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CARROT OR STICK?: THE BALANCE OF VALUES IN QUALIFIED INTERMEDIARY REFORM

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Abstract: The qualified intermediary program allows foreign financial institutions to assume certain tax responsibilities ordinarily borne by U.S. withholding agents. The purpose of the program is to collect more foreign taxpayer information by creating a more direct link between the I.R.S. and recipients of foreign income payments. By accepting more responsibility, qualified intermediaries are provided numerous benefits that make business less costly. Nevertheless, the program has recently come under attack due to perceived abuse by wealthy U.S. citizens who use the system to evade income taxes. In response, the Obama Administration proposes numerous changes to the program, intended to strengthen it. But these changes fail to appreciate the balance of values at stake in reforming the qualified intermediary system. This Note argues that until more benign changes are made, the unique jurisdictional dilemma created by the U.S. international income tax system should not be solved by shifting from a “carrot” to a “stick” approach for foreign intermediaries.

INTRODUCTION

A country faces a host of important choices when it decides to collect revenue through taxation.¹ The most obvious is the subject to be taxed: usually property, income, or consumption.² The United States relies most heavily on income taxation, the largest single source of federal revenue.³ Additionally, unlike most other countries, the United States taxes income primarily based on citizenship rather than resi-

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² See id.
income.\(^4\) Income paid to nonresident aliens from within the United States (U.S. source income) is also subject to taxation by the United States,\(^5\) and special “source rules” determine whether an item of income is U.S. source income.\(^6\) If the rules dictate that income is U.S. source, the payment will be taxed by the United States even if the recipient is neither a U.S. citizen nor a resident.\(^7\)

To enforce its income tax regime against nonresident aliens with U.S. source income, the United States requires tax to be withheld from the income payment (or “withholding tax”) along with information reporting on the foreign beneficial owner of the income.\(^8\) These requirements create a large amount of responsibility for those U.S. entities making income payments abroad, known as “withholding agents.”\(^9\) In 2000, the United States created a program to reduce the burden for withholding agents: the qualified intermediary (QI) program.\(^10\)

The QI program allows foreign financial institutions to enter into an agreement with the I.R.S. to assume some or all responsibilities of U.S. withholding agents.\(^11\) The program’s purpose is to strengthen enforcement of the U.S. withholding regime, but it has recently come under attack due to perceived abuse by wealthy U.S. taxpayers who have, somewhat ironically, used the system to hide income and thereby evade income tax.\(^12\) Recent proposals for strengthening the QI program in light of these perceived abuses have sparked intense debate among commentators in the tax community.\(^13\)

This Note addresses the Obama Administration’s recent proposals to strengthen the QI program, with an eye to the program’s original purpose. Part I explains the QI program within the context of the U.S. income tax system and presents the current problems facing the program. Part II focuses on the proposals for strengthening the program in light of its perceived failures and discusses the various responses to these problems.

\(^4\) U.N. Ctr. on Transnational Corps., International Income Taxation and Developing Countries 7, 9 (1988). In doing so, the United States asserts its tax jurisdiction on a world-wide basis. Id.
\(^5\) See id. at 3.
\(^7\) See U.N. Ctr. on Transnational Corps., supra note 4, at 3.
\(^8\) I.R.C. § 1441(a) (2009); Treas. Reg. § 1.1441–1(a) (as amended in 2003).
\(^10\) See Susan S. Morse, Qualified Intermediary or Bust?, 124 TAX NOTES 471, 471 (2009).
\(^11\) See Morse & Shay, QI Status Act I, supra note 3, at 334.
\(^12\) See Dep’t of the Treasury, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals 41 (2009).
proposals in the international tax community. Part III analyzes the competing values at stake in the debate discussed in Part II. As a result of this analysis, Part III suggests a more benign approach to QI reform that considers the economic uncertainty regarding the effects of the Administration’s proposals and questions whether the United States should be able to shift costs to foreign institutions when such costs are a direct result of the United States’ unique jurisdictional decisions.

I. Background

From the United States’ perspective, it is irrelevant that an income payment is made outside the United States as long as the payment recipient is a U.S. citizen. If income is paid to a nonresident alien rather than U.S. citizen, the United States will tax the payment in one of two ways depending on whether it is business income or investment income. If the income payment is “connected with United States business,” then it will be subject to a graduated tax rate as if the taxpayer were a U.S. citizen. If the income payment is not connected with U.S. business, it is generally taxed at a flat rate of 30%. In general, then, U.S. source income paid to foreign investors is taxed at a flat 30% rate. This rate may be reduced or eliminated pursuant to a tax treaty or an exemption under another section of the Internal Revenue Code. Further, if the beneficial owner of the income payment—the owner of the income for tax purposes—is in fact a U.S. citizen or resident rather than a nonresident alien, the 30% withholding tax does not apply.

