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March 24, 2005

The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue, NW, Suite 2100
Washington, DC. 20220

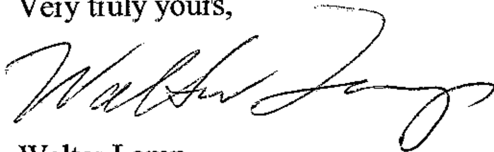
Re: Submission of Comments

Dear Panel:

An overhaul of our system of international taxation would (1) hurt terrorists and others tax evaders, (2) raise substantial revenues without it being viewed as a tax increase, and (3) address the inequity of taxing ourselves more heavily than we tax foreigners.

It is all explained in the attached copy of my article *Financial Competitiveness* published in the February 6, 1995 issue of Tax Notes.

Very truly yours,



Walter Lamp
Attachments.

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM
2005 APR 21 A 10: 56

3/24/2005

EXECUTIVE SUMMARY

Why doesn't the United States tax the interest, dividends and capital gains that foreigners earn in the US the same way the US taxes its own citizens? Right now, the US effectively exempts foreigners from US tax on financial income earned here. In so doing, the US loses revenues, and helps terrorists and others in evading taxes and bolsters funds available to them.

When a foreigner earns financial income in the US, the US exempts it from the US income tax that Americans earning the same income would pay. The existing US withholding tax rules applying to part of that income has so many exceptions and loopholes that foreigners effectively avoid all US tax. Huge amounts are invested here and the US collects almost no tax on the financial income flowing abroad.

All the arguments against extending the US tax are flawed:
1) It is said that the foreigners (terrorists, drug czars and ordinary people avoiding tax) would invest their money elsewhere, in some tax haven. Financial income is earned only when money is put to use, and there are no investment needs in a tax shelter country -- the funds must flow out of the tax haven to be used.
2) Alternatively it is said the funds would be diverted from the US to other developed countries capable of putting money to use. Money flows globally to where it is used and needed. If money is artificially diverted away from one country where it is used and need, it would indirectly flow back to that country. Walter Wristen, former Chairman of CitiBank, addressed this when the Saudi's had threatened to pull all their money out of the US and invest it elsewhere. -- he said, we would merely borrow it back and the Saudi move would have no effect. Net, net, the funds would go where they go now.
2) Double taxation of legitimate residents of countries like the UK (France, Japan, Germany, Italy etc) that tax their residents can easily be avoided, while the terrorists and other tax avoiders who use trusts, banks, partnerships and corporations in those countries so as to avoid both the US and UK etc tax will no longer be able to do so. This becomes very technical and I would be pleased to provide a paper on it.
3) Residents of countries that do not tax them, including residents of the tax havens and countries like some of those in the Middle East and Latin America, will accumulate more wealth than those who pay tax. Over time, this uneven playing field will shift significant wealth and power to them and away from Americans. For example, Saudi money invested in the US (or the UK etc) escapes all tax. There can be no objection to Saudis not being taxed by Saudi Arabia on income earned there or anywhere, but there is no reason for the US not to tax them on income earned in the US. The existing system also induces Latin American residents to export funds from their countries to tax havens, only to force the US to prop up those countries.

The net result is that the US will (1) collect billions more tax revenues, (2) reduce the income and wealth of terrorists, and tax avoiders of all counties, (3) eliminate the shift of wealth and power away from US citizens, and (4) help stem capital flight from Latin America. **Why do we so burden our own citizens and help the very people we should not help?**

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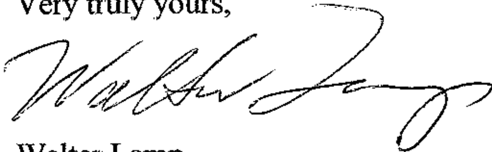

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viewpoint

Financial Competitiveness

by Walter Lamp

Walter Lamp is an attorney and CPA in the state of New York. During his 30-year career, he has been an international tax partner in what is now known as a Big 6 firm and a corporate tax executive.

As an American, I personally resent the fact that foreigners investing in the United States escape taxes that Americans pay. A foreigner making a profit investing in Walt Disney stock would pay no U.S. tax, while I would. If I earned interest on a U.S. government bond, I would pay U.S. tax on the interest I earned, but a foreigner would not.

