of US outward private portfolio investment in 2005 was about $7.6 trillion in 2005, and the estimated inward flows of interest, plus inward portfolio flows of dividends, were $234 billion to private US persons. Hence the implied yield was only 3.2 percent (see table 4.2).[42] With these magnitudes we speculate that underreporting of income flows to US taxpayers is at least 15 percent of reported flows, or about $35 billion annually. In a properly functioning global system, the tax due on these income flows could amount to 10 percent of the underreported interest and dividends, or as much as $3.5 billion annually.[43]

To start the ball rolling on effective global taxation of portfolio income, we recommend that the United States adopt a backup withholding tax at source on cross-border portfolio income payments, coupled with a reimbursement system under which tax withheld at the source would be credited or refunded to the taxpayer by his resident country, once the resident country's tax was paid. If, as anticipated, other countries followed the US lead and adopted their own backup withholding systems, an international clearinghouse mechanism should then be established to sort out each resident country's claims against source-country backup withholding taxes.

---

41. For more details, see Lynnley Browning, "Tax Breaks Lure Money Managers to the Caymans," *International Herald Tribune,* July 3, 2007.

42. Private portfolio-investment stock abroad is defined as total private holdings of foreign passive assets (bonds and bank and nonblank claims) and foreign corporate equities (see table 1.5). The figure cited in the text for private inward interest and portfolio dividends excludes payments of interest to the US government by foreign entities (see table 4.2).

43. In other words, we assume that a more reasonable return was at least 3.7 percent on the stock of portfolio investment. It is also possible that the portfolio investment stock was underreported.

Peterson Institute for International Economics | www.petersoninstitute.org

Table 4.2 Foreign interest and portfolio dividends paid to US persons, 2005 and 2006 (billions of dollars)

Type of interest payment	2005	2006
FDI-related interest payments		
Paid to US parent firms from their foreign affiliates	9.7	10.0
Paid to US subsidiary firm from their foreign parents	3.9	5.2
Other private interest payments		
Bond interest payments	44.2	53.4
Bank interest payments	62.5	107.9
Interest paid by nonbank financial firms	47.3	79.7
US government interest receipts[a]	2.7	2.4
Private portfolio dividends	63.7	79.9
Total receipts	234.0	338.5

a. Total income receipts less receipts from debt forgiveness and debt rescheduling.

Note: The term "person" includes corporations, partnerships, governments, trusts, as well as individuals.

Source: Bureau of Economic Analysis, *Survey of Current Business,* April 2007.

Backup withholding would require host countries to share tax information with home countries and to end the issuance of bearer bonds and other anonymous securities.[44] Fortunately, the OECD's Agreement on Exchange of Information on Tax Matters has already envisaged an excellent framework for exchanging tax information between tax authorities.[45]

The United States could begin the cooperative process by enacting legislation along the following lines:

- All US residents paying interest income to nonqualifying foreigners would be required to withhold a backup tax of 10 percent and pay that amount to the US Treasury. The IRS would issue a certificate of tax paid to the US payer, who would forward the certificate to the

44. A blank endorsement on a negotiable instrument can create a bearer instrument. Thus, the prohibition against banks and corporations from issuing instruments represents only the first step—but an important one—in a full-scale system of title registration of securities.

45. The OECD (1998) recommends using standard magnetic format for automatic information exchange to match information more efficiently and simplify conversion of the magnetic format into a standard for electronic exchange of tax information. Under the information exchange system proposed by the EU Savings Directive, the communication of information between member states is automatic and takes place at least once a year, within six months following the end of the tax year of the member state of the paying agent, for all interest payments made during that year to individual beneficial owners residing in every other member state.

Peterson Institute for International Economics | www.petersoninstitute.org

nonqualifying foreign recipient. No backup tax would be withheld on interest paid to "qualifying" foreign residents.

- Nonqualifying foreigners would include all foreigners other than those who could establish to IRS satisfaction that they had a history of reporting all interest income to their home tax authority, did not act as a financial conduit for anonymous beneficial recipients, and did not deal in anonymous securities.[46]
- Nonqualifying foreign recipients would present certificates of taxes paid to their own taxing authorities. The authorities in turn could present certificates to the IRS for reimbursement of the backup withholding tax. If the foreign taxing authority did not meet several conditions (see appendix C3), the United States would retain the backup withholding tax on interest paid to residents of those countries.
- The United States should open discussions with the European Union to expand the scope of the EU Savings Directive to non-EU members of the OECD and other key financial-center countries and apply the directive not only to interest payments but also to other portfolio payments.[47]

Enacting such legislation could prompt key financial countries to hostility rather than cooperation. However, if the United States coordinates its legislation with the European Union and other countries, the chances for a backlash are slim. In the worst case, the withdrawal of foreign portfolio capital in anticipation of backup withholding would cause US interest rates to rise by the full 10 percent backup tax—say, from 5.0 to 5.5 percent on US Treasury bonds. Because this extreme possibility cannot be ruled out, it seems wise to start with a low backup withholding rate—the 10 percent figure mentioned—rather than a rate closer to what a normal taxpaying recipient might pay, such as 20 percent or higher.[48]

---

46. Normally, foreign affiliates of US subsidiaries including financial-sector firms, would be characterized as qualifying foreigners. Likewise, the foreign subsidiaries of US MNEs should normally qualify for exemption from mirror backup withholding taxes imposed by foreign jurisdictions.

47. In fact, the European Council has already started parallel discussions with the United States and other key countries (Switzerland, Andorra, Monaco, Lichtenstein, San Marino, and the dependent and associated territories of the United Kingdom and the Netherlands) with the aim of encouraging these countries and territories to adopt similar measures. Those discussions were stimulated by the European Union's concerns that the Savings Directive proposal would incite paying agent operations to relocate outside the European Union. See EU Memo/01/266 (available at http://europa.eu).

48. EC Commissioner Christiane Scrivener proposed a 15 percent withholding rate for portfolio flows between Europe and the United States, whereas the US Foreign Investment in Real Property Tax Act (FIRPTA) legislation imposes a 10 percent rate.

Peterson Institute for International Economics | www.petersoninstitute.org

Skilled financial diplomacy and the self-interest of tax collectors should prompt most industrial countries to enter into information exchange systems with the United States. The United States has already signed agreements for information exchange with 30 countries, most of them countries with which the United States has not entered into a comprehensive income tax treaty.[49] In addition, most US income tax treaties contain articles providing for the exchange of information.

In the end, only countries that choose to serve as havens for tax evasion and avoidance, or that administer their tax laws irregularly, would remain outside the net. For an indefinite period, interest payments to entities in these countries could simply remain subject to the new 10 percent backup tax. Presumably these countries would constitute a relatively small part of the world capital market, and yields there would simply drop to 90 percent of the yields available in the industrial world. Tax evasion would still flourish, but evaders would indirectly pay some tax, whereas now they pay none.[50] Meanwhile, to the extent that other countries emulate the US initiative, considerably more foreign interest and dividends should be reported to the IRS, and US Treasury collections might increase as much as $3.4 billion annually.

49. See Federal Tax Coordinator 2d (RIA) T-1006, 2005, and the US Department of the Treasury web press room, available at www.treas.gov (accessed on July 8, 2007).

50. To discourage the creation of holding companies in these jurisdictions, special look-through rules would require the deemed distribution of all portfolio income to beneficial recipients who are US residents. Stiff penalties would apply to concealed income.

Peterson Institute for International Economics | www.petersoninstitute.org