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15 See I.R.C. § 871(a)–(b) (2009).
16 See id. § 871(b). I.R.C. § 6012 requires foreign persons engaged in U.S. business to file a U.S. tax return. Id. § 6012.
17 See id. § 871(a) (2009). For the list of exceptions, see I.R.C. § 1441(c) (2009). The primary income payments subject to the 30% tax are “fixed or determinable annual or periodical gains, profits, and income” (FDAP income), including interest payments, dividend payments, and rent payments. See id. § 871(a)(1)(A).
18 See id. § 871(a)(1)(A).
19 See, e.g., id. § 871(b) (30% tax rate does not apply to portfolio interest earned by nonresident aliens); id. § 871(j) (30% tax rate does not apply to certain gambling winnings by nonresident alien persons); id. § 1441(c) (listing twelve exceptions to the general 30% withholding rate); Treas. Reg. § 1.1441–6(a) (as amended in 2003) (withholding tax rate may be reduced in accordance with an income tax treaty between the United States and the foreign country in which the nonresident alien resides).
21 See id. § 1.1441–1(b)(1). Income payments made to U.S. citizens abroad are subject to backup withholding, and a separate reporting system (form 1099 rather than form
U.S. source income payments to foreign persons thus present a unique jurisdictional dilemma.\textsuperscript{22} Although the United States claims tax jurisdiction over all U.S. source income paid abroad, collecting this tax requires more than mere assertion of jurisdiction.\textsuperscript{23} The United States’ solution is twofold: (1) to require a 30\% withholding tax on foreign income payments;\textsuperscript{24} and (2) to require information reporting on the beneficial owner.\textsuperscript{25} Both these requirements create liability for withholding agents, the U.S. entities making income payments abroad.\textsuperscript{26} The withholding agent is responsible for gathering information on the beneficial owner of the income payment and withholding accordingly.\textsuperscript{27} The withholding agent is liable for any tax it is required to withhold.\textsuperscript{28} Failure to obtain reliable documentation is no excuse.\textsuperscript{29}

A central information gathering function of the withholding agent is to determine whether the beneficial owner is a U.S. person or a foreign person.\textsuperscript{30} For foreign persons, the withholding agent must further determine whether the income payment is exempt from withholding or whether a reduced withholding rate applies.\textsuperscript{31} In the event a withholding agent cannot obtain reliable documentation providing beneficial owner information, a set of complicated legal presumptions ob-
tain. Clearly, this information gathering function creates a somewhat large burden for U.S. withholding agents. Yet the information reporting is essential to ensure that U.S. source income payments abroad do not evade U.S. tax jurisdiction.

In most cases income payments abroad will not be made directly to the beneficial owner of the income but rather to a foreign financial institution. This foreign intermediary accepts the payment on behalf of its account holder, whether the beneficial owner or some other intermediary. The foreign intermediary must provide a withholding certificate to the withholding agent through which the intermediary identifies itself as a foreign person and intermediary with respect to the income payment rather than the beneficial owner. A foreign intermediary is doubtless in a better position to collect beneficial owner information than is the U.S. withholding agent. Hence, the I.R.S. created the QI system in 2000 to encourage foreign intermediaries to assume withholding and information reporting responsibilities for U.S. withholding agents.

A QI is a foreign intermediary that has entered into an agreement with the I.R.S. to assume certain responsibilities normally imposed on withholding agents and to submit to external audits to ensure compli-

32 See Treas. Reg. § 1.1441–1(b)(3)(v). As a general matter, these presumptions direct the withholding agent to treat an income payment to an unknown beneficial owner as if made to a U.S. person and to withhold 31% of the payment, called backup withholding. See id. § 1.1441–1(b)(3)(i), (iii); David Luntz, What Is Really Wrong with the QI Program and How It Should and Should Not Be Fixed, 25 Tax Mgmt’ Real Est. J. 43, 45 (2009).


34 See Morse & Shay, QI Status Act I, supra note 3, at 332; see also Greenaway, supra note 23, at 759–60 (reasoning that “jurisdiction without information is useless” and that “[t]he best tax enforcement tool is the information return”).

35 See generally Morse & Shay, QI Status Act I, supra note 3, at 333 (describing how intermediaries act on behalf of beneficial owners in receiving income payments).

36 Treas. Reg. § 1.1441–1(c)(15).

37 Id. § 1.1441–1(e)(3)(i). If the intermediary attaches a beneficial owner certificate to the withholding certificate, the withholding agent can treat income payments to the intermediary as being made to a foreign person. Id. § 1.1441–1(e)(1)(ii)(A)(1); see Luntz, supra note 32, at 43. If a foreign intermediary does not furnish the withholding agent with any beneficial owner information, backup withholding may apply. See Morse, supra note 10, at 472.