This paper focuses solely on the exemption of foreigners from U.S. tax on capital gains and on interest earned from sources in the United States. Americans pay these taxes, but foreigners do not.

This paper recommends that foreigners be taxed, and answers the arguments advanced to support the continuation of their present exemption from taxation. Whether our new Congress provides a special tax rate on capital gains or indexes capital gains, the proposal advanced herein remains the same — tax the foreigner just as Americans are taxed, on all interest as well as capital gains.

Most important, this paper explores the pernicious effect the foreigners' tax exemption has had on our country in terms of our financial competitiveness, growth, and well-being as a nation. The paper also discusses how we can get off the existing treadmill without negatively impacting the international financial markets.

Fairness and Equity for Americans

I can't help but wonder what there is in the scheme of things that causes us to tax ourselves more heavily than we tax foreigners. Normally, rational people attempt to export their taxes through schemes that would tax foreigners while their own citizens escape the tax. We don't even level the playing field by taxing American and foreigners alike. We go to the opposite extreme by taxing ourselves while we exempt foreigners.

We pay lip service to things like "neutrality." We say we believe in "capital neutrality" or "investment neutrality," and debate the differences endlessly, but yet we are anything but neutral when it comes to foreigners; we just exempt them. We want to make certain that Americans get no special benefit investing domestically or internationally, but think nothing of taxing Americans at home more heavily than we tax foreigners.

One does not need much explanation to exhibit the inequality, the basic unfairness to Americans. It's simply that Americans are taxed while foreigners are not. The arguments against taxing the foreigners are based on impracticality, financial effects, technical mumbo jumbo, and the like — the basic unfairness and inequality for Americans is explicitly or implicitly accepted.

> ***I can't help but wonder what there is in the scheme of things that causes us to tax ourselves more heavily than we tax foreigners.***

Proposals to tax foreigners on all U.S.-source income have surfaced from time to time as members of Congress discovered the situation that exists. These members objected to the basic unfairness, but they were always beaten back by tax technicians advancing reasons why it shouldn't and couldn't be changed. I do not recall ever seeing a tax professional come forth to say that the law should and could be changed without the country falling apart, and Congress always has backed off. The esoteric technical arguments has Congress cowed.

Perhaps the tax professionals lacked the financial background to realize that the financial markets would not collapse, or lacked the motivation to create mechanisms to tax the foreigners. Perhaps the time wasn't right, or that the professionals and their clients had too much of a vested interest in the status quo. Personally, I lean to believing the latter.

It's More Than a Matter of Mere Taxes

The failure of the United States to tax foreigners would not be so serious a matter if only tax revenues

were involved. Tax professionals are accustomed to think of taxes in terms of the stuff that helps balance budgets. But taxes represent wealth and economic power, which can be vastly more important than mere budget balancing tax revenues. The foreigner who doesn't pay the tax an American pays gets wealthier faster, and the economic balance in the world changes.

> ***The failure of the United States to tax foreigners would not be so serious a matter if only tax revenues were involved.***

This shift in relative economic power, created by the current tax policies of the United States, is of primary concern to me. With the passage of time, the untaxed foreigner becomes wealthier, much wealthier than his or her American counterpart. We all know the value of compounding at a higher interest rate, how fast money grows with compounding. Without tax, the compounding of earnings grows faster yet. Even though America is very, very rich, eventually the compounding will get to us.

In addition to creating a major shift of wealth and economic power to foreigners, we also create an incentive for Americans to join them — either by hiding assets offshore or by expatriation. We present American tax cheats with an incentive they can't resist. They can continue to invest in America and not pay tax just as the foreigners escape the tax. In time, that, too, compounds meaningfully and more economic power is shifted abroad. While in this case, the wealth and economic power remains American, the effect merely would be one of lost U.S. tax revenues unless or until the tax cheats expatriate themselves. Then we lose much more as a nation.

Financial Competitiveness Is the Primary Victim

As long as the means of production stay in the United States, many persons might not become too concerned about the shift in wealth abroad. That is, as long as Walt Disney stays here, they believe we shouldn't be too concerned that foreigners are accumulating relatively more wealth than Americans. In my view, this is shortsighted and wrong.