38 See U.S. Gov’t Accountability Office, QI Program Provides Some Assurance that Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved 12 (2007); Morse & Shay, QI Status Act II, supra note 33, at 269.

39 See Morse, supra note 10, at 471.
ance with this agreement. In exchange for its agreement to become a foreign agent of the I.R.S., the intermediary is provided special treatment. This treatment includes, most importantly, the ability to submit beneficial owner information in an aggregate rather than individual owner-by-owner basis. Information reporting in so-called “rate pools” provides intermediaries with two major benefits. First, “rate pools” are far more cost-efficient than reporting beneficial owner information on an individualized basis, eliminating some of the burden of information reporting. Second, providing information in the aggregate better preserves client confidentiality compared to information reporting on an individualized basis. These benefits are intended to provide a “market-oriented” incentive to foreign intermediaries to become QIs. From the perspective of the I.R.S., the more foreign intermediaries become QIs, the more beneficial owner information will actually be collected because the foreign intermediary is in the best position to collect such information. By transforming the role of non-U.S. financial institutions in the administration and enforcement of the U.S. withholding regime, the QI program is intended to improve U.S. enforcement of its withholding tax on income payments abroad.

A nonqualified intermediary (NQI) is simply a foreign intermediary that does not enter into a withholding agreement with the I.R.S. The NQI must still submit an intermediary withholding certificate to the withholding agent, but the responsibility for withholding and information reporting remains solely with the withholding agent. Unless the foreign intermediary has actual knowledge that a person for whom it collects income is a U.S. non-exempt recipient, the NQI is not re-

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40 See Treas. Reg. § 1.1441–1(e)(5)(i) to (iii) (as amended in 2003). The external audit is performed by the intermediary’s “approved auditor,” not by the I.R.S directly. See id. § 1.1441–1(e)(5)(iii)(B).
41 See id. § 1.1441–1(e)(5)(i)(B).
42 See id. § 1.1441–1(e)(5)(iii)(B), (v)(C)(1).
43 See Morse & Shay, QI Status Act I, supra note 3, at 334.
45 Morse & Shay, QI Status Act II, supra note 33, at 267–68; Morse & Shay, QI Status Act I, supra note 3, at 334.
46 Morse & Shay, QI Status Act I, supra note 3, at 331.
47 See generally Morse & Shay, QI Status Act III, supra note 44; Morse & Shay, QI Status Act I, supra note 3, at 334.
48 See Morse & Shay, QI Status Act II, supra note 33, at 260–61.
50 See Morse & Shay, QI Status Act I, supra note 3, at 334.
required to disclose any information regarding such persons. But because the NQI has not agreed to assume withholding and reporting responsibilities, it may not submit beneficial owner information in the aggregate. On one hand, this prohibition provides a disincentive to foreign intermediaries to remain nonqualified, both in terms of higher administration costs and reduced ability to preserve confidentiality for clients who desire to claim withholding tax reductions or exemptions. On the other hand, the NQI does not assume the same responsibilities as a QI and does not agree to external audits. As a result, the liability of an NQI is substantially lower than that of a QI. Ultimately, the decision to become a QI is a complex calculus that is highly context-specific.

Recently, the QI program has come under critical scrutiny. Although the QI system successfully enhanced assurance that tax benefits are properly provided to nonresident aliens, the majority of U.S. source income payments do not travel through the QI system. More visibly, the system has been subject to abuse. The recent United Bank of Switzerland scandal is a prominent example. The Swiss bank allegedly advised U.S. clients to establish non-U.S. companies as account holders in QIs, and thus appear as foreign beneficial owners, possibly owed reduced withholding rates. Consequently, many wealthy U.S. citizens successfully exploited the QI system to evade paying their full amount of income tax. The current administration has proposed several changes to the QI program in response to such perceived abuses of the system. These proposals are designed both to strengthen the with-
holding and reporting rules under the QI regime and to provide further incentives for NQIs to enter into QI agreements with the I.R.S.\textsuperscript{64}

II. Discussion

In response to perceived abuse by wealthy U.S. citizens using the QI program to evade U.S. taxes, the Obama Administration has made several proposals intended to “ensure that U.S. persons are properly paying tax in connection with foreign income and accounts and that proper withholding tax applies with respect to foreign persons.”\textsuperscript{65} The Administration’s approach to strengthening the QI program is two-fold.\textsuperscript{66} First, increase reporting requirements for QIs to prevent U.S. taxpayers from manipulating the system to evade taxes.\textsuperscript{67} Second, create incentives for NQIs to become QIs.\textsuperscript{68} With more foreign intermediaries acting as QIs, coupled with increased reporting responsibilities, the Administration suggests that tax evasion through offshore accounts will be significantly reduced, thereby increasing withholding revenue.\textsuperscript{69} For present purposes, two of the proposals are especially pertinent.\textsuperscript{70} First, the Administration proposes that QIs be required to identify all account holders that are U.S. persons, by filing Form 1099’s with respect to all payments to U.S. account holders.\textsuperscript{71} In addition, the U.S. Treasury would be authorized to issue regulations to implement this proposal, including the possible requirement that financial institutions may only be QIs if all commonly-controlled financial institutions are also QIs.\textsuperscript{72} Second, the Administration proposes to mandate that U.S. withholding agents withhold tax from all income payments made to NQIs, thereby requiring the underlying beneficial owners to seek a refund if the blanket withholding tax results in over-withholding.\textsuperscript{73} The Administration reasons that this proposal will discourage tax evasion by

\textsuperscript{64} Id. at 41.

\textsuperscript{65} Id. The Obama Administration’s proposals are not the first of their kind. \textit{See, e.g.}, I.R.S. Announcement 2008–98, 2008–44 I.R.B. 1087. Rather, they can be viewed as the culmination of a variety of similar proposals, such as those made by the Government Accountability Office in December 2007. \textit{See U.S. Gov’t Accountability Office, supra note 38}, at 34–35.

\textsuperscript{66} \textit{See Dep’t of the Treasury, supra note 12, at 41.}

\textsuperscript{67} Id.

\textsuperscript{68} Id.

\textsuperscript{69} Id.

\textsuperscript{70} Id. at 41–43.

\textsuperscript{71} Id. at 42.

\textsuperscript{72} \textit{Dep’t of the Treasury, supra note 12, at 42.}

\textsuperscript{73} Id. at 43. Technically, this is limited to FDAP income, such as interest or dividend payments. \textit{See id.}
incorrect information reporting conducted through NQIs and encourage the use of QIs “by requiring withholding of tax on payments made through nonqualified intermediaries.”

Although most commentators agree that addressing tax evasion in today’s economic climate is especially important, the reactions to the Administration’s proposals are varied. Indeed, more radical proposals would eliminate the program altogether. Some commentators argue that the QI program was a mistake from the start, a “purely administrative program designed for the comfort of foreign banks.” From this perspective, the program naively trusts foreign banks to act as the I.R.S.’s sole means of information gathering and withholding, and thereby facilitates tax evasion, as demonstrated by the United Bank of Switzerland. Moreover, such commentators argue, the program does not even offer any tangible benefit to the United States because it has not significantly increased revenue through withholding. Other commentators have implied that the program’s scope, and recent proposals to expand this scope, represents the latest form of U.S. imperialism. As one commentator colorfully puts it, “Obama wants banks everywhere to behave as if they were on Main Street, Ohio.” From this perspective, a program that requires foreign banks to become agents of the U.S. government—such as the QI program—is far more problematic than tax evasion. Nevertheless, notwithstanding these more radical positions,

74 Id.
77 Sheppard, Ineffectual Information Sharing, supra note 76, at 1144.
79 Sheppard, Ineffectual Information Sharing, supra note 76, at 1144. Elsewhere Sheppard argues that tax treaties and other information agreements are much more effective than the QI program because the withholding tax is used more often by the United States as a bargaining chip in treaty negotiations rather than as an actual enforcement mechanism. Sheppard, UBS’s Sweet Deal, supra note 62, at 852. Thus, the immediate purpose of the U.S. withholding regime has never been to collect revenue. See id.
80 See Maddox, supra note 76.
81 Id.
82 See id.
most commentators seem to agree that the QI program serves an important function and that it can, and should, be fixed.83

The QI system is designed to improve the U.S. withholding regime, with the goal in mind to attract foreign capital.84 Because eliminating tax evasion through foreign financial accounts is virtually impossible, any controls aimed at deterring tax evasion should not be viewed independently of their effects on foreign capital influx.85 Thus, any analysis of the proposals must consider the effects on the willingness of foreign financial institutions to become QIs.86 The immediate response of foreign intermediaries to increased reporting requirements was concern over additional costs.87 Financial institutions must ask themselves whether QI status is worth the additional costs associated with identifying and reporting all foreign source income made to their U.S. account holders.88 It is entirely possible that many will decide that QI status is not worth this price.89

Therefore, some argue, the increased reporting requirements ignore adverse efforts borne by the majority of QIs who abide by the program.90 Indeed, the requirement’s success in preventing tax evasion could be “Pyrrhic” if the resulting program fails to attract foreign financial institutions who no longer consider the “carrot” of QI status sufficiently appealing to enter the agreement with the I.R.S.91 Given that confidentiality is the single greatest attraction of the QI system, some suggest it is naive to presume that the adverse effects of the Administra-