In some industries, the means of production have stayed here (maybe) even though the cost of capital is an important factor. For example, the movie studios remain here, but perhaps talent, not capital, was the important factor. While the United States still has many steel mills, factories, and the like, one could hardly maintain that we've held our ground.

With funds being accumulated abroad faster than in the United States, it is understandable that jobs and production facilities tend to shift abroad. While this can happen and is happening in a number of industries, it is difficult to directly and exclusively attribute it to the foreign accumulation of wealth — other factors could be involved. But we do know that the faster foreign accumulation of funds plays some part in shifting production and creating competition abroad in every industry. Every industry has a financial component, and they all are involved to a degree.

While financial competitiveness affects all industries, the effects are most apparent when one focuses on the financial industry. In the financial industry, the accumulated funds themselves are the core (the raw material) of the business. Foreign accumulations of funds have resulted in the creation of new financial centers (job outflows), which seem to be springing up everywhere, and have resulted in foreign financial enterprises growing much faster than their American counterparts.

We see this pragmatically. American financial enterprises, which ranked amongst the largest in the world a few decades ago, don't even make the listings anymore. Banks and other financial institutions in relatively small countries have become larger than their American counterparts. After years of tax-free accumulation of funds by these institutions or the investors they serve, they have become world-class competitors.

It's not that those countries provide good, indigenous investment opportunities, for we know that the money just flows into those countries and flows right out again. It's not that those countries have greater financial know-how and expertise or are smarter, for we know that most financial innovation has taken place here. Yet, competitively, these institutions have prospered much more than ours, primarily due, in my view, to our exemption of foreigners from tax.

Some of these foreign competitors are located in countries that are essentially rocks in the middle of the ocean. Others are tucked away in mountains. They can be anywhere, but they all have a common attribute. These "rocks" provide nothing of indigenous value. They are merely funnels, parasitic ones primarily aimed at taking advantage of external conditions.

Some "rocks" have been around a long time in economically viable but small countries, yet it is clear that their extraordinary financial growth has little to do with their economies. Some "rocks" provide secrecy in addition to funneling services, perhaps to support their funneling services or perhaps for other reasons that one may seriously question. For ease of reference and simplicity, I refer to all of these countries as "rocks."

These "rocks" and their financial enterprises are only the tip of the iceberg — the part we can see. The economic wealth and power accumulated abroad without tax by investors using the "rocks" must, by this time, be absolutely huge. The shift of economic power abroad by investors funding nonfinancial industries is not as apparent as in the financial industries, but it must exist across the board. In many industries, foreign competitors may appear to look like normal enterprises, and they are, except that the flow of wealth and power abroad helped fund them and grow them faster than their American counterparts.

This is why the lack of an even playing field in our own country by not taxing foreigners has hurt the financial competitiveness of all American enterprises, financial and nonfinancial. It has hurt us in competing

in our own country and in competing internationally. Perversely, the uneven playing field created by the American tax law hurts Americans.

Arguments Against Creating an Even Playing Field

The arguments I have heard against the proposal to tax foreigners is not that the foregoing discussion is wrong, but that there are other reasons why the proposal should not or could not be implemented. The implication is that these other reasons are stronger; that they are potent enough to cause us to drop our concerns about basic fairness and financial competitiveness.

Before addressing these contrary arguments, let me state clearly that I can accept no theory, no rationale as being more important than fairness and competitiveness. While I find those contrary arguments to be without any substance, I would suspect that some people would not dismiss them and may have some concerns. However, I cannot conceive that those concerns could be meaningful enough so as to tilt the scales so much for these people that they would forego the entire proposal. Even if there were a price to be paid to achieve fairness and competitiveness (I believe there is not), I would gladly pay it to clean up the inequity and eventually improve the future for all of us.

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Nevertheless, let me delineate those contrary arguments and explain why I find them to be either specious or invalid.

Foreigners Do Pay Tax — Sometimes

The argument about foreigners paying tax is grounded on the proposition that their countries of residence may well tax them. Just like Americans are taxed on capital gains whether sourced in the United States or abroad, foreign countries may tax their residents on the same basis. The proposition is that there is no inequality since the foreigners are taxed by their own countries.

While it is true that *some* foreign countries tax capital gains, many or most countries do not. And none of the "rocks" do. If I were to guess, I would say that most countries do not tax capital gains, but that most of the big developed countries, which have the biggest markets, and presumably produce the most gains, do tax their own citizens on capital gains but exempt foreigners

But all this is irrelevant. The United States could tax all foreigners on U.S.-source capital gains. Foreigners from countries that do tax capital gains would avoid double taxation if their countries exempted the U.S. capital gains from local tax or gave a credit against the local tax for the tax paid to the United States.

There is no reason for us to be concerned with whether foreigners incur a foreign tax. Some do, and some do not. Some of the foreign tax rates are high, and some low. But the fact remains that, in large part, there is an inequality with Americans. All Americans have to pay tax at the U.S. rate. Equality can be achieved only by taxing foreigners at the same rate without taking into consideration whether or not they are taxed abroad or at what rate.

There is no reason for us to be concerned with whether foreigners incur a foreign tax.

Nor should we be concerned about foreigners being subject to double taxation if the United States should start to tax capital gains. Avoidance of double taxation really is in the hands of the foreign country. Not many foreign countries are concerned about double taxation of Americans, but perhaps we should adopt a higher standard. The solution is in the hands of the foreign government, and there is no moral, logical, or legal reason why the United States should yield its primary right to tax.

Under generally accepted international tax standards, it is the country where money is earned that has the primary right to tax it. The home country of the person earning that money also may tax it, exempt it, or provide a credit. We see this with the taxation of salaries and other forms of income, and it applies equally with respect to capital gains.

The U.S. withholding rate generally is lower than most of the foreign rates, which would leave the foreign countries free to apply residual taxation (collect the difference in rates). In addition, U.S. implementation of a withholding system well may help some foreign countries improve their tax collection system by bootstrapping the U.S. system.

Whatever our level of concern about foreign investors who are subject to home country taxation, the argument fails when the foreign investor is not subject to home country taxation. Those investors certainly should be taxed, for the playing field is most uneven with respect to them.

Thus, the argument to exempt foreigners from U.S. tax because some of them are subject to home country tax is specious. Most foreigners are not in fact subject to home country tax. When they are, their home countries can avoid the double tax — it's not our job to protect them against double tax.

Where double tax does exist, we could avoid it by creating some special exemption system. This could be accomplished by tax treaty, and it may be appropriate as between the major developed countries. Nevertheless, I would advise against any exceptions. For effectiveness, the situation calls for across-the-board treatment without exceptions, and I will address this later.

As a subset of this argument, it is argued that we shouldn't tax the foreigner because that would induce the foreign countries to retaliate and tax Americans on the capital gains Americans have abroad. (Of course, in this situation, the United States provides Americans with a credit so as to avoid double taxation — some-

thing we pusillanimously say we cannot expect the foreign countries to do.)

This retaliation cannot just be against Americans. The foreign countries would have to impose a general tax to retaliate. To that I say "fine!" It would leave the investor hiding behind the "rock" paying tax for the first time. A host of countries would have a new source of revenue — and a fair and equitable one to boot.

The contrary argument then shifts to express concern that the world would be adding an unnecessary level of complexity if the United States starts to tax foreigners and other countries follow. The argument goes on to assert that the "cross-flows" would balance and, thus, there is no benefit from having started the process in the first place.

Attempts to justify foreigners' continued exemption from taxation based on the "cross-flows" being equal should not be allowed to benefit the "rocks" and those hiding behind the "rocks." There would be no "cross-flows" with the "rocks." There is little, if any, local investment in the "rocks." They just receive the flows from other countries where the investments take place.

Pragmatically, we know that the "cross-flows" do not balance. We know that the "rocks" and the investors hiding behind them are the prime beneficiaries of the existing system, and the loss of tax revenues is huge. Trapping those taxes is reason enough for the world to start taxing all capital gains. There is no "cross-flow" balance — nowhere near it.