83 See Shay testimony, supra note 75, at *7; see also Banking Secrecy Practices, Wealthy Taxpayers: Hearing Before the H. Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means, 111th Cong. (2009) (testimony of Doug Shulman, Comm’r, Internal Revenue Service), 2009 WL 828059, at *3 [hereinafter Shulman testimony] (stating that “the QI system is critical to facilitating sound tax administration in a global economy”); Banking Secrecy Practices, Wealthy Taxpayers: Hearing Before the H. Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means, 111th Cong. (2009) (testimony of Peter H. Blessing, Lawyer, Shearman & Sterling LLP), 2009 WL 828057, at *15 [hereinafter Blessing testimony] (stating that the QI program is “well-conceived and plays a key role in the U.S. withholding tax regime”). Shay argues that in a world without the QI program it would be much more likely for withholding agents to simply treat foreign banks as beneficial owners and fail to withhold appropriately, notwithstanding their liability for doing so. See Shay testimony, supra note 75, at *7.
84 See Shay testimony, supra note 75, at *12.
85 See Blessing testimony, supra note 83, at *2.
86 See id. at *15.
88 Parillo, supra note 13, at 680.
89 See id.
90 See Luntz, supra note 32, at 45.
91 See id. at 49.
tion’s proposal will be minimal.\textsuperscript{92} Furthermore, the documentation requirements are already incredibly complex, and adding to this confusion will make compliance more difficult for honest QIs.\textsuperscript{93} The information reporting requirement therefore seems to punish compliant QIs—who must now breach their confidentiality agreements—for the activities of a few noncompliant QIs such as the United Bank of Switzerland.\textsuperscript{94} From this perspective, the increased information reporting requirement looks excessive: an uncritical overreaction to a politically “hot topic.”\textsuperscript{95}

Others argue that, on the contrary, the increased reporting requirement would not likely discourage foreign financial institutions from becoming QIs.\textsuperscript{96} Proponents of increased information reporting do seem to have one ace in the hole: the QI system, as it stands, is easy to abuse, and requiring QIs to report all U.S. account holders rather than submitting information in the aggregate is one way to decrease tax evasion through the program.\textsuperscript{97} In addition, doing so places the obligation for reporting “more securely in the internal processes and computing systems of the gatekeeper closest to the client,” contributing to the

\textsuperscript{92} See id. at 44; see also U.S. Gov’t Accountability Office, supra note 38, at 11 (finding that “[o]ne of the principal incentives for foreign financial institutions to become QIs is their ability to retain the anonymity of their client list”). Confidentiality is a critical component of the QI program because disclosure may be prevented by regulations within the QIs’ jurisdiction, and QIs do not want to share client information with competing financial institutions. Luntz, supra note 32, at 44.

\textsuperscript{93} See Ruth Ann Schneider, Qualified Intermediaries: Caught in the Complexity of New U.S. Withholding Requirements, TAXES, Dec. 2000, at 18. Indeed, QIs may make honest mistakes based on their unfamiliarity with the incredibly complex U.S. tax regime. Luntz, supra note 32, at 52. The Administration and its supporters seem to presume that any QI that fails to comply with its obligations does so intentionally, and further that any complying QI would have no problem with increased information reporting. See id. at 48, 52. But both these assumptions seem false. See id.

\textsuperscript{94} See id. at 48; see also Nelson, supra note 87, at 265 (noting the “potential risk that clients who have always complied with documentation requirements would bear the cost burden of a few U.S. tax evaders, many of whom may not even be clients of the same financial institution”).

\textsuperscript{95} See Luntz, supra note 32, at 45, 50. Luntz admits that some may view tax evasion as possessing social significance that would justify the costs to the QI program. Id. at 50. In this view, tax evasion “warps the social fabric” and inefficient solutions such as increased information reporting are therefore worthwhile. Id. Ultimately, Luntz concedes, it is a question of social values. Id.

\textsuperscript{96} See Shay testimony, supra note 75, at *9. But Shay is aware that “an important question is how much burden and risk of liability can be imposed on QIs without causing material participants to leave the QI system.” Id. at *8.

efficiency and clarity of the information reporting process. As a result, many commentators have recommended increased reporting. The reaction to the Administration’s proposal to require blanket withholding on nonqualified intermediaries has received less attention from those in support of the proposals, perhaps because it seems less controversial. The Administration’s rationale appears simple enough: NQIs do not enter into a special agreement with the U.S. government; thus, there is no reason to refrain from full withholding to prevent tax evasion. Moreover, default withholding rules already apply to NQIs who fail to forward detailed beneficial owner documentation to withholding agents. The Administration’s proposal would simply apply these default rules universally, which amounts to no longer trusting NQIs to collect beneficial owner information because they do not agree to any form of U.S. oversight—such as an external audit.