In addition to the "rocks," there are many other countries that do not tax capital gains. As long as those foreign countries do not tax capital gains, the inequality continues to exist in the United States — Americans and American enterprises continue to be at a competitive disadvantage as investors from these foreign countries accumulate wealth from sources in the United States faster, tax-free. The inequality in the United States would be eliminated only when the foreign country started to tax that investor or the United States did.

We should want to induce the "cross-flows." We should want to induce foreign taxation of capital gains. Only in that fashion can we assure an even playing field for Americans who are already taxed. We can't force the foreign countries to tax capital gains, but we can certainly even the playing field by taxing their citizens when they earn U.S.-source capital gains. Foreign taxation of capital gains is not adverse — it is what we should want. The prospect of "cross-flow" balancing is favorable, not unfavorable.

While the foregoing focused on capital gains, the same applies to interest. I find that there is no theoretical difference between the two. The practical differences with respect to implementation of source taxation are covered later. But again, I believe there should be across-the-board taxation without any exemptions or exceptions. No exemptions based on the nature of the interest paid, nor the status of the payer, nor the status of the recipient. For an extreme example, I see no reason to exempt foreign governments or foreign central banks from taxation. We should apply our normal taxes to them, and they should apply their normal taxes to us, whichever way the "cross-flows" currently flow.

Again, I advocate across-the-board withholding taxes, no exceptions except possibly as discussed below, so as to ease the burden on the withholding agents and allow the systems to operate easily and more equitably. Perhaps some investors will incur an additional burden of having to reclaim the tax withheld, but the additional tax revenues collected by governments around the world would outweigh that, and so would the resulting fairness and competitiveness for Americans.

Capital Outflows Would Not Destroy Markets

I am sure that the thought that immediately comes to mind when one considers a proposal to tax foreigners is that the foreigners will dump their U.S. investments, creating a huge capital outflow from the United States.

Many years ago, after the so-called oil crisis, there was much concern that the huge amount of funds held in the United States by the oil-producing countries might be pulled out. The concern at that time was that we would be at the mercy of these countries, since they would have the power to cause a collapse at any time by pulling their dollars out.

A famous banker then said he wasn't concerned. If they pulled their dollars out of the United States, he would just borrow the dollars back.

Simple, but true. Since the U.S. dollar is so freely transferable and can be exchanged for other currencies or spent so easily, we tend to view the dollars as disappearing or being transmuted into something else when they are exchanged. But that is not so.

When a dollar is exchanged for another currency, the dollar still remains in existence. It's just that someone else now owns it. The U.S. dollars that are held abroad should be viewed as a commodity; they remain in existence as dollars no matter how many times they are transferred, bought, or sold.

Telescoping all of this, at the end of the day, a foreigner holding dollars must either buy a U.S. dollar-denominated physical asset like a U.S.-produced machine or invest it in a U.S. dollar-denominated financial asset like a U.S. Treasury bond.

A foreigner not liking the imposition of a U.S. tax on the interest paid on U.S. Treasuries could sell those bonds, but the foreigner then would have U.S. dollars. Certainly, the foreigner could sell the dollars to another foreigner, but the purchaser or some purchaser down the line would have to be willing to buy a U.S. dollar-denominated asset. Assuming the demand for U.S.-produced machines already is being satisfied, it means that the sale of one U.S. financial asset would lead only to the purchase of another one.

To be sure, foreign exchange rates could be affected by large dispositions of U.S. financial assets, and the dollar could go down in relative value. But if the dollars are invested back into the United States, as I say they must be, foreigners' after-tax yield would be reduced — that is, foreigners as a group would have to

bear the tax since there is no alternative use for those dollars.

Obviously, nobody is going to take dollars and leave them unproductive under the mattress. They have to be invested somehow, even if the earnings on them are to be (forgive the word) taxed.

The foreigner cannot go to his or her favorite "rock" and make a deposit of dollars, earning interest thereon, unless the financial intermediary on the "rock" can invest those dollars to earn the interest it has to pay the foreigner. Someone along the chain will be willing to invest in dollars and the exchange rates will adjust to bring the market and yields to an equilibrium. Wherever that equilibrium might be, it is clear that the change in the tax laws will not cause a capital outflow.