But some commentators have responded negatively to increasing the burden of being an NQI. Although this kind of intermediary does not agree to be an agent of the I.R.S., it is not thereby relieved of all withholding responsibilities. And without the ability to aggregate accounts, the NQI system is already more “cumbersome and expensive” than the QI system. Adding to these higher costs is no trivial matter. And what is even more concerning, not all NQIs choose to forego QI status: many simply cannot become QIs because the I.R.S. does not approve of their home country’s “know-your-customer” rules for identifying beneficial owners. Some commentators have expressed special concern over extending authority to the Treasury to grant QI status conditional upon whether all commonly-controlled financial institutions are also QIs. To these commentators, such a measure would

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98 See Morse, supra note 10, at 472.
99 See, e.g., id.
100 Compare the discussion of increased 1099 reporting requirements for QIs with the lack of any discussion for strengthening withholding obligations of NQIs in Shay testimony, supra note 75, at *9–11, 23–26.
101 See Dep’t of the Treasury, supra note 12, at 43.
102 Morse, supra note 10, at 472.
103 See id.
104 See Parillo, supra note 13, at 680.
106 Morse & Shay, QI Status Act I, supra note 3, at 339.
107 See id.
108 Michaels et al., supra note 105, at 2140. These rules are central to the QI program. See Morse & Shay, QI Status Act II, supra note 33, at 262.
109 Parillo, supra note 13, at 680.
force NQIs into QI status when they have no legitimate business reason to do so. Rather than encouraging foreign intermediaries to become QIs through a “carrot” approach, the proposal simply discourages foreign intermediaries from remaining NQIs through the “stick” of making business more difficult.

Thus, a wide range of positions has been adopted by commentators in response to the Administration’s proposals for the QI program. Irrespective of the merit of these proposals, their very promulgation and subsequent debate highlights the important role the program was designed to play in the U.S. withholding tax regime.

III. Analysis

Ultimately, the Administration’s proposals fail to adequately consider the important balance of values in QI reform. Until more benign and higher order changes, such as increased U.S. oversight of external audits, are made, the United States should neither increase reporting requirements on QIs nor require blanket withholding on NQIs. Clearly, tax evasion is a serious problem, both economically and legally. But the simplest solution to tax evasion—eliminating the QI program and requiring complete withholding and information reporting on all foreign income payments by withholding agents—ignores the balance of values at stake and would represent throwing the baby out with the bathwater. As commentators have indicated, the privacy of

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110 Id. (“Essentially, you’re taking affiliates that did not become QIs because they had no reason to be a QI—either because they’re not handling U.S. source payments, they’re only doing local banking or foreign-source stuff, and may have only a trickle of U.S. expats that they’re dealing with—and making them become a QI.”).
111 Id. at 487–88.
112 See generally Morse & Shay, QI Status Act III, supra note 44.
113 Cf. Luntz, supra note 32, at 45 (implying that earlier similar proposals failed to consider the important balance of values at stake).
114 See generally id. at 51 (explaining the attractiveness of requiring increased oversight by the I.R.S.).
115 See Shay testimony, supra note 75, at *3 (“Taking steps to address the so-called tax gap, the difference between taxes due and taxes actually collected, is an important element of putting our fiscal house in order.”); Shulman testimony, supra note 83, at *1 (“It is of paramount importance to our system of voluntary compliance with the tax law that citizens of this country have confidence that the system is fair. We cannot allow an environment to develop where wealthy individuals can go offshore and avoid paying taxes with impunity.”).
116 Cf. Luntz, supra note 32, at 47 (arguing that “given the uncertainty as to the actual losses to the Treasury . . . any proposed changes to the Program should not be disproportionate in their effects to the problem it is attempting to remedy”); Morse & Shay, QI Status
nonresident aliens is an important consideration. Even more important, at least from the United States’ perspective, is attracting foreign capital investment. Every step made to reduce tax evasion potentially discourages foreign investment and potentially decreases financial privacy for foreign investors. Additionally, the QI program is not, and was never intended to be, the primary system for enforcing tax compliance outside the United States. In assessing QI reform, then, it is necessary to keep these various considerations in mind and to appreciate the overarching U.S. economic interest when focusing on the relatively minor problems caused by offshore tax evasion.

A. The Balance of Values and the Administration’s Proposals

The uncertainty regarding the effects of the Administration’s proposals, in conjunction with the United States’ unique jurisdictional decisions, demonstrate that the proposals do not adequately reflect the balance of values in QI reform. The noneconomic concern with privacy may not seem as noteworthy as the economic concern with attracting foreign capital. Indeed, the effects of increased reporting requirements on client confidentiality, along with any negative implications of eliminating confidentiality, are highly uncertain. Yet if we assume, at a minimum, that financial privacy is a value, it is unwise to disregard this uncertainty. Although the value of financial privacy may not trump the value of tax compliance, neither should it be ignored.

Act II, supra note 33, at 272 (noting the balance between enforcement objectives and burdens to foreign intermediaries).


118 See Shay testimony, supra note 75, at *12.

119 Cf. id. at *8 (noting that “an important question is how much burden and risk of liability can be placed on QIs without causing material participants to leave the QI system”).

120 Id. at *21.

121 See Luntz, supra note 32, at 47.

122 Cf. id. at 45.

123 Cf. Sheppard, Ineffectual Information Sharing, supra note 76, at 1144 (questioning the claim to financial privacy and stating facetiously “[h]ow beneficial ownership in the hands of the U.S. government or a U.S. bank is supposed to fall into the hands of Columbian guerillas is never explained”).

124 Cf. Blum, supra note 117, at 630–32 (considering the potential impact of increased information reporting requirements on the financial privacy of nonresident aliens).

125 See id. at 648. Ultimately, Blum argues that “the nonresident alien’s claim to secrecy is convincing only if the home government is likely to misuse (or allow misuse of) the information, and not if the home country can insure that the information is used solely to enforce the tax obligation of the depositor to his home country.” See id. at 632. For an al-
Regardless of the final judgment regarding the value of financial privacy, the prospect of discouraging foreign capital investment in the United States should not be taken lightly. A chief purpose of the QI program is, after all, to increase tax compliance while simultaneously making investment in the United States more attractive to nonresident aliens. Especially given the United States’ current economic situation, attracting foreign investment is a top priority. If the proposals are likely to discourage foreign investment, this is a major defect. Moreover, any new international tax policy adopted by the United States is bound to have unintended economic consequences. Due to the complex interrelatedness of the global market and all its interactions, it would be irresponsible to pretend that even the short-term effects of the current proposals can be successfully predicted. This does not, by any means, necessitate inaction; however, it does serve as a reminder that when the United States runs an “experiment” with tax policy, small steps are more prudent than large transformations.

Furthermore, were it not for the United States’ unique jurisdictional choices, QIs would not be put in the uncomfortable position of

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126 See Blum, supra note 117, at 624–25 (“The more significant concern of a nonresident depositor is that the IRS will convey [its] information to the tax authority of [its] residence country. . . . The [resident’s] government might use this financial information about its resident to carry out illegitimate acts such as expropriation or persecution.”).
127 See Blessing testimony, supra note 83, at *2 (suggesting that attempts to decrease tax evasion cannot place “undue burden[s] on the benefits that come with free flows of capital across borders”).
128 See Morse & Shay, QI Status Act I, supra note 3, at 331 (noting that the QI program was designed to create a “market-oriented” incentive to comply with the U.S. tax system).
129 See Shay testimony, supra note 75, at *12 (reasoning that the United States’ ability to tax investment income abroad is constrained by “its interest in attracting foreign capital to the United States”).
130 See Blessing testimony, supra note 83, at *2; Shay testimony, supra note 75, at *12.
131 See Blessing testimony, supra note 83, at *2.
133 Cf. Morse & Shay, QI Status Act I, supra note 3, at 341 (describing the QI program as an “experiment in international tax enforcement” and noting the difficulty of predicting the effects of making changes to the program).
potentially facilitating tax evasion by U.S. citizens.\textsuperscript{134} In taxing its citizens and residents on a world-wide basis, the United States creates a unique situation: in addition to collecting tax on U.S. source income paid to foreign persons, the United States collects tax on the income of U.S. citizens and residents abroad.\textsuperscript{135} There are thus two separate regimes for tax withholding at play and two separate information reporting systems.\textsuperscript{136} Both systems are involved in the QI program because the original obligations of withholding agents implicate both types of income payment.\textsuperscript{137}

If the United States had no interest in determining U.S. citizenship status for foreign account holders (for purposes of 1099 reporting), withholding agents—and by implication QIs—would not be required to identify whether the beneficial owners of income payments were U.S. persons.\textsuperscript{138} From the perspective of cost-shifting, placing the burden of 1099 reporting on foreign intermediaries seems disproportionate.\textsuperscript{139} Although tax evasion is a serious problem, as long as the United States retains its jurisdictional choice to tax citizens on a world-wide basis, the burden of discovering U.S. account holders should not be placed disproportionately on the shoulders of QIs.\textsuperscript{140} This argument does not imply that the program should not be strengthened to enforce the U.S. withholding regime, but it does reinforce the value of taking small steps in QI reform.\textsuperscript{141}

B. Requiring Increased U.S. Oversight Is a Better First Step

In light of the inherent uncertainty regarding the economic and noneconomic effects of the host of proposed changes, as well as the United States’ unique jurisdictional decisions, the most reasonable first

\textsuperscript{134} See Neuenhaus, supra note 21, at 918 (“[A]n intermediary’s obligation to report and withhold regarding U.S. payees can be imposed on both U.S.- and non-U.S-source income.”).