However inconsequential or consequential the effect on exchange rates might be, it is likely to be gradual. It may take years to negotiate and implement this proposal. Some foreign investors may anticipate the changes and sell out early, and others won't. It seems to me that economics, not taxes, underpins successful investing, and most investors will just accept the inevitable once they become convinced it will happen. The tax-free ride will be over, but the funds still have to be invested.

U.S.-Source Tax Can Be Implemented Effectively

The major argument heard for not taxing capital gains at the border is that the tax would be too easy to avoid. The argument is that a cross-border capital gains tax cannot be implemented because U.S. assets merely would be bought and sold abroad.

Of course, a foreigner holding Walt Disney stock could sell it abroad to another foreigner and so avoid the U.S. capital gains tax. But the purchaser would be taking on a potential liability for the U.S. tax that had been avoided, and would pay less for those shares. The party wanting to invest in Walt Disney shares could go into the U.S. market to buy them without taking on a potential tax liability.

A dual market for U.S. stocks cannot be established effectively abroad. The amount of the potential U.S. tax liability inherent in any block of stock about to be sold could not be known, and that would destroy general trading. While special deals could be negotiated, the lack of trust (could the buyer ever trust the sellers' statements?) and the lack of a liquid market would make it most unsatisfactory for a potential seller. What is to be saved in U.S. tax may well be lost by accepting a lower price in the offshore market. Thus, while it is certainly possible for foreigners to sell the stock abroad, the discount received should eliminate most of the glamour.

In this computer age, it would be relatively easy to track certificate numbers so as to be able to pick up a foreign-held certificate coming back into the United States and collect the tax going back to the value when it left. Or U.S. safekeeping could be required for U.S. stocks — the custodian being required to compute gain and withhold tax. I am certain there are still other ways to do it. The huge amount of revenues at stake justifies any mechanism.

A foolproof collection scheme is not a requirement of this proposal to tax. It isn't necessary to collect the last tax dollar, since collections would be huge even with some avoidance. Arguments as to potential avoidance should not be allowed to derail the proposal. The stakes are high, very high indeed, and much will be made of this point.

This reminds me of the time the United States proposed to do away with tax-exempt municipal bonds in *bearer* form. Those dealing in this market, even though they weren't the tax cheats avoiding tax through the bearer bonds, swore that the markets would fall apart if the change were made. Needless to say, the markets didn't fall apart.

In addition to cross-border portfolio capital gains, cross-border capital gains on direct investments also should be taxed. In this case, opposition by American business interest might be expected, as foreign countries can be expected to reciprocate and tax capital gains of Americans on the direct investments in their countries. Some countries already tax capital gains on direct investments.

The prospect of some additional foreign tax on direct investments, even though it would be creditable in the United States, could be expected to lead to opposition by American business as a new tax is always a no-win situation for them — they can only lose, never win, when they incur a new tax, even though it is recoupable.

However, American business should not oppose this proposal, since they will be the primary beneficiaries of a level playing field. They are the ones who are being hurt by the absence of financial competitiveness. The few companies that may not be in a position to recoup a foreign tax should not be allowed to tilt the scales. Everyone benefits from the boost in U.S. tax revenues from this proposal, and the avoidance of revenue shortfalls that otherwise would have to be funded.

Tax Coordination Between Developed Nations

The proposal to tax *all* cross-border capital gains and interest flows would be more effective if other developed countries would do the same. While capital flows ultimately will balance out and not be a problem, dislocation of foreign exchange rates would be reduced or eliminated if all the major developed nations adopted similar rules of taxation.

> ***The proposal to tax all cross-border capital gains and interest flows would be more effective if other developed countries would do the same.***

Such coordination would avoid the possibility of any competition between the countries and would improve the tax systems and the tax collections of each.

Coordination by the developed nations could be accomplished through the use of a multinational treaty obliging each country to implement a cross-border withholding tax scheme with certain characteristics and with special antiabuse treaty-shopping rules.

Upon internal law implementation, the system could be put into effect. There is precedent for multinational tax treaties, and I see no reason why one cannot be used as an umbrella to achieve coordination of internal laws.

The big users of capital are the developed countries, particularly the G-7 countries. If a withholding tax fence were placed around these countries, money could flow between them as it will, and the withholding tax would apply when money flowed across the perimeter of the fence. Money would flow across the fence, and the withholding tax would be paid, since money flows to where it is used.