\textsuperscript{135} See U.N. Ctr. on Transnational Corps., supra note 4, at 9; Neuenhaus, supra note 21, at 914.

\textsuperscript{136} Neuenhaus, supra note 21, at 914. The first involves reporting for nonresident aliens to whom U.S. source income is paid, called 1042-S reporting. Id. The second involves reporting for presumed U.S. citizens to whom any income is paid, called 1099 reporting. Id.

\textsuperscript{137} See Shay testimony, supra note 75, at *15–17.

\textsuperscript{138} See Treas. Reg. § 1.1441–1(b)(5).

\textsuperscript{139} See Luntz, supra note 32, at 47.

\textsuperscript{140} See id.

\textsuperscript{141} See id.
step in QI reform seems to be the one with the least impact.\textsuperscript{142} The two major proposals discussed above are connected by a sense of tightening restrictions and punishing noncompliance rather than rewarding compliance: a drastic shift from “carrot” to “stick.”\textsuperscript{143} As one commentator points out, a more benign change to the program would involve the United States more directly in the QI external audit requirement, by requiring external auditors to “associate” with U.S. auditors.\textsuperscript{144} Although this proposal may not possess the same promise of curbing U.S. tax evasion as a more “integrated” approach, it does represent a less intrusive requirement for foreign intermediaries and may help significantly reduce honest errors made in the reporting process.\textsuperscript{145} Moreover, this requirement imposes a change at a higher level in the program than individual financial institutions: the involvement of the U.S. government in administering the program.\textsuperscript{146} Because this requirement does not require much more of an obligation from QIs, individual institutions are less likely to perceive it as a burden than the current proposals.\textsuperscript{147} Therefore, the association requirement better respects the competing values of protecting financial privacy and attracting foreign investment.\textsuperscript{148}

This proposal is championed by many commentators, but it is usually suggested as part of an “integrated approach” involving many more changes—such as increased information reporting—to be made at once.\textsuperscript{149} But such an “integrated approach” is precisely the wrong approach given the uncertainty surrounding the effects of QI reform.\textsuperscript{150} Taking a small step at the level of U.S. oversight of the QI system rather than increasing regulations for foreign financial institutions represents an initial compromise that better balances the values of attracting foreign investment, respecting financial privacy, and curbing tax evasion.\textsuperscript{151}

\textsuperscript{142} Cf. id. at 45 (arguing that any attempt at QI reform should “maximize[] the benefits and minimize[] the costs of each affected party”).

\textsuperscript{143} See Parillo, supra note 13, at 680.

\textsuperscript{144} See Luntz, supra note 32, at 51.

\textsuperscript{145} See id. at 51–52.

\textsuperscript{146} See id.

\textsuperscript{147} See id. at 49, 51.

\textsuperscript{148} See id. at 45.

\textsuperscript{149} See Shulman testimony, supra note 83, at *2, 4.

\textsuperscript{150} See Blessing testimony, supra note 83, at *2 (noting that “[t]ax measures adopted in response to legitimate concerns can have unanticipated and unhappy consequences from the standpoint of economic efficiency”).

\textsuperscript{151} See Luntz, supra note 32, at 47; Maddox, supra note 76.
Conclusion

The qualified intermediary program was created as a compromise among competing values. In exchange for facilitating U.S. withholding tax enforcement, foreign financial institutions would be provided privileges for reporting taxable U.S. income. In light of perceived abuse of this program by wealthy U.S. taxpayers, the Obama Administration proposes reform that will strengthen reporting requirements and further “encourage” nonqualified intermediaries to enter the QI regime. Yet these proposals come at a cost, in terms of increasing the burden of being a QI, and thus represent a drastic shift from “carrot to stick” in the QI program. Although there is disagreement about whether foreign financial institutions will in fact be discouraged from entering the program, the uncertainty surrounding the proposed changes provides ample reason for alarm, especially considering the importance of attracting foreign capital at present economic times. Moreover, the United States’ decision to tax U.S. citizens and residents on a world-wide basis—the only developed country to do so—is directly responsible for the enhanced responsibilities of U.S. withholding agents and, by implication, QIs. Given these considerations, a more responsible first step in QI reform would be increasing U.S. involvement in the external audit procedure already in place, rather than increasing reporting requirements for QIs and increasing the burden of remaining an NQI. As long as the United States desires to keep the QI program and its unique system of international tax jurisdiction, it is necessary to involve compromises the Administration’s proposals fail to make.