The countries outside the fence could be grouped into three categories: the less-developed countries, the "rocks," and the developed countries that do not join the G-7 nations within the fence.

The less-developed countries would be outside the fence. These countries tend to have a problem with "flight capital," and foreigners' current exemption from tax presents an invitation or incentive for capital to flee these countries. It's simply that yields are higher on a tax-free basis, and those investors can use a "rock" to achieve the tax exemption. Thus, the less-developed countries would want to be outside the fence so as to help combat flight capital, and the developed countries should help them do it.

This is not meant to suggest that I favor constraints on money flow. I don't favor any constraints on the flow of funds, and I do not view taxation as a constraint on money flows. Money can flow freely even though it is taxed. Flight capital still could flee, but it would be subject to normal tax when foreigners' tax exemption is eliminated. The yield and incentive for flight capital would be reduced, and free economics would be allowed to determine whether capital is to stay in these countries or flee.

The "rocks" also would be outside the fence. The financial institutions on the "rocks" would have very limited opportunities to invest deposited funds without incurring a withholding tax. Most funds flow to the developed countries that have the need for funds and the ability to pay for them, with the degree of safety usually sought. The yields these institutions would pay on deposits, or on their flow-through fiduciary investments, would reflect the withholding taxes they are forced to face.

If the funds can't be used without incurring a withholding tax, the funds might not flow to the "rock" in the first place. They could be invested directly. Whether the foreign investor invests directly or invests through a "rock," the investor would pay the tax — which is the purpose of the entire proposal.

Of course, the foreign investors could avoid the tax by not crossing the fence. They could direct their investments to less-developed countries (outside the fence) that exempt foreigners from tax. To the extent that such investments flow to Africa, Eastern Europe, and other areas in need of funds, the world would applaud. Having these areas compete for funds with the large developed nations that give a tax exemption to such funds makes no sense. Eliminating the tax exemption eliminates the artificial incentive to invest in the developed countries. It allows true economics to operate to allocate funds.

Other countries (neither "rocks" nor less-developed) could and should join the G-7 nations within the fence. The antiabuse rules and the ability of those countries to implement them are most important. Each nation will have to have rules to keep investors outside the fence from sneaking under the fence and to avoid the withholding tax net. The ownership of corporate enterprises would require vigilance. While the multinational tax treaty would be the initial umbrella agreement for the G-7 group, separate tax treaties could be used to supplement it and let others join.

The countries that do not join would, of course, be free to continue to exempt foreigners from tax. They might attract more investment funds, but there is a limit to the amount of funds they could absorb. They could not accept funds for funneling to the group of nations within the fence, and their own investors could encounter the withholding net created by the fence. Of course, there are disadvantages as well as advantages in not joining the group of nations within the fence.

Although I include myself as a true believer in the free movement of money across borders, I also believe that taxation is not inconsistent with free movement. Money can move freely and yet the earnings on it be subject to taxation. We see this today, with money moving freely between residents of the developed countries while these residents all are subject to some fairly heavy taxes. The withholding of taxes at the border is no more than a tax collection mechanism and should have no bearing on the movement of money (except by the tax cheats).

With modern systems, it well may be easier and more efficient to withhold taxes across the board, without incorporating any exceptions in the process. The creation of an exception requires the creation of special systems to process the exception, to handle the collection of exemption forms, and to police customers. Withholding agents should want to avoid this, along with the invariable assumption of risk and liability for errors or omissions. Errors and omissions tend to disappear with across-the-board treatment. Governments also would want to avoid exceptions, which require a host of antiabuse rules and increase audit costs

> ***A simple across-the-board withholding system might lend itself to computer-to-computer implementation of both the withholding of tax and the credit or refund of those taxes.***

A simple across-the-board withholding system might even lend itself to computer-to-computer implementation of both the withholding of tax and the credit or refund of those taxes. For example, the withholding agent could withhold and immediately remit to the government, computer-to-computer, by supplying the payee's foreign identification number. The government immediately could remit to the foreign government, again computer-to-computer, for immediate

credit by the foreign government to the payee in refund situations.

Third-country nationals would find it very difficult to game such a system, and large amounts would be saved in terms of efficiency/audit/antiabuse — enough to pay for the systems and perhaps also pay some interest on the refunded withholding taxes.

Foreigners' Tax Exemption as a Tax Expenditure

The foreigners' exemption from U.S. tax on U.S.-source capital gains and interest income of certain types is, in my view, a clear tax expenditure. Other than blaming stale, ingrained thinking, I do not understand why it has escaped inclusion in the tax expenditure listings published by the U.S. Treasury and others.

With the three largest tax expenditures each losing tax revenues in the magnitude of $50 billion annually (mortgage interest, health care, pensions), I would expect the foreigners' tax exemption to be up there in amount, but with much less social justification.

In fact, I see no social justification at all for the foreigners' exemption and have listed a host of reasons why it should be repealed, certainly before the socially justifiable tax expenditures are rolled back or tinkered with.

Whose Ox Will Be Gored? Who Will Benefit?

It seems to me that the other large developed countries will go along with, or actually favor, this proposal. For instance, it wasn't too long ago that Germany made some changes to its withholding tax rules, only to repeal them as money began to flow abroad to a "rock" to escape the tax.

This proposal should help the treasuries of all the countries involved. To varying extents, all these developed countries incur large expenditures for social and other needs and could use supplemental revenues. The "cross-flow" of funds between these countries, assuming they all tax cross-border capital gains and interest, would be more or less balanced. That is, none of these countries should benefit at the expense of the others. Tax treaties can be used to assure this, or to create exemptions if they are desired.

The revenues woiuld come from American tax cheats hiding abroad, and from investors from countries that have low or incentive tax rates. It would come from investors in the countries that cannot and choose not to tax the capital gains or interest income of their residents. It would come from residents of countries that start to implement capital gains or interest taxation.

That is, most interest and capital gains that currently escape tax around the world would become subject to tax and supplement the revenues of all countries. Those revenues would be contributed by untaxed foreigners and by local residents not previously taxed. To the extent that a country starts to tax its own residents on interest or capital gains, it would have a new revenue source that, if not desired, could be returned through rate reduction.

The proposal would impact the "rocks" negatively in terms of the amount of business conducted by their enterprises and the fees those governments collect.

The ancillary benefits flowing from the proposal also are important. It would create a more level environment for financial competition around the world. The larger developed countries would benefit from the new financial competitiveness of their enterprises. It also would eliminate the need faced by some of those enterprises to join competitors on the "rocks" to compete.

The less-developed countries would benefit from the elimination of the existing tax incentives for flight capital. More local capital would stay home to fuel local development. Less-developed countries with tremendous financial needs might find more capital available to them as the tax incentive to invest in the developed countries disappears.

At the end of the day, there will be a battle as those who benefit from the existing system attempt to preserve it, and they are powerful. The amount of money involved is large, so they can be expected to stop at nothing. The theories will fly all over the place, dangers will be said to lurk behind every step, and everything will be said to fall apart.

On the positive side, we have financial competitiveness, fairness, equality, and a strike against flight capital — not all of which is of interest to many of us. But we can all be interested in the revenue effects, especially if it makes up shortfalls we will be called to fund.

Let the tax economists estimate the amounts involved, but I would say that it would supply tens of billions in tax revenues, if not hundreds of billions. Something worth striving for, and taking the heat.

Lobbying the IRS and Treasury: The Reg Comments You Never See

by Paul Streckfus

Paul Streckfus is the editor of *The Exempt Organization Tax Review* and a contributing editor of *Tax Notes*.

The tax practice game here in Washington has always been a high stakes, behind-the-scenes game. Edwin Cohen makes this point time and again in his delightful book, *A Lawyer's Life: Deep in the Heart of Taxes* (published by Tax Analysts). Recent action surrounding the controversial corporate sponsorship regulations suggests that this game is becoming ever more sophisticated and even downright surreptitious.

Close the Door Behind You . . .

What may surprise some is the extent to which the IRS is now subject to taxpayer lobbying. The main reason why taxpayers lobby the IRS so much (aside from the money involved) is the secrecy that blankets such communications. In private meetings, taxpayers